"HOLDING THE LINE: RATES TO BE MAINTAINED"

PRE-POLICY ANALYSIS

16th May 2025

FIRST CAPITAL RESEARCH

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Previous Pre-policy report: Recap – Accurate

The Central Bank of Sri Lanka maintains the Overnight Policy Rate (OPR) at the current level

In line with our expectations, The Monetary Policy Board of the Central Bank of Sri Lanka, at its meeting held on 25 March 2025, decided to maintain the Overnight Policy Rate (OPR) of the Central Bank at its current level of 8.00%. The Board arrived at this decision following a careful analysis of the current and expected macroeconomic developments on the domestic and global fronts. This decision was made with a medium-term view of ensuring that inflation converges to the target of 5.00%, while supporting the economy to reach its potential. Inflation remains negative at present mainly due to repeated reductions in electricity tariffs and fuel prices. Deflationary conditions are expected to gradually ease from March 2025, with inflation projected to turn positive by mid-2025.

Key Arguments considered by CBSL for its policy stance held on 25th Mar 2025

- ✓ Deflationary conditions are expected to gradually ease from March 2025, with inflation projected to turn positive by mid-2025.
- ✓ The latest annual estimates revealed that the domestic economy recorded a strong recovery in 2024 after two years of contractions.
- ✓ Rupee liquidity remains at surplus level. Market interest rates continued to decline in line with the eased monetary policy stance.
- ✓ External sector performance has been more favorable than expected.

Source: CBSL, First Capital Research

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, out of which a probability of 15% is assigned 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.

Analysis of upcoming policy decision on 22nd May

Arguments against a Monetary Relaxation

80%

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

- Volatility in reserves continues, build up expects to be slow ahead
- Budgetary push is expected to drive GDP towards the 5% mark for 2025E
- Deflation slows down, inflation to hit CBSL thresholds soon
- Total credit disbursed continues to improve
- Global uncertainties to slowdown investments towards government securities

Arguments for a Monetary Relaxation

20%

- Liquidity in the domestic market continue to improve
- Reduce pressure and give direction for the market

