



First Capital
A Janashakthi Group Company

“THE ROAD AHEAD: STEERING INTEREST RATES IN AN UNCERTAIN ECONOMY”

PRE-POLICY ANALYSIS

20TH SEP 2024

 First Capital Research

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Previous Pre-policy report: Recap – Partly Accurate

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The CBSL maintains policy interest rates

Partly in line with our expectations, CBSL decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 25bps to 8.25% and 9.25%, respectively at the monetary policy review held on 23rd Jul-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 below 5.0% over the medium term, all while supporting the economy in reaching its potential level. The Board acknowledged that inflation is expected to remain well below the target in the coming months due to the adjustments of electricity tariffs, falling domestic food prices, and weak demand conditions. Despite a widening of the trade balance, the external sector has shown improvement with increased foreign currency inflows, tourism-related inflows, and elevated workers' remittances. However, the Board emphasized the need to continue to ease monetary conditions to sustain the revival of economic activity towards full potential in the absence of significant inflationary pressures, and will continue to monitor inflation developments.

Key Arguments considered by CBSL for its policy stance held on 23rd Jul-24

- ✓ Inflation is expected to remain well below the targeted level over the medium term.
- ✓ The CBSL will continue to monitor inflation and adjust rates as needed.
- ✓ The external sector continued to strengthen amidst a widening trade deficit.
- ✓ Recovery in domestic economic activity is expected to continue.



Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, there is an **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 25bps and a lower level of 5% for 50bps 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	80%
Cutting Policy Rates by 25bps	15%
Cutting Policy Rates by 50bps	5%
Cutting Policy Rates by 200bps	0%

20%

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

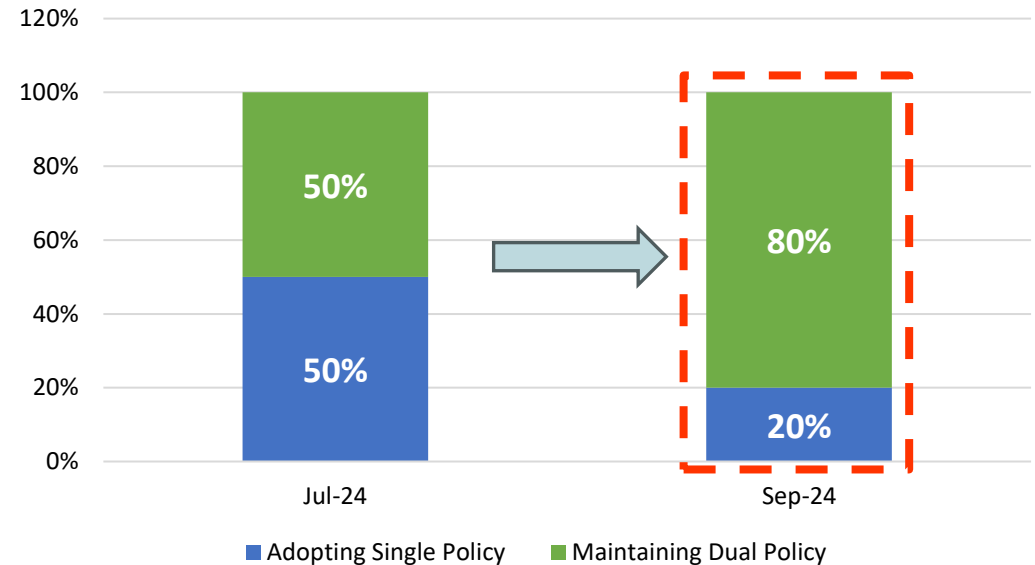
Considering the reduction of SRR by 200bps to 2.0% on 09th Aug-23, we expect SRR to remain unchanged at the same level. However, there is a 20% probability for CBSL to raise SRR by 100bps.

Single Monetary Policy Stance

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 **20% probability for CBSL to relax SLFR**, while there is an **80% probability for CBSL to maintain the SLFR rate at its current level of 9.25%**.

Policy rates likely to remain unchanged: FCR

Probability for implementing a single policy stance in Sep-24 is low



Expected Single Monetary Policy Stance	Probability
Adopting a single policy stance	20%
Maintaining a dual policy stance	80%

100%

We believe that there is a 20% probability for an SLF rate cut to adopt a single monetary policy stance.

Analysis of upcoming policy decision on 19th Sep

Arguments **against** a Monetary Relaxation

80%



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

- PMI expansion across Manufacturing, Services, and Construction signals economic growth
- Private credit surges by LKR 60.2Bn in Jul-24
- Consumer Confidence Indices reach record high
- Currency appreciation prompts exchange rate stabilization
- Low policy rates restrict risk mitigation and external shock responses
- External debt restructuring (EDR) completion and political uncertainty cause diverging yields

Arguments **for** a Monetary Relaxation

20%



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

- Inflation remains well below the baseline target of 5.0% at 0.5% in Aug-24, risking lowflation
- Global interest rates fall amidst uncertainty



