



First Capital
A Janashakthi Group Company

“POLICY LIGHTHOUSE: SIGNALS HOLD RATES IN ECONOMIC GROWTH WAVES”

PRE-POLICY ANALYSIS

17TH JUL 2024

First Capital Research

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Previous Pre-policy report: Recap –



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The CBSL maintains policy interest rates

In line with our expectations, CBSL decided to maintain the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) at their current levels of 8.50% and 9.50%, respectively at the monetary policy review announced on 28th May-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 its potential level. The Board acknowledged that although headline inflation slightly increased, it is expected to remain below the target in the coming months due to recent price adjustments and eased food prices. The external sector has also shown improvement with increased foreign currency inflows, tourism-related inflows, and elevated workers' remittances, leading to a stronger overall economic outlook. However, the Board emphasized the need for further reduction in market lending interest rates in line with policy rates to support domestic economic recovery. Although government securities yields and average deposit interest rates have declined, lending interest rates on selected loan products remain elevated.

Key Arguments considered by CBSL for its policy stance announced on 28th May-24

- ✓ Inflation is expected to converge to the targeted level over the medium term.
- ✓ A further decline in market lending interest rates is warranted.
- ✓ The external sector continued to strengthen further.
- ✓ Recovery in domestic economic activity is expected to continue.



Expected Monetary Policy Stance

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As per our view, at the upcoming policy meeting, there is a **70% probability for CBSL to maintain rates at the current levels**, allowing further strengthening of key economic indicators. However, there is a **30% probability for CBSL to relax the policy rates, with a probability of 25% 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 accelerate economic growth. Further, there is an **80% probability to keep SRR unchanged**; while considering the improved liquidity levels in the system, we consider a **20% probability for a SRR hike of 100bps**.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	70%
Cutting Policy Rates by 50bps	25%
Cutting Policy Rates by 100bps	5%
Cutting Policy Rates by 200bps	0%

30%

We believe that there is a 70% 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	20%
SRR to remain unchanged	80%
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Considering the reduction of SRR by 200bps to 2.0% on 09th Aug-23, we expect SRR to remain unchanged at the same level. However, there is a 20% probability for CBSL to raise SRR by 100bps.

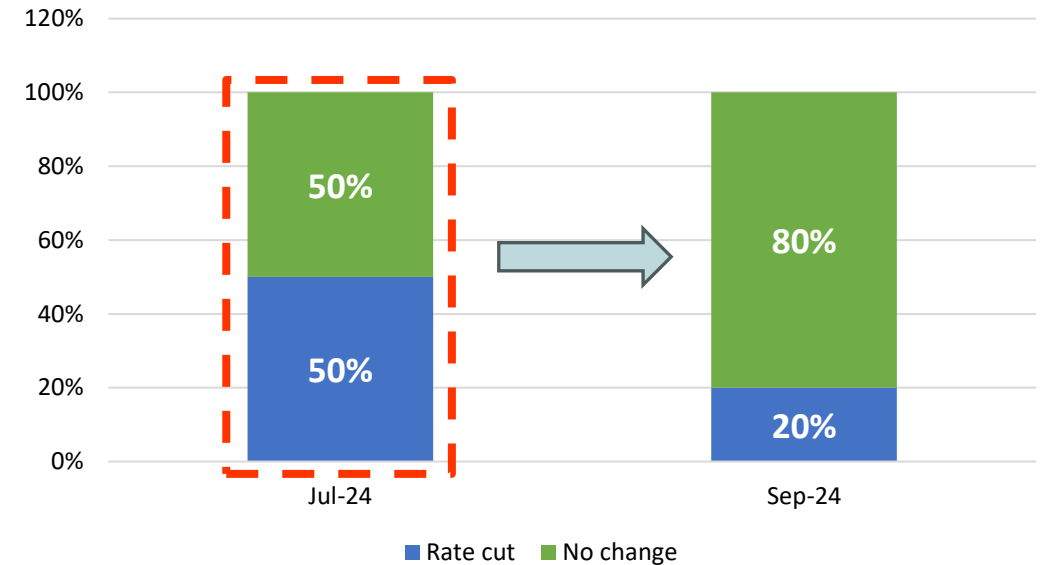
Single Monetary Policy Stance

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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 for CBSL to maintain the SLFR rate at its current level of 9.50%.**

Sri Lanka considers move to single policy rate
CBSL plans overhaul of monetary operations and improved liquidity forecasting

If a rate cut is given in Jul-24, probabilities for a rate cut in Sep-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 a 50% probability for an SLF rate cut to adopt a single monetary policy stance.

Analysis of upcoming policy decision on 23rd Jul

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Arguments against a Monetary Relaxation

70%



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

- Private credit surges by LKR 60.7Bn in May-24, indicating economic resurgence
- Overnight liquidity remains positive for over 3 consecutive months since Mar-24
- PMI expansion across Manufacturing, Services, and Construction signals economic growth
- Reserves surge to a 3 ½ year peak in Jun-24
- GDP climbs 5.3%YoY in 1Q2024, highest in 3 years
- EDR completion anticipated to drive yields down

- Inflation remains well below the baseline target of 5.0%
- US Fed poised to cut rates following Europe's lead