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

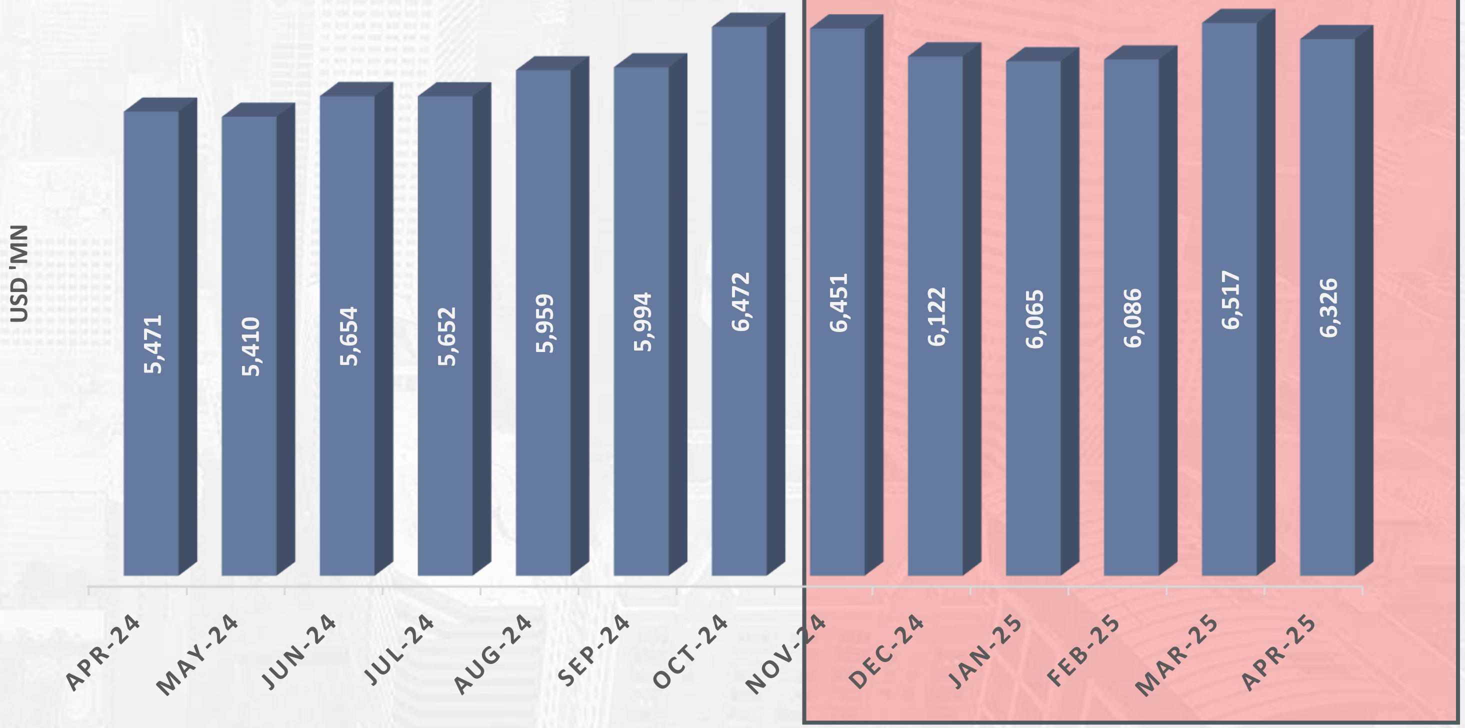
Source: CBSL, First Capital Research

Arguments *against a relaxation* in monetary policy

Arguments against a relaxation in monetary policy

Volatility in reserves continues, build up expects to be slow ahead

With the unlocking of IMF 4th tranche of USD 333.0Mn in early March 2025, Sri Lankan reserves hit its peak reserves of USD 6.5Bn in March 2025. However, despite the active efforts by the CBSL through USD purchases (collected USD 645.3Mn between Jan-Apr 2025 period), Sri Lankan gross official reserves tumbled down in April 2025 back to USD 6.3Bn, hurt by debt repayments undertaken during the concerned period. Looking ahead, we expect the volatility in reserves to continue with potential IMF tranches boosting SL reserves position whilst repayments are expected to add adverse pressure towards reserve build up. Moreover, with peak tourism coming to a close in March 2025, we expect tourism receipts to slowdown whilst off-peak months in remittances, are also expected to limit CBSL capacity to purchase USD in the coming months, slowing down reserves growth.