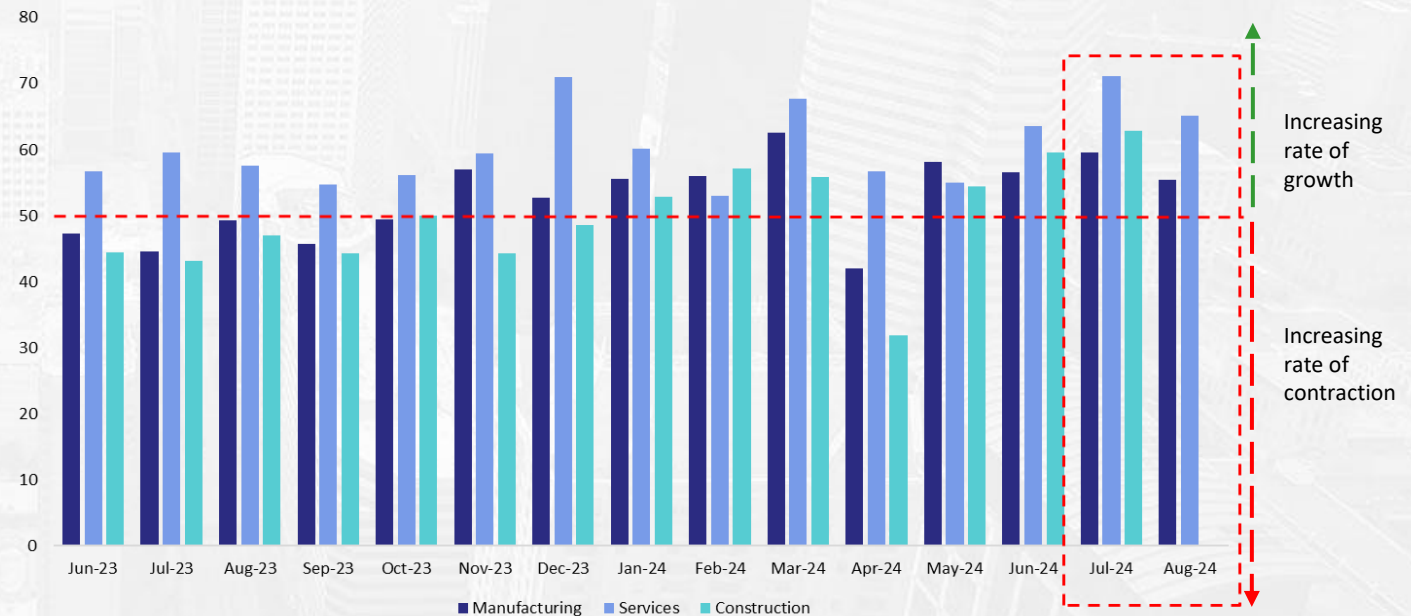
Arguments *against a
relaxation* in monetary
policy

Arguments against a relaxation in monetary policy



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

The PMI for Aug-24 and Jul-24 signaled robust expansion across the Services, Construction, and Manufacturing sectors, reinforcing the upward trend seen in previous months. The Services sector experienced the most significant expansion recording a PMI of 71.1 in Jul-24, the highest value so far this year. In Aug-24, the Services sector continued to expand, with a PMI of 65.2, reflecting strong growth, though slightly moderated compared to the record-high July figure. This growth was fueled by improvements in entertainment and recreation activities, wholesale and retail trade, transportation services, and financial services. The Manufacturing sector also continued to expand in Aug-24, with a PMI of 55.5, reflecting healthy growth, even if at a slightly slower pace than Jul-24's 59.5. Notably, all subindices, except for Employment, remained above the neutral threshold signaling resilience in the sector. The Construction sector maintained its positive momentum, expanding to an index of 62.9 in Jul-24, supported by an increase in construction projects funded by multilateral agencies. Improvements in PMI are indicative of supply side expansion and a 4.7%YoY growth in GDP in 2Q2024. Therefore, a rate cut, and further intervention would be less necessary given that expansion in economic activity and improvements to GDP growth are already taking place at satisfactory levels.