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

Arguments for a Monetary Relaxation

30%





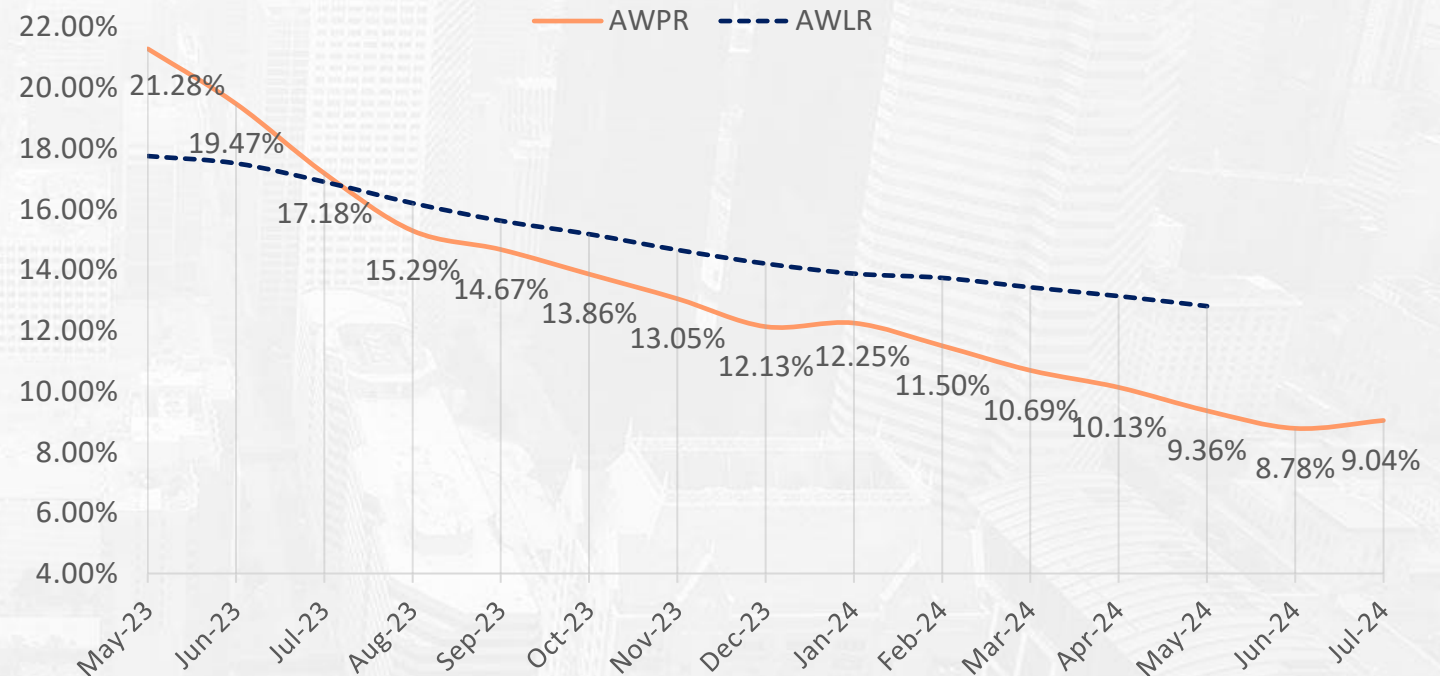
Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy



Private credit surges by LKR 60.7Bn in May-24, indicating economic resurgence

AWPLR declined to 9.04% in Jul-24, while the AWLR declined to 12.81% in May-24, down from 13.14% in Apr-24. Despite the notable spread between these two rates, private sector credit increased by LKR 60.7Bn MoM, reaching LKR 7.4Tn in May-24, rebounding from the contraction seen in Apr-24 due to the extended holidays. The growth in May-24 occurred amid low inflation, declining import prices, and a stable exchange rate, encouraging importers to utilize supplier credit. This trend broadly aligns with the monthly average required over the next 7 months to meet FCR's projected growth of 7.5% for 2024E. The increase in private sector credit coincides with declining interest rates, heightened business confidence, which has strengthened for the 4th consecutive month, and consumer confidence which reached an all-time high in Jun-24. However, caution is advised regarding the risks associated with excessive borrowing and spending, which could potentially destabilize the economy. Therefore, maintaining current policies is crucial to sustain economic stability.