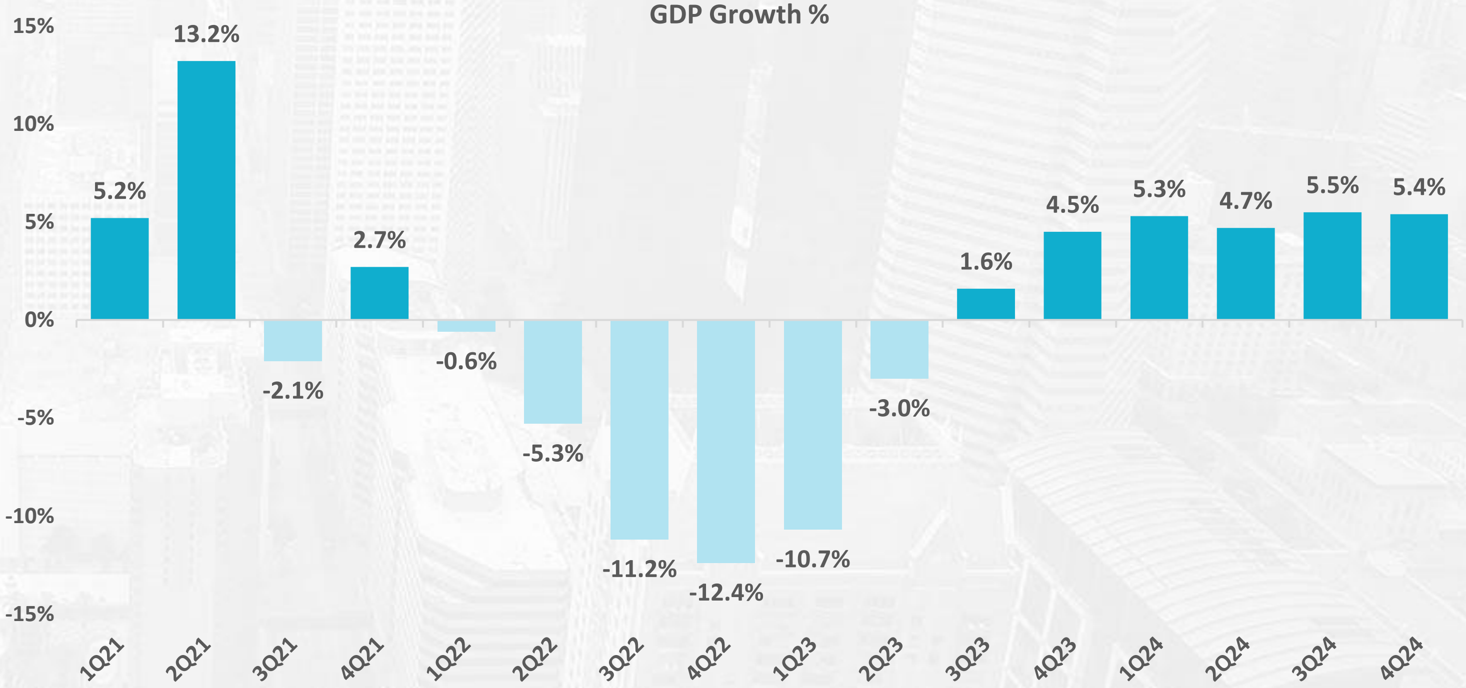


Source: CBSL, First Capital Research

Arguments against a relaxation in monetary policy

Budgetary push is expected to drive GDP towards the 5% mark for 2025E

Sri Lanka's GDP growth hit 5.4%YoY in 4Q2024, growing for the 6th consecutive quarter after recording 5 quarters of continuous decline. The growth in GDP during the period was driven by both Industry and Services subsegments, which recorded a growth of 13.1%YoY and 2.5%YoY, respectively whilst Agriculture segment recorded a decline of 2.2%YoY for the quarter. Having upgraded our GDP outlook for 2025E from our investment strategy in Jan-25 to between 4%-5%, we believe that the 1Q2025 growth could outpace our expectations, predominantly due to the bullish performance of all leading indicators including purchasing managers Index and business confidence during that period. Moreover, First Capital also believes that the growth during the remaining 9 months (2-4Q2025E) also to be strong, largely aided by the budgetary push to boost consumption, which came in to play from April 2025 via state sector salary and pension increases, increased allowance for Aswesuma benefits and higher capital spending allocations for 2025.



Arguments against a relaxation in monetary policy

Deflation slows down, inflation to hit CBSL thresholds soon

Recovering from the lowest deflation recorded in Feb-25 of 4.2%, Sri Lankan deflation continued to slowdown during April 2025 to -2.0% driven predominantly by higher food prices, whilst downward adjustment in electricity tariffs in Jan-25 by 20% continued to insert adverse pressure on non-food inflation. With evident signs of a recovery in demand in the system through improved PMI and business confidence indices, we believe that the deflationary levels will continue slowdown during the next few months whilst a possible upward revision of electricity tariffs from July-25 revision (inline with the IMF recommendation to move back to cost reflective pricing mechanism), base effect coming to play from Aug-25 onwards and budgetary push by GoSL to boost consumption are expected to be key catalysts towards inflation moving towards the CBSL envisaged range during 2025E. According to FC expectations, we expect inflation to move towards the positive territory from 2H2025E onwards whilst hitting the CBSL directed threshold of 4%-6% during 4Q2025E period.

Total credit disbursed continues to improve

The positive credit growth continued in 2025 as well with private sector credit growth recorded at LKR 173.2Bn in Mar-25 whilst YTD disbursements of private sector credit surpassed the LKR 274.1Bn mark. The recovery in the economy, prevailing low interest rates in the country and pick up in key business sectors including Tourism and Construction are identified as key, supporting credit expansion during 1Q2025. Looking ahead, with minimal pressure on interest rates to move up (partially due to improved revenue collection and reduced budget deficits), and a further recovery in the economy with economic benefits trickling down to all major parts of the economy, we believe private sector credit will grow at a CAGR of 12% within the next 2-year period. Apart from private sector credit, state credit also has been on an improving trajectory and recorded at LKR 80.4Bn in 1Q2025 period. With total credit on growth, we believe another rate cut is unnecessary whilst highlighting the risk of credit demand overheating in an event of a potential cut, given the advanced steps taken by the government to boost consumption.