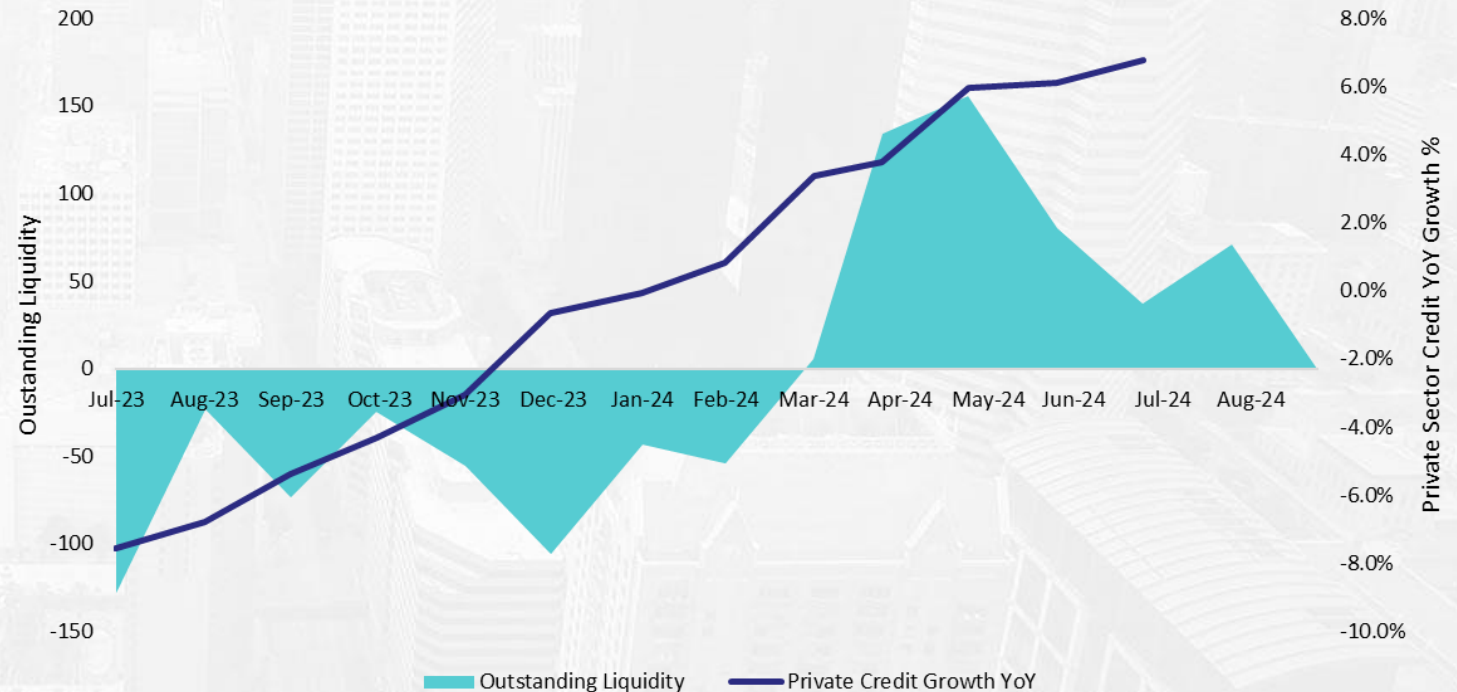


Arguments against a relaxation in monetary policy



Private credit surges by LKR 60.2Bn in Jul-24, and liquidity improves

Total Private Sector Credit increased by LKR 60.2Bn to LKR 7.6Tn in Jul-24, and by LKR 74.5Bn in Jun-24, indicating constantly improving credit growth, liquidity, and economic activity, aligning with FCR targets. Amidst this growth, the Average Weighted Lending Rate (AWLR) fell to 12.25% in Jul-24, and the Average Weighted Prime Rate (AWPR) rose slightly to 9.13% in Aug-24 from 8.81% in Jul-24. These indicators suggest that while there is room for a rebound, current rates are sufficient for growth in economic activity given the rise in private sector credit. The resultant outstanding liquidity reflected in private sector credit growth has consistently remained between the LKR 30.0Bn – LKR 80.0Bn target in Jun-Aug 24. This ample liquidity, driven by the central bank's relaxed policy rates, has been sufficient to stimulate business activity and maintain positive liquidity levels in the banking system. A further relaxation of monetary policy could cause excessive credit growth, leading to an increase in net imports, resulting in overheating of the economy. Therefore, indicators suggest that current economic conditions are conducive to stable growth to maintain liquidity and credit growth without a further relaxation of monetary policy.

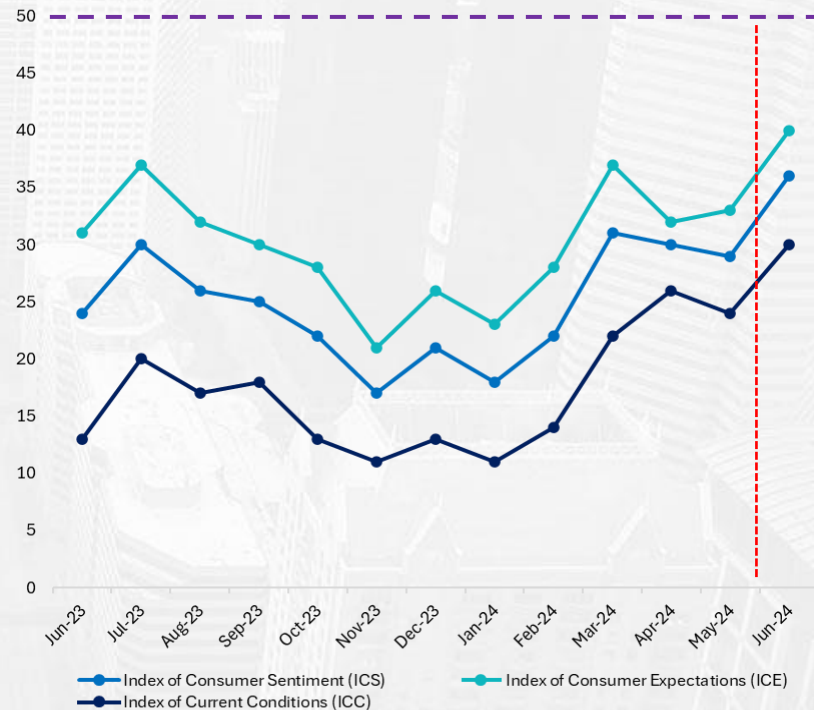


Arguments against a relaxation in monetary policy



Consumer Confidence Indices reach record high in Jun-24

Consumer Confidence indices reached an all-time high in Jun-24. The Index of Consumer Sentiment (ICS), which measures public perception of their economic status and the national economy, rose to 36 points. The Index of Consumer Expectations (ICE), tracking future perceptions, increased to 40 points, and the Index of Current Conditions (ICC), which reflects current economic conditions, climbed to 30 points—the highest values since 2021. The measure of current buying conditions also rose to 29 points, indicating increased demand for purchases. While still below the optimistic 50-point mark amidst political uncertainty, rising consumer confidence, coupled with approved wage increases (40% for the national minimum wage and 24%-50% for state workers), suggests future growth in aggregate demand will take place post-election. Therefore, as aggregate demand is foreseen to pick-up in the future, and as all leading political candidates propose tax cuts, further monetary policy easing would be counterproductive, as it could lead to undue demand driven inflation and economic overheating resulting from increased disposable income and aggregate demand.