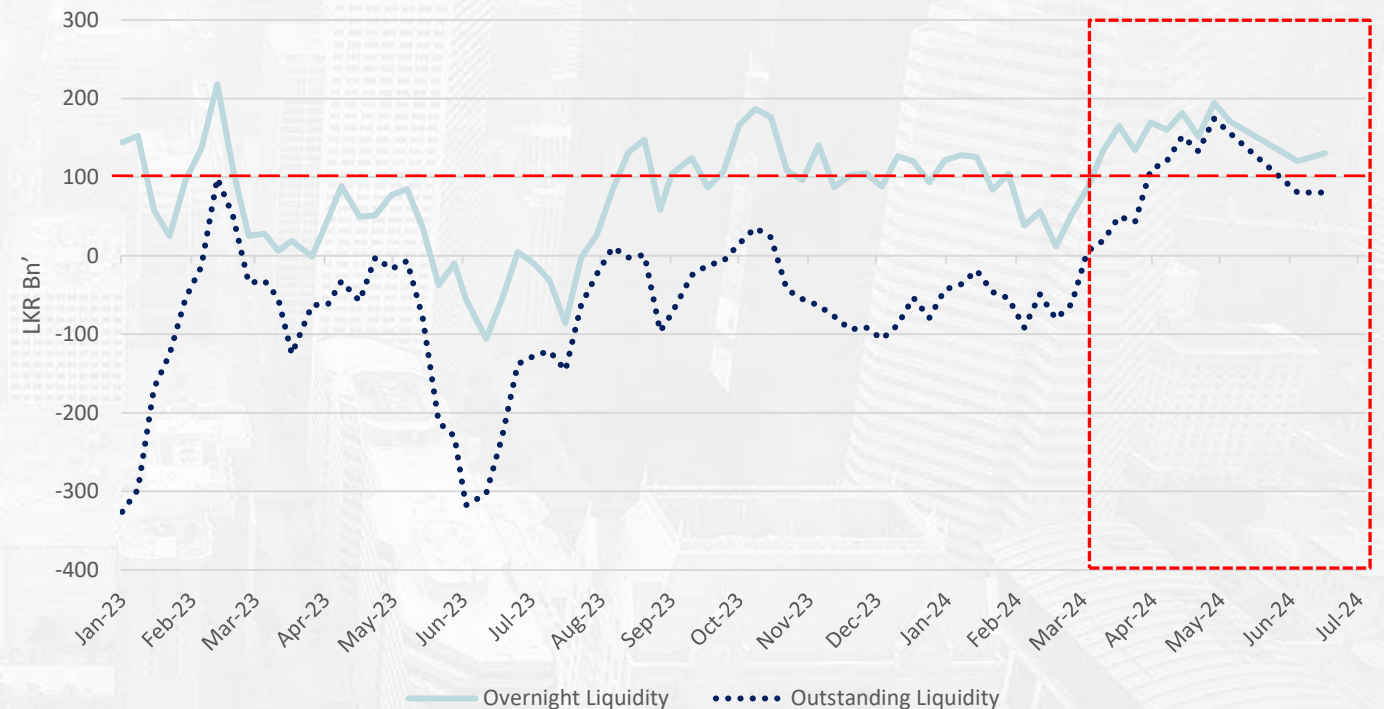
Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy



Overnight liquidity remains positive for over 3 consecutive months since Mar-24

In 2024, the overall liquidity in the domestic money market has showed notable improvement, largely attributable to CBSL relaxing borrowing limits for Licensed Commercial Banks (LCBs) in Feb-24. This policy adjustment aimed to stimulate interbank lending and borrowing activities, thereby bolstering liquidity across the financial system. Despite facing inflationary pressures, the CBSL refrained from implementing rate cuts until May-24. Since Mar-24, overnight liquidity has consistently remained positive, often surpassing the LKR 100.0Bn mark, bolstered by dollar purchases. This sustained level of liquidity is a positive sign, as higher liquidity can gradually reduce market interest rates without necessitating direct intervention from the CBSL through rate cuts.



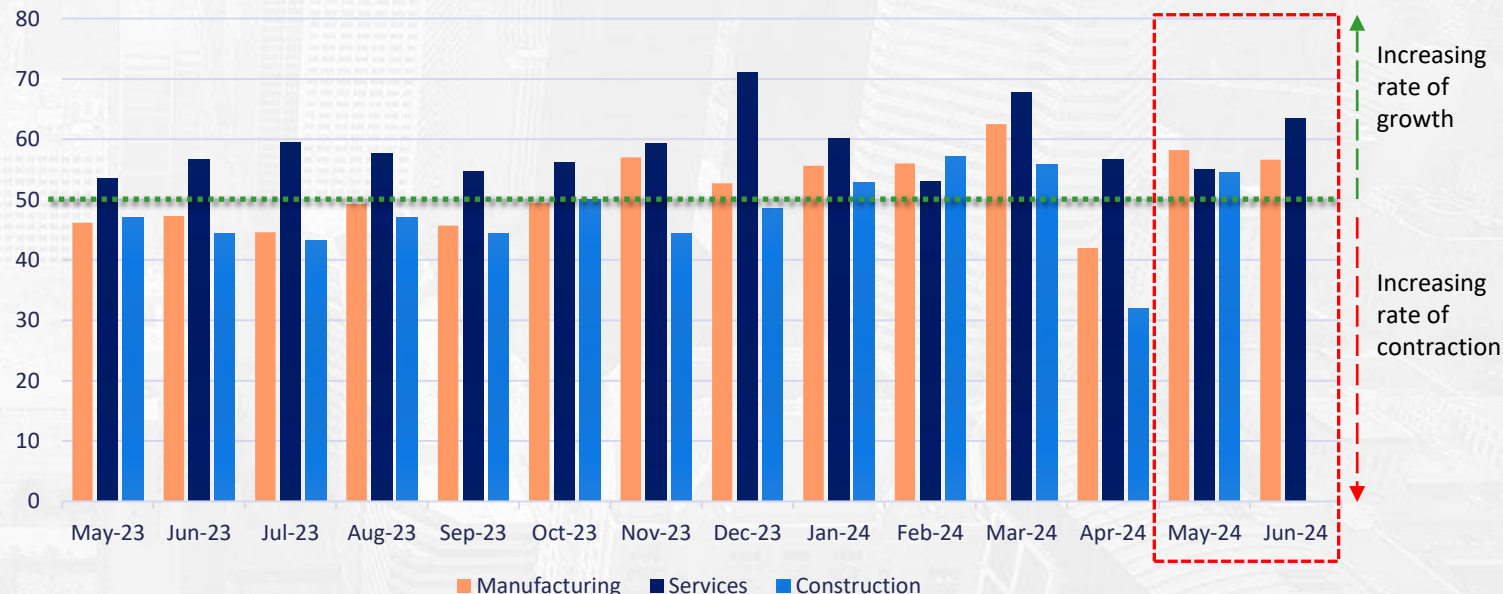
Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy