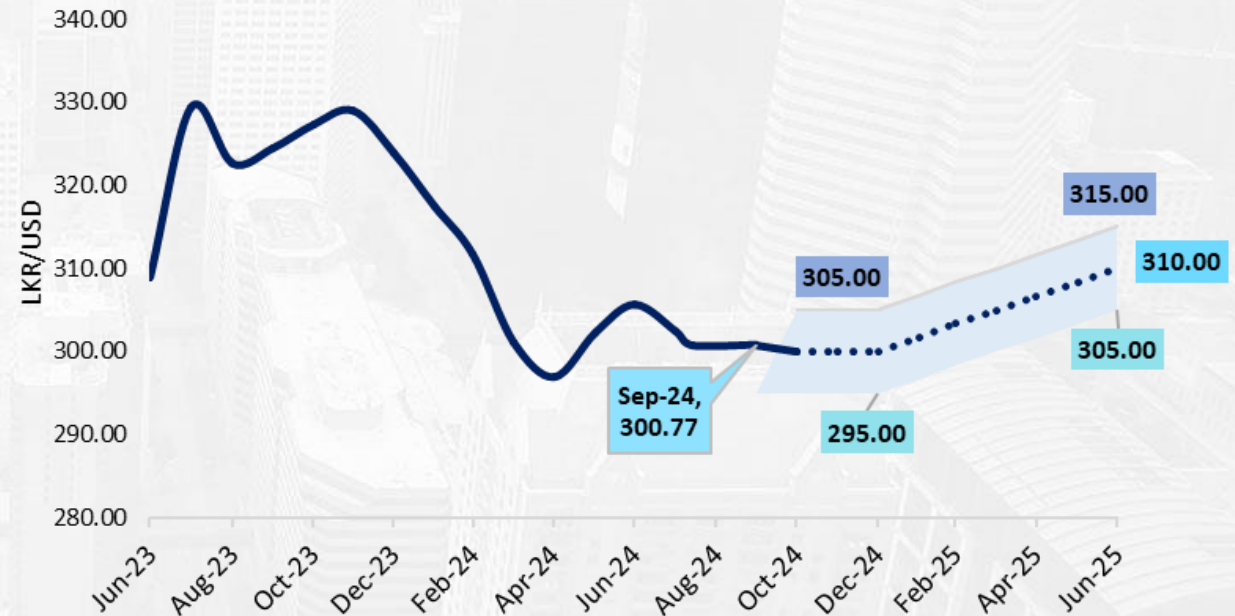


Arguments against a relaxation in monetary policy



Currency appreciation prompts exchange rate stabilization

The Sri Lankan Rupee (LKR) has been strengthening since the beginning of the year, moving from LKR 317.41 in Jan-24, to LKR 302.37/USD in Jul-24 and LKR 300.33/USD in Aug-24, and further to LKR 300.77/USD in Sep-24. Increased inflows from tourism and worker remittances recorded in Jul-24 have been attributed to the appreciation of the LKR. Following recent fluctuations, the months of August and September suggest some stability for the exchange rate in the future. This strengthening of the currency has helped offset potential inflationary pressures that could arise from the present low interest rates which could risk currency depreciation. With anticipated increases in inflows from tourism and remittances in the upcoming months, the stable outlook for the currency indicates favorable macroeconomic conditions to attract further foreign currency, strengthen the LKR, and bolster economic activity at the current interest rate levels. Lower interest rates could result in lower returns on fixed-income investments, reducing demand of the LKR and reducing foreign inflows, potentially weakening the LKR. Therefore, given the expected expansion in these segments over the coming months, current rates should be maintained to sustain economic stability, attract foreign inflows, and prevent currency depreciation by avoiding unnecessary rate cuts.

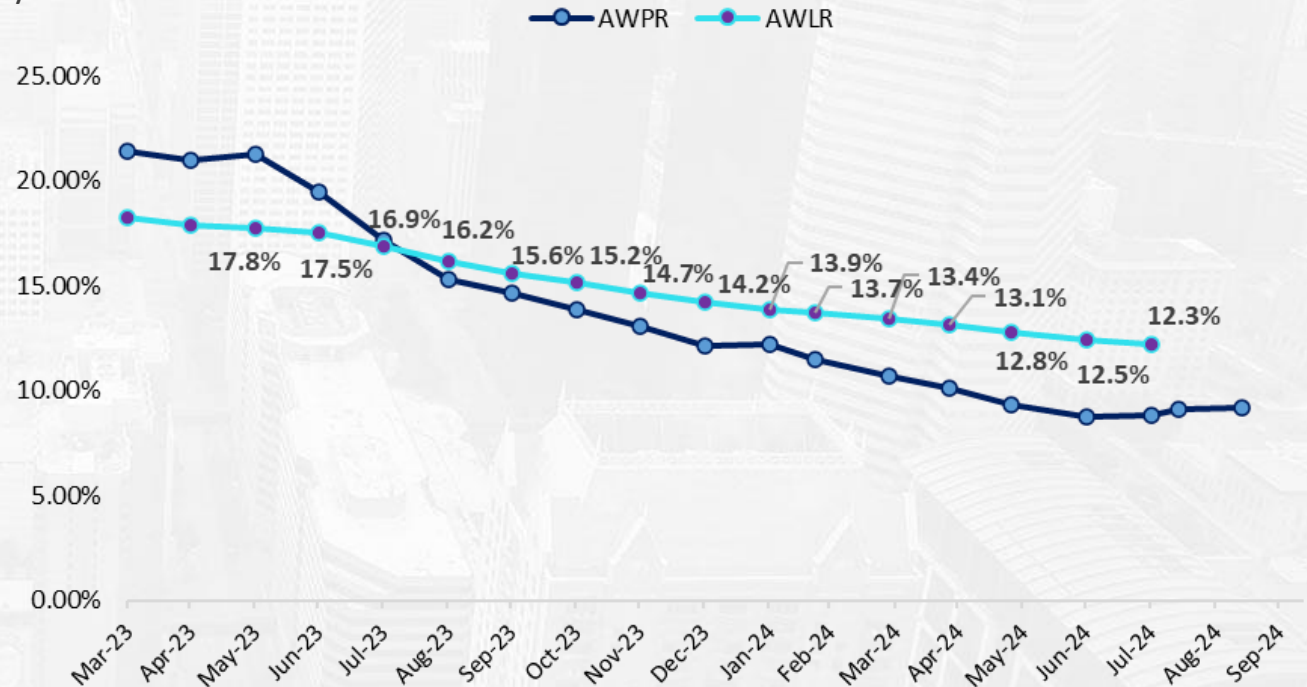


Arguments against a relaxation in monetary policy



Low policy rates restrict risk mitigation and external shock responses

Maintaining adequate policy rates and interest rates at the current level, AWPR (9.23%), AWPLR (12.25%), SDFR (8.25%), and SLFR (9.25%) is crucial to preserving the CBSL's ability to respond to future economic crises. While low lending rates have encouraged business confidence and spending, caution is advised regarding the risks associated with excessive borrowing and spending, which could potentially destabilize the economy. If interest rates are set too low, the central bank would have limited policy tools available to stimulate the economy during potential downturns. Currently, with rates low, further relaxation of policy rates could reduce the room for adjusting monetary policy to encourage consumer spending and economic activity further, leaving the economy vulnerable to external shocks or domestic challenges. Thus, it is essential to maintain current interest rates to ensure the CBSL has sufficient flexibility to support the economy if a crisis arises. Keeping rates steady provides a buffer to counter future economic turbulence, ensuring that policy options remain robust and effective in safeguarding economic stability.

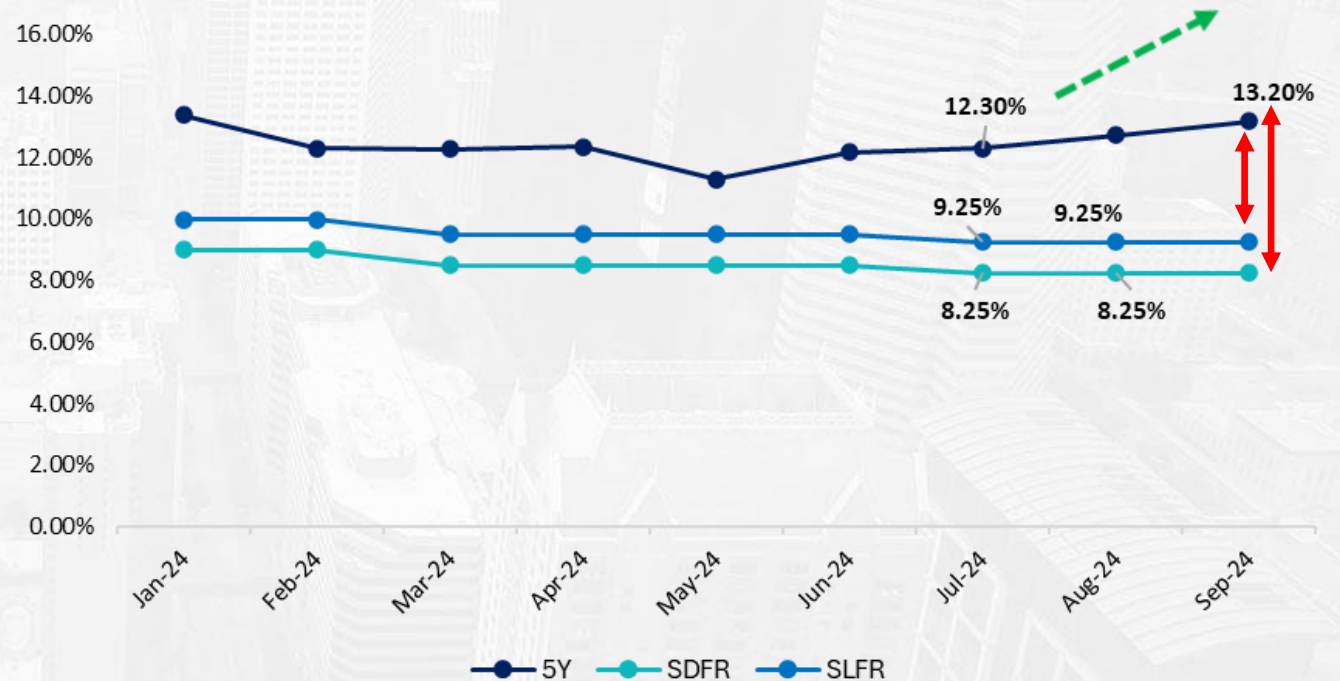


Arguments against a relaxation in monetary policy



External debt restructuring (EDR) completion and political uncertainty cause diverging yields

Recent trends have shown that market yield rates are on the rise, creating a distinct gap between policy rates and market rates due to political uncertainty and the EDR process. This divergence indicates that policy rates display no impact on market yield rates, suggesting that the market is not adapting or responding to monetary conditions. A reduction in policy rates further could widen this gap and lead to excess liquidity in the system, potentially distorting financial markets and creating imbalances. With the expected full implementation of the EDR, risk premiums on government securities are expected to decline, which should naturally reduce bond yields and narrow spreads. This adjustment, along with a potential credit rating upgrade, could attract more foreign investment without the need for further rate cuts. Given that falling policy rates have not impacted changes in market rates due to political uncertainty and delays in the completion of EDR, it is expected that yield rates will eventually adapt to market conditions post election and EDR completion. Therefore, maintaining the current policy rates is crucial to ensure economic stability and avoid unnecessary interventions in the financial system, allowing the market to adjust organically.