PMI expansion across Manufacturing, Services, and Construction signals economic growth

The PMI for May-24 signaled expansion across Manufacturing, Services, and Construction sectors, a trend that continued into Jun-24 for Manufacturing and Services. Manufacturing improved to an index of 56.6 in Jun-24, driven by growth in the food and beverage sector. The Services sector rose to 63.5, buoyed by increased wholesale and retail trade during the Haj festive season, alongside growth in transportation, financial services, and personal services. Moreover, the accommodation, food and beverage services maintained previous levels in Jun-24, reflecting sluggish tourist arrivals during the off-season. However, FCR anticipates a gradual increase in tourist arrivals starting in Jul-24, with expectations to surpass 2.0Mn visitors by the end of the year and exceed pre-pandemic levels by 2025E. In May-24, construction activities expanded to an index of 54.5, as several projects resumed after the extended holidays in April. Therefore, a rate cut may be inappropriate and counterproductive, as the sector outlook signal expansion for the next 3 months, supported by favorable macroeconomic conditions.



Note: A reading above 50 indicates an expansion; below 50 represents a contraction; while 50 indicates no change.

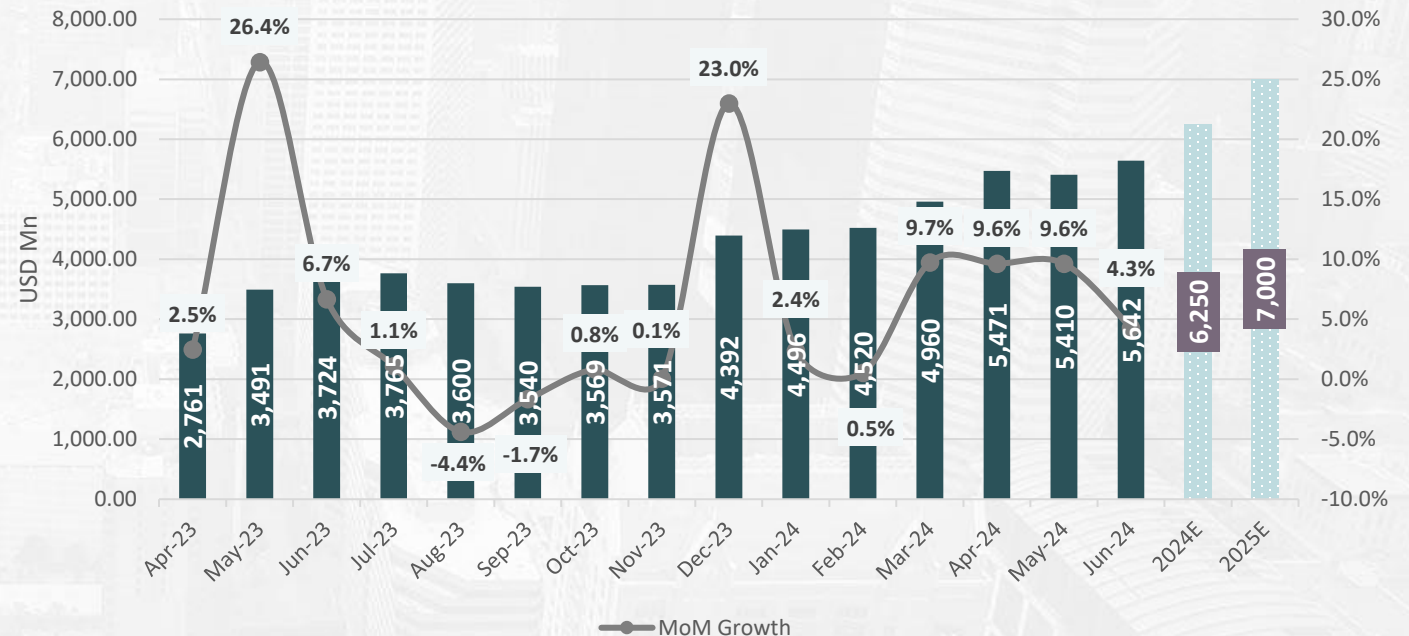
Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy



Reserves surge to a 3 ½ year peak in Jun-24

CBSL's official reserves surged to a 3 ½ year high of USD 5,642.0Mn (+4.3% MoM) in Jun-24, after IMF's release of the 3rd tranche amounting to USD 336.0Mn. The reserves growth was supported by significant net purchases by CBSL from the domestic FX market amidst increased foreign currency inflows and proceeds from the China swap arrangement. The BOP for Jan–May-24 recorded a surplus of USD 1.4Bn, with a net inflow of USD 76.1Mn in May-24, driven by increased tourism earnings and worker remittances. This robust increase in reserves and BOP expansion reflects enhanced economic stability. However, with debt repayments approaching in Sep-24 and further trade relaxations, reducing rates may pose a risk of currency depreciation, potentially constraining CBSL's ability to accumulate further reserves through dollar purchases. Therefore, the CBSL is likely not in a favorable position to implement a rate cut due to the risks associated with upcoming repayments and a potential currency depreciation, as the focus should remain on maintaining economic stability.



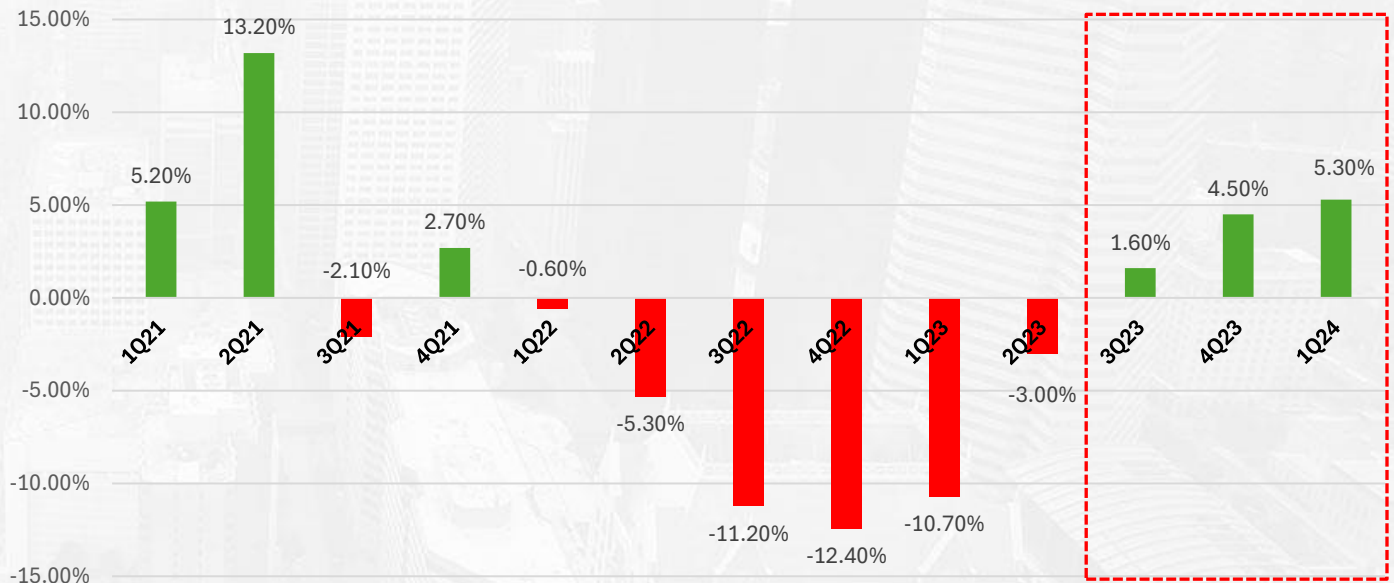
Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy



GDP climbs 5.3%YoY in 1Q2024, highest in 3 years

After nearly 3 years, the GDP surged to 5.3%YoY in 1Q2024, despite a tax hike and a low base effect. The CBSL, prioritizing monetary stability in line with IMF recommendations, avoided monetary expansion strategies such as printing money to lower rates or boosting growth through increasing potential output under its new monetary law. Instead, CBSL pursued deflationary policies and facilitated LKR appreciation (+6.4%YoY as of 17-Jul-24). The 1Q2024 GDP growth was driven by agriculture (+1.1%), services (+2.6%), and industry (+11.8%), notably with construction up 14.2% and mining up by 18.3%. FCR forecasts GDP growth of 2.0%-3.0% in 2024E, increasing to 3.0%-4.0% in 2025E. Recent increases in private sector salaries, reflected in the real wage index rising to 81.8 in Feb-24 (compared to 61.1 in the public sector), indicates a recovery in domestic consumption. With the economy already on an upward trajectory, additional monetary stimulus may not be necessary and could undermine CBSL's goal of sustaining monetary stability by potentially stoking inflation.



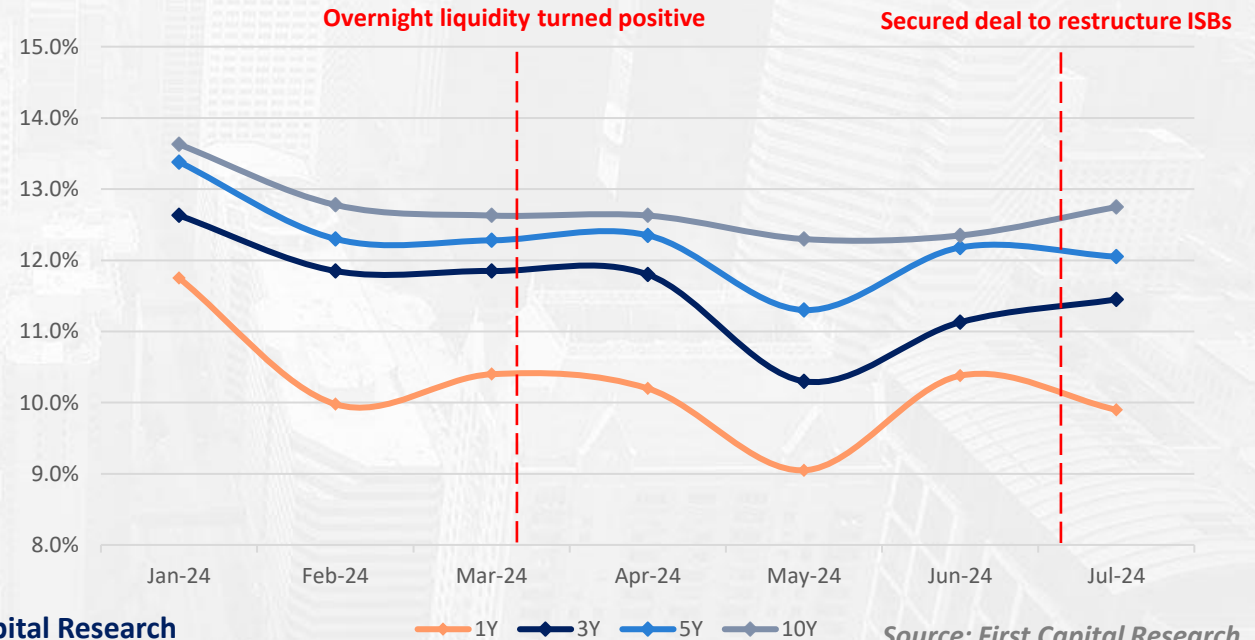
Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy