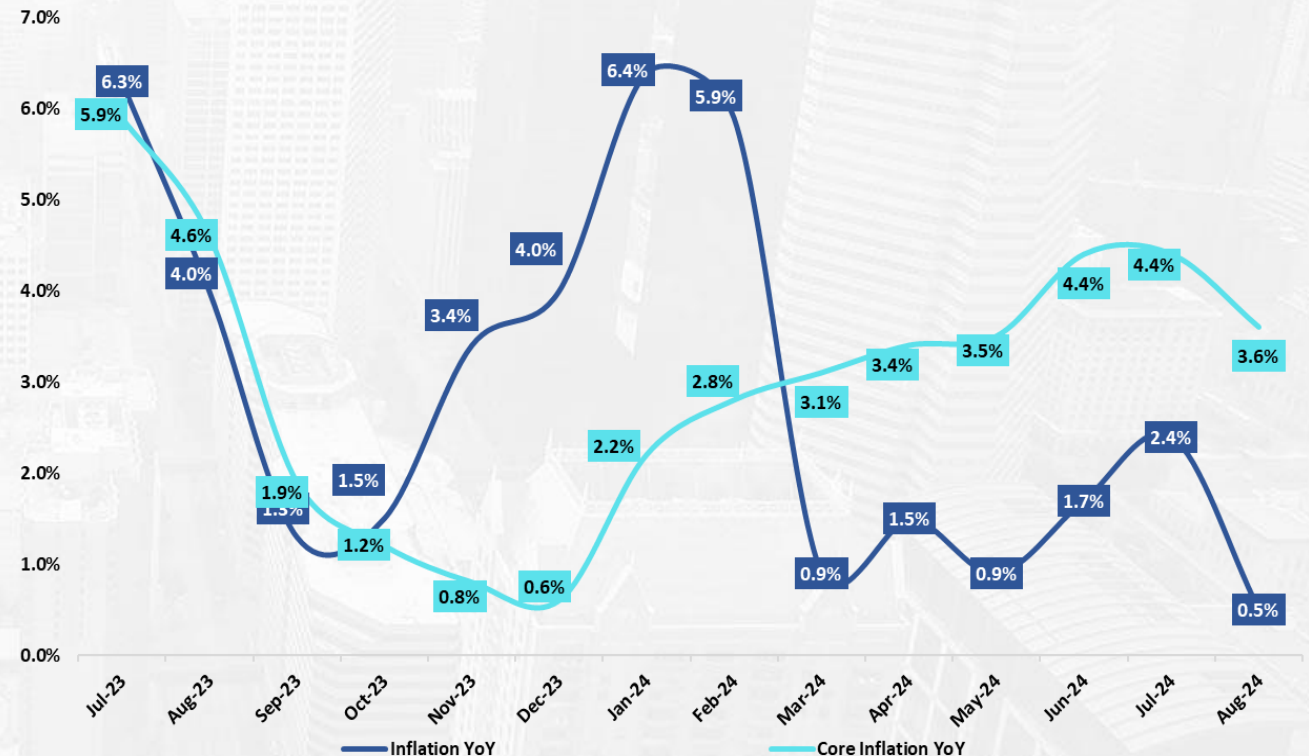
Arguments *for*
relaxation in monetary
policy

Arguments for relaxation in monetary policy



Inflation remains well below the baseline target of 5.0% at 0.5% in Aug-24, risking lowflation

The rate of inflation dipped well below the 5% target to 0.5%YoY in Aug-24, from 2.4%YoY in Jul-24, marking a 1.8%MoM decline. Food inflation decelerated to 0.8%YoY in Aug-24 from 1.5%YoY in Jul-24. Further, Non-Food inflation also decelerated sharply to 0.4%YoY in Aug-24 from 2.8%YoY in Jul-24. The decline in headline inflation is attributed to reductions in energy prices, a slowdown in food inflation, and subdued demand conditions. Given the current inflation rate, there is a risk of low inflation or deflationary pressure if economic conditions do not improve. Stagnant, low inflation combined with sluggish demand can lead to a deflationary environment, where declining prices further dampen economic activity. To counter this risk, a rate cut could be an effective measure to stimulate demand and boost economic activity. Lower interest rates would reduce borrowing costs and encourage investment, lifting inflation from its current low level. Therefore, given the low inflation rate and potential for economic stagnation, a rate cut would be prudent to prevent economic slowdown.