External debt restructuring (EDR) completion anticipated to drive yields down

With the full implementation of the EDR, risk premiums on government securities are expected to reduce. FCR projects a decline in long-term bond yields by 50-100bps and a re-rating of short-term bonds by 30-50bps in 2024E. CBSL is anticipated to refrain from rate cuts, as the completion of EDR should gradually narrow spreads. An anticipated rating upgrade of up to two notches from the current Restricted Default (RD) status for Sri Lanka, could further stimulate foreign market activity without further rate cuts. Excessive monetary easing might deter foreign investors, who may prefer higher-yielding AAA securities, yielding at around 5.0%. This is reflected in the market's lack of reaction to the 50bps rate cut in Mar-24, suggesting that additional easing might be short-lived and unwarranted. This trend is evident from the LKR 41.6Bn (USD 138.6Mn) foreign outflow from government bonds in the first 20 weeks of 2024, following the reduction in key policy interest rates by 700bps since Jun-23. Foreign holdings in T-Bills and T-Bonds fell sharply from LKR 117.4Bn as of Dec-23 to LKR 53.1Bn by the week ending 11th Jul-24. Therefore, a rate cut is not necessary until the EDR process is completed, as premature cuts could undermine the positive impacts of EDR and reduce the attractiveness of local assets relative to other investment opportunities.



Source: First Capital Research

A background image showing a pair of hands holding several coins, with a dark, semi-transparent overlay. The text is overlaid on this image.

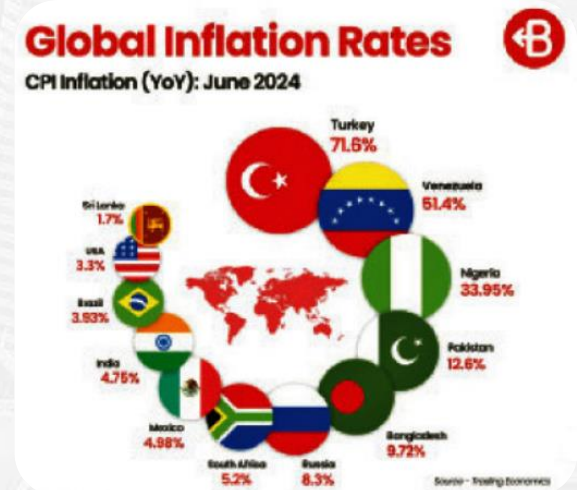
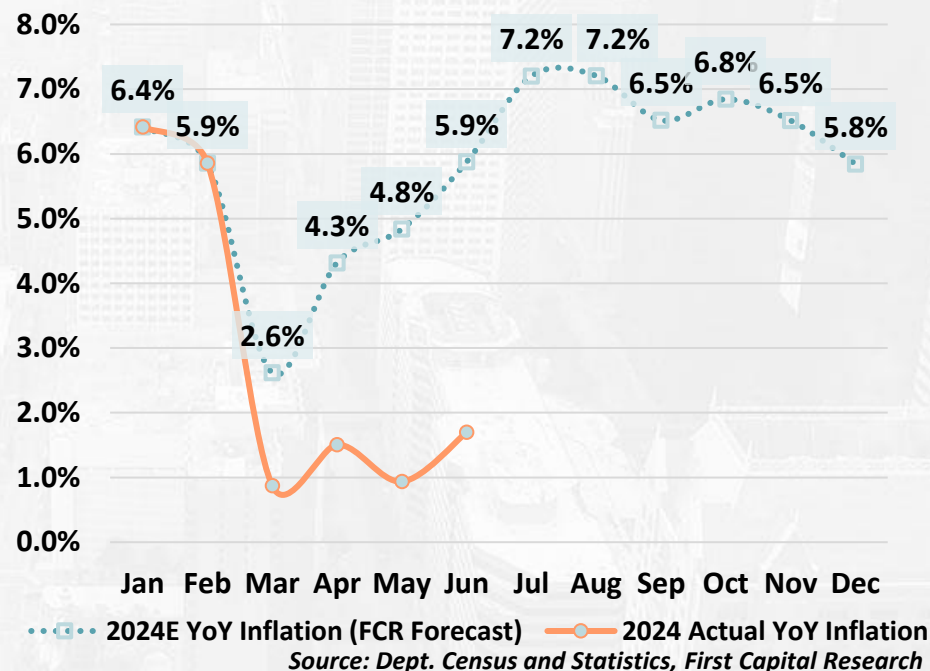
Arguments *for* *relaxation* in monetary policy

Arguments *for* relaxation in monetary policy



Inflation remains well below the baseline target of 5.0%

Headline inflation rose to 1.7%YoY in Jun-24, significantly below CBSL's baseline target of 5.0%. This increase was driven by price hikes in both Food and Non-Food categories, which grew by 1.4%YoY and 1.8%YoY, respectively. Similarly, core inflation rose to 4.4%YoY in Jun-24, also remaining well under the baseline level. Looking ahead, substantial cuts in electricity tariffs by 22.5% and a subsequent reduction in water tariffs in Jul-24 are expected to lower Non-Food prices, leading to lower-than-expected inflation in the coming months. Additionally, the All-Island Canteen and Restaurant Owners' Association has reduced prices of certain food items and has urged the government to implement price controls on keeri samba rice, samba rice, eggs, and chicken. If implemented, this could lead to an additional 25.0% price reduction for consumers, further decreasing food inflation. Therefore, CBSL is well-positioned to consider a prudent rate cut as inflationary pressures are projected to further ease with these price adjustments, whilst maintaining economic stability.



Arguments *for* *relaxation* in monetary policy

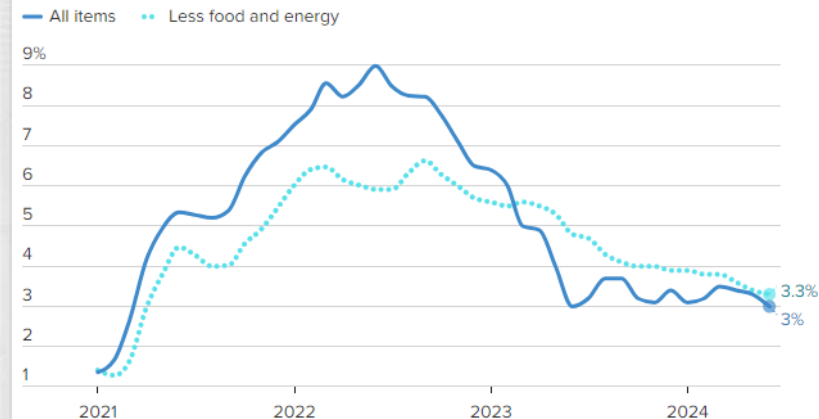


US Fed poised to cut rates following Europe's lead

Fed Chair Jerome Powell stated that with price pressures easing, as indicated by the decline in the CPI in Jun-24, and the labor market showing signs of cooling, the Fed is gaining confidence that inflation is moving back toward its 2.0% target. This sets the stage for a potential first reduction in borrowing costs in Sep-24, ahead of the US elections. In Jun-24, both the CPI and core CPI saw declines, with the CPI dropping to 3.0%YoY and core CPI falling to 3.3%YoY. After maintaining a 23-year high benchmark policy rate of 5.25%-5.50%, the Fed is expected to cut rates once in 2024 and four additional times in 2025. The anticipated rate cut aims to achieve a "soft landing," where inflation drops back to target levels without a sharp rise in layoffs. According to JPMorgan, this outcome depends on the Fed starting to ease soon and gradually reducing the policy rate closer to 3.0%. Meanwhile, the ECB recently cut its key interest rate to 3.75% from 4.00%, marking the first reduction since 2019. The ECB's decision is supported by better-than-expected economic data, a continuing downshift in consumer price pressures, and signs of financial stress among lower-income customers. Consequently, the optimistic outlook in the US and Europe, along with their shift towards lower interest rates, creates a favorable environment for the CBSL to consider a similar rate cut.