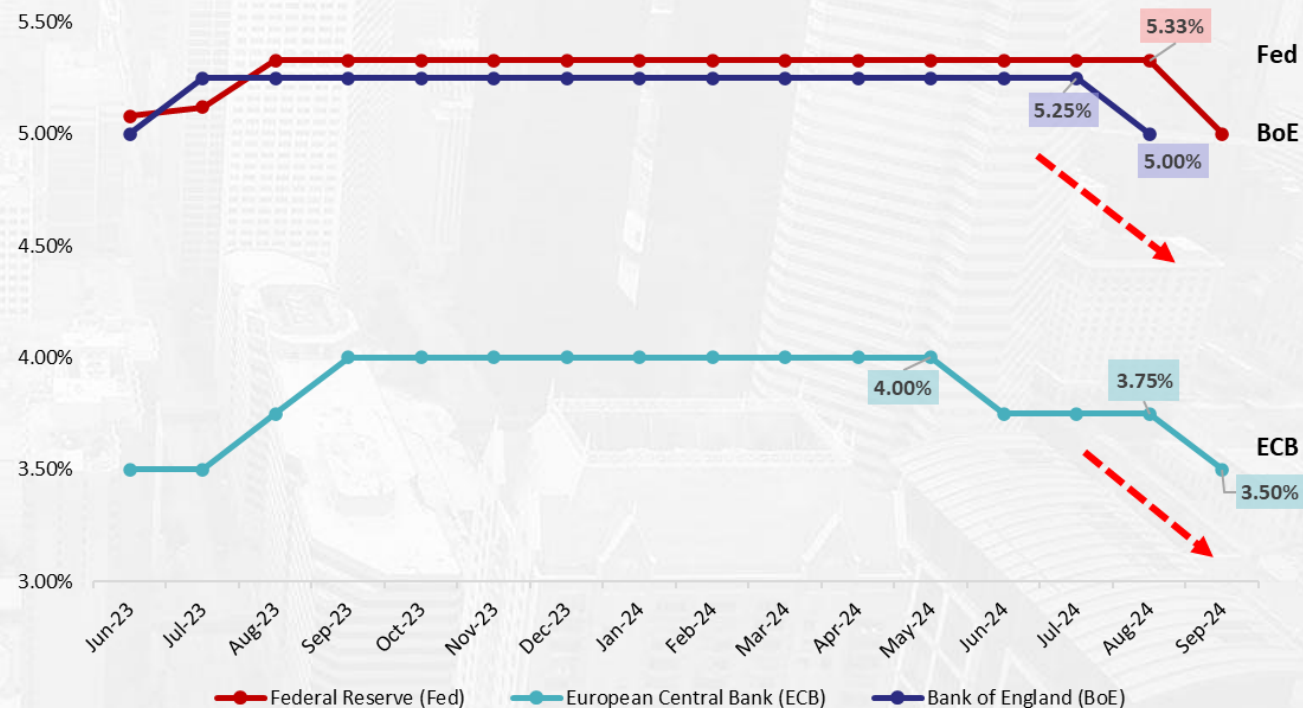


Arguments for relaxation in monetary policy



Global interest rates fall amidst uncertainty

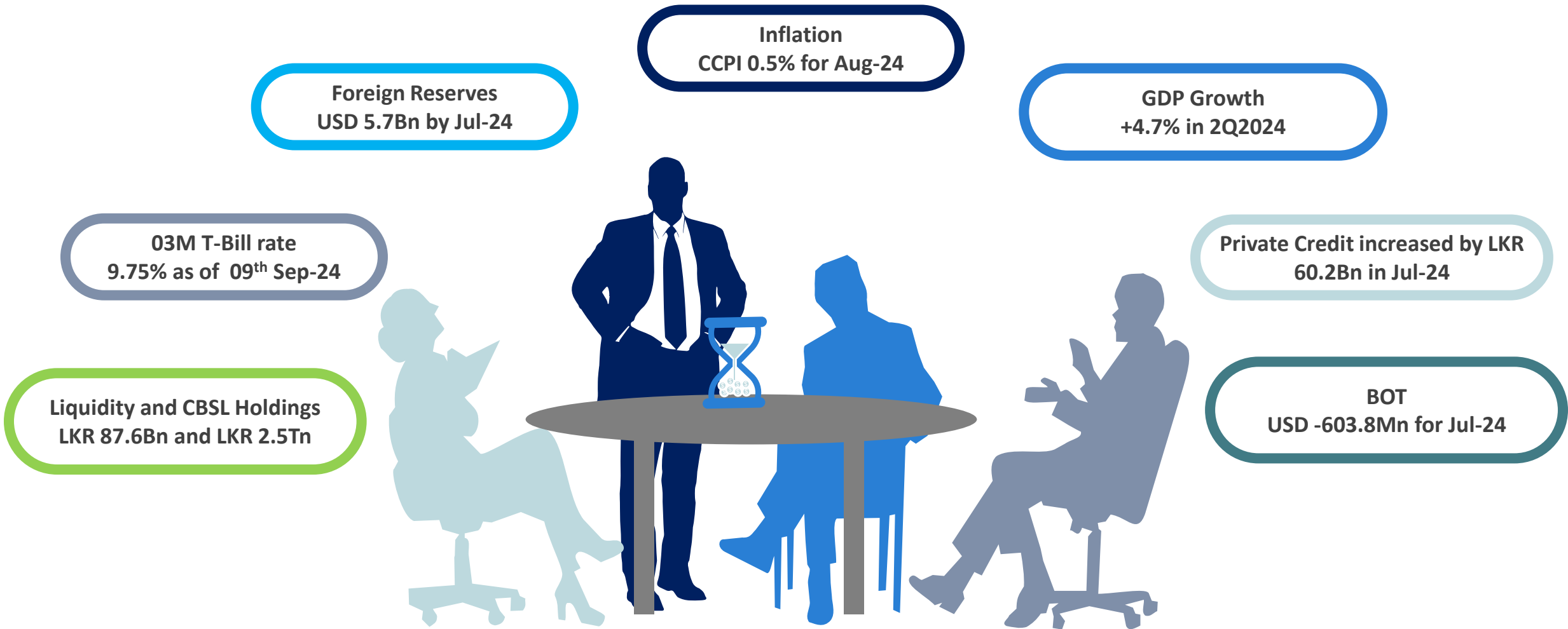
Global interest rates are experiencing a downward trend as central banks adopt more accommodative monetary policies. The BoE's policy rates declined to 5.00% in Aug-24 from 5.25% in Jun-24; the ECB's rates fell to 3.50% in Sep-24 from 3.75% in Aug-24. The Fed reduced policy rates for the first time since 2020 at the Sep-24 meeting, lowering rates by 50bps from 5.33% to a range of 4.75% - 5.00%. A further rate reduction by the Fed is also expected in Nov-24 and 2025. This shift creates an opportunity for Sri Lanka to align with global trends by reducing its own policy rates. Furthermore, with bilateral debt funding costs declining because of decreasing global interest rates, the CBSL has a lower debt financing requirement and can manage debt more effectively, creating room for a rate cut without jeopardizing financial stability. Declining interest rates reduce the pressure on maturities, creating room for further rate cuts in the future. Given the favorable conditions of declining global rates, reduced debt servicing pressure, and a lower cost of funding, the CBSL could consider further monetary easing to finance debt effectively.