U.S. consumer price index

Year-over-year percent change January 2021–June 2024

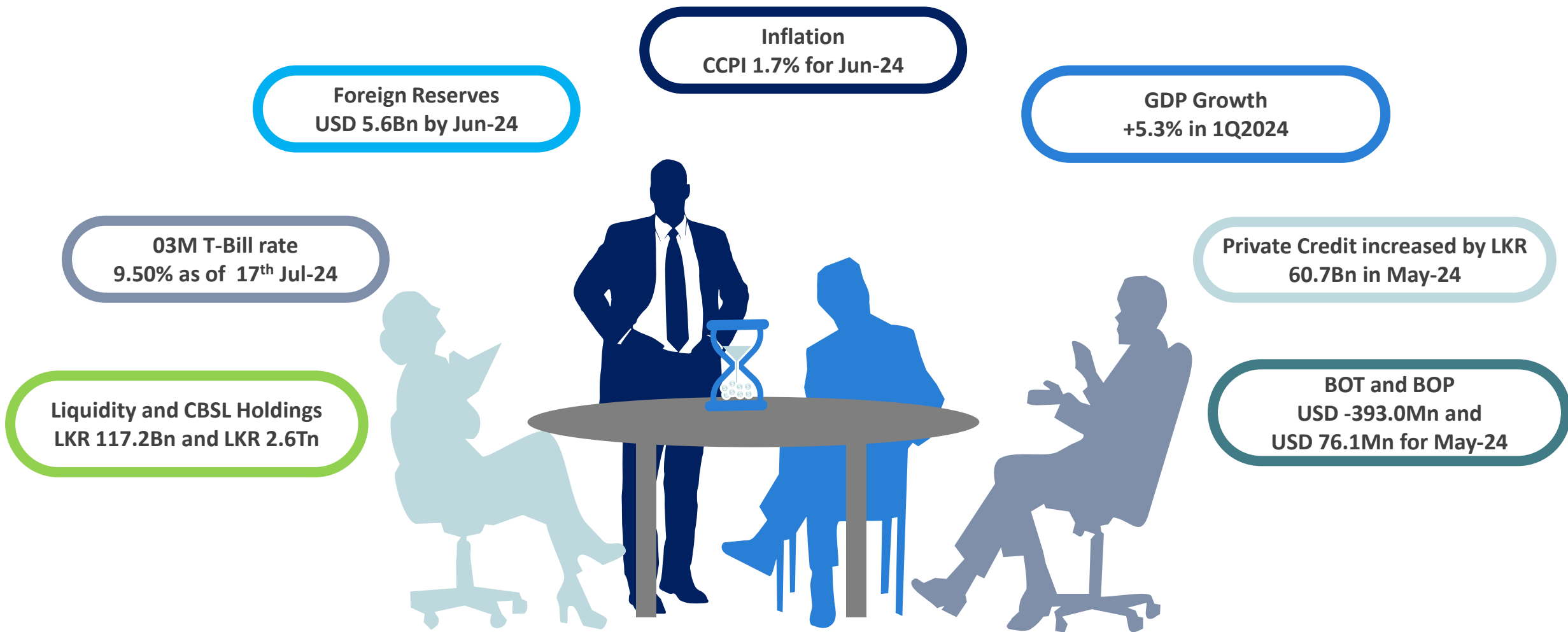


Source: U.S. Bureau of Labor Statistics
Data as of July 11, 2024

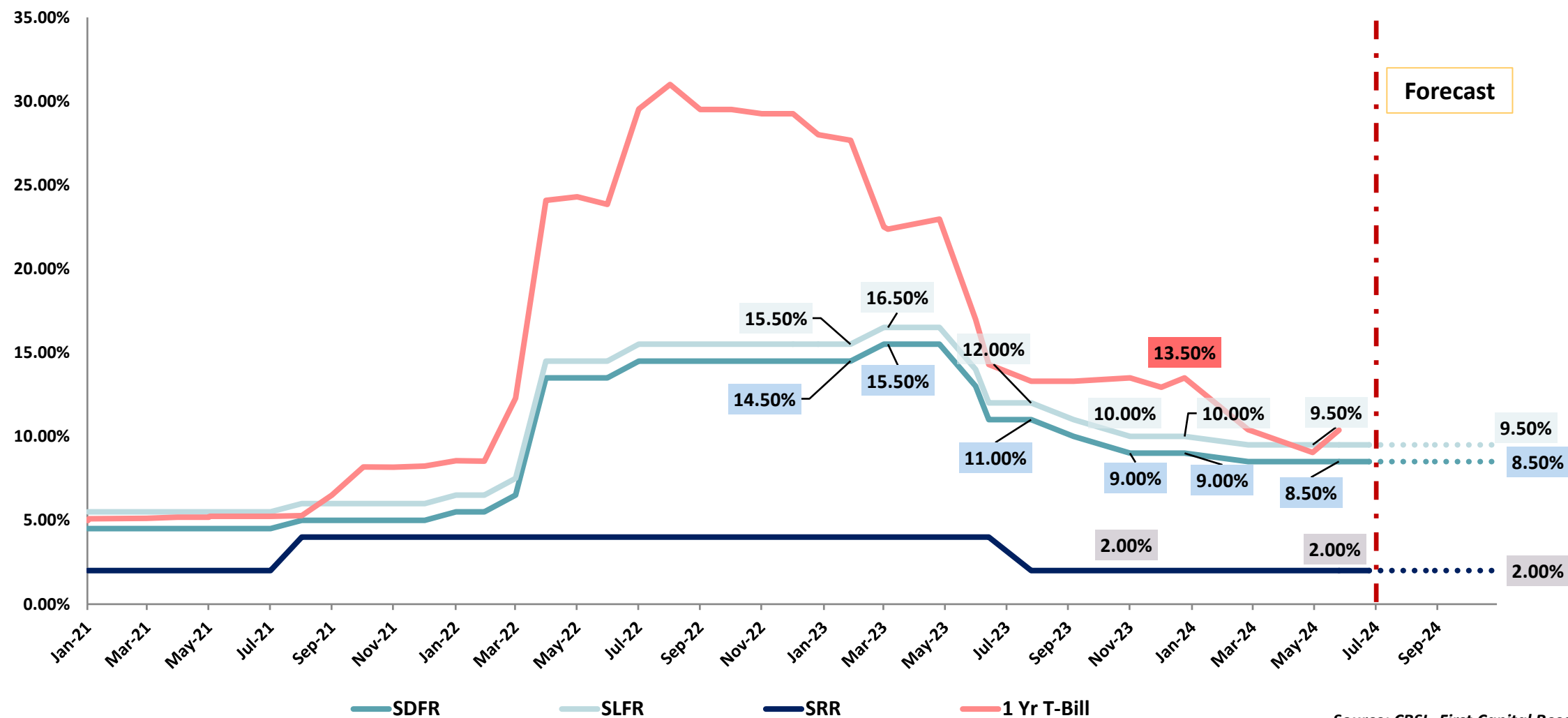


Factors in consideration at the policy review

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Monetary Policy Rates



Source: CBSL, First Capital Research

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Thank you!

***“SUCCESSFUL INVESTMENTS IS ABOUT
MANAGING RISKS”***

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