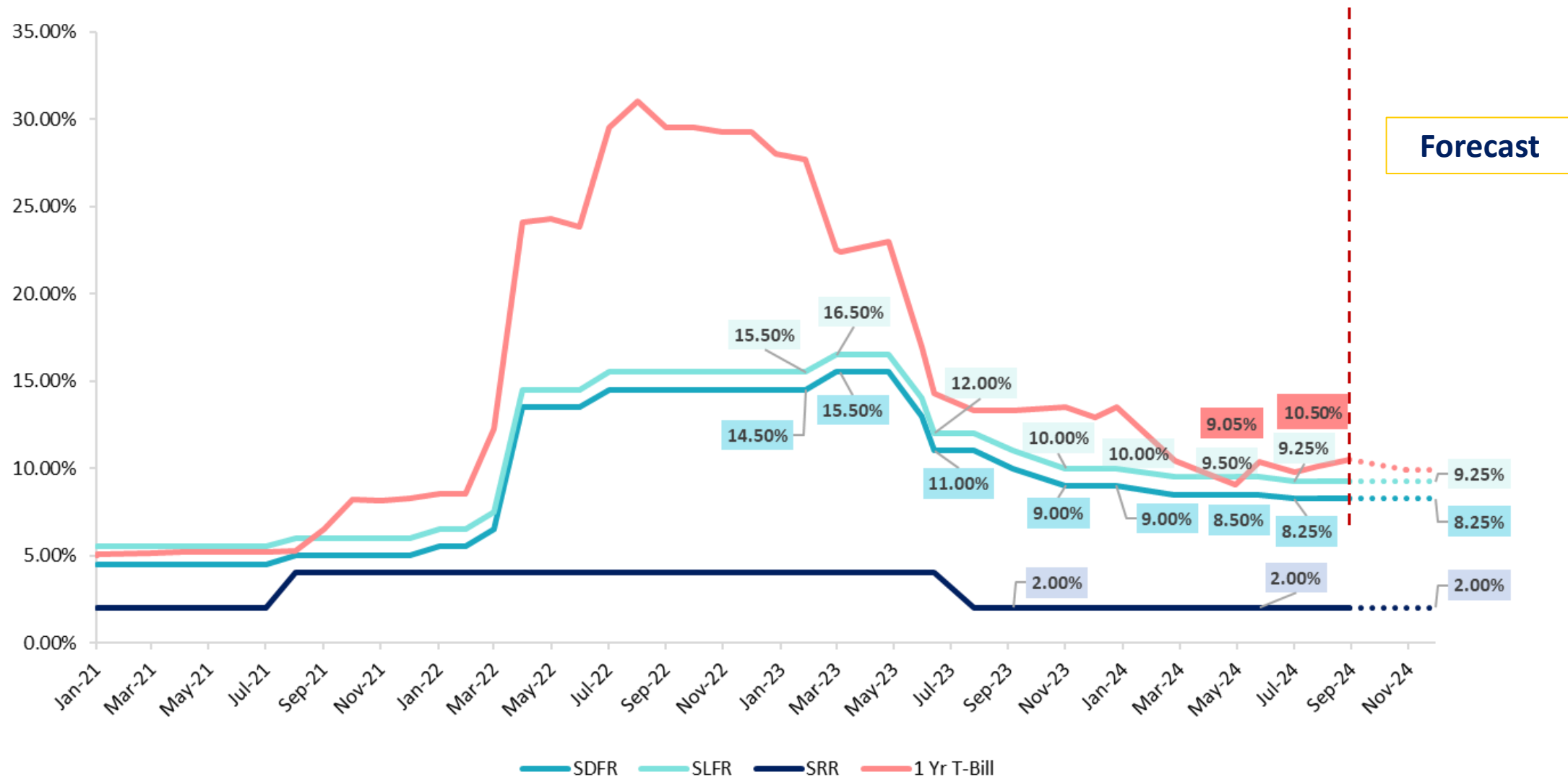
The Fed's September Dot Plot



Factors in consideration at the policy review



Monetary Policy Rates



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*“SUCCESSFUL INVESTMENTS IS ABOUT
MANAGING RISKS”*

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