Arguments against a relaxation in monetary policy

Global uncertainties to slowdown investments towards government securities

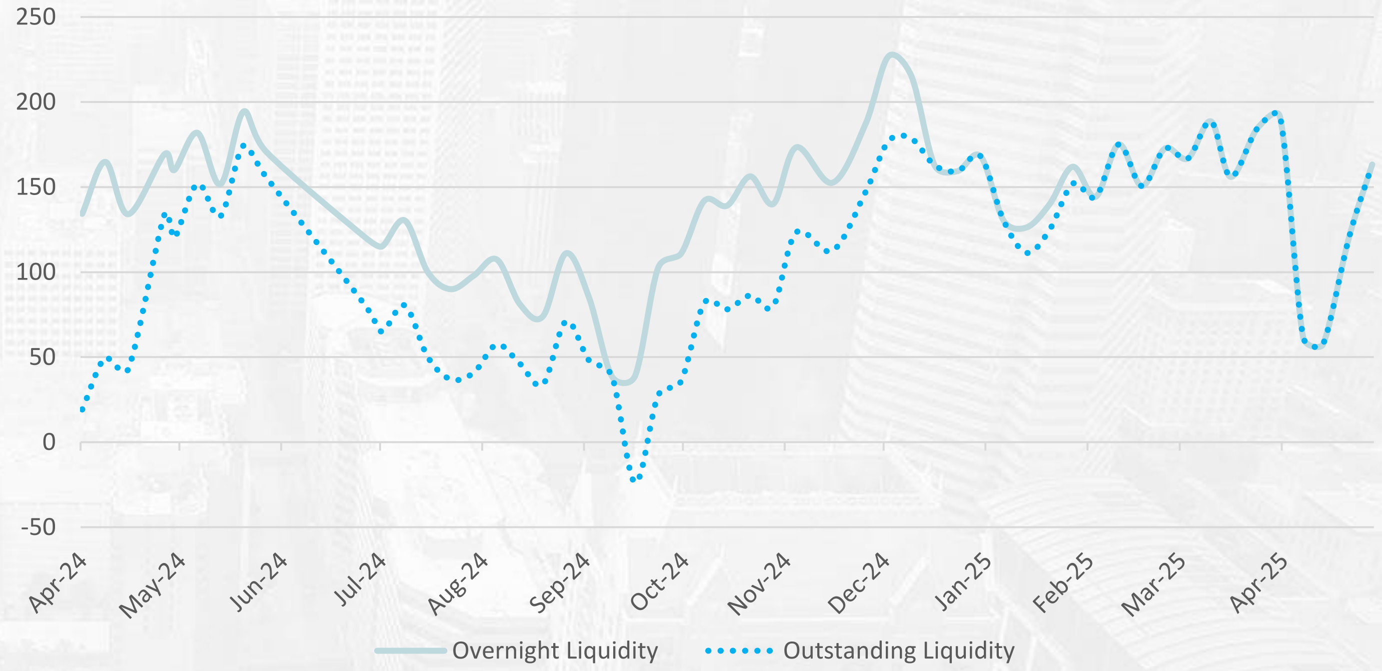
Foreign Holdings in government securities increased marginally during the period under review to LKR 91.1Bn yet participation continued to remain minimal at 4.9% of the total outstanding government securities stock. We believe the ongoing global challenges varied between trade war between United States and China, escalating regional conflicts in Asia, Europe and Middle East are expected to pose a set of uncertainties for global funds and investors, thus limiting investments towards emerging economies like Sri Lanka. Moreover, with Federal Reserve opting to maintain rates at the May Federal Reserve meeting, is also expected to adversely affect investments, considering the relatively higher returns offered abroad. Therefore, considering the uncertain investment climate and better opportunities in developed markets, we believe maintaining a wait and see approach at current juncture is suited, waiting for better clarity on the global developments.

Arguments *for relaxation* in monetary policy

Arguments for relaxation in monetary policy

Liquidity in the domestic market continue to improve

Despite the sudden drop in liquidity to near LKR 50.0Bn mark during the month of April, possibly caused by payment of salaries and bonuses, liquidity re-entered the banking system during the following days and total outstanding liquidity improved back again near LKR 200.0Bn mark. Total outstanding liquidity currently hovers near the LKR 183.2Bn during May-25 driven by aggressive USD purchases by the CBSL which totaled to USD 169.8Mn in April 2025 whilst overnight borrowings from the banks also continue to remain weak at LKR 0.2Bn as of May-25. Going forward, we expect available overnight liquidity in the banking sector to gradually reduce as demand for credit picks up whilst slow unravelling of CBSL Holdings are also expected to cause adverse pressure in the coming months. Moreover, heading into off-season in tourism and remittances, we believe USD purchases by the CBSL can also slowdown, potentially leading to slow injection of liquidity into the system.



Source: CBSL, First Capital Research

Arguments for relaxation in monetary policy

Reduce pressure and give direction for the market

Despite the strong performance in country’s macro indicators, growing tensions in the global markets caused by uncertain tariffs, fears of regional wars and reduced global growth prospects from multi lateral agencies, are pushing up W.A.Y.R on bids during recent auctions. This was evident with higher bids yet partial acceptance from 91 day and 182 day maturities during past 2 auctions whilst CBSL opted to maintain W.A.Y.R on the 364-day maturity. The increase in W.A.Y.R on bids received comes in the wake of stringent management of government finances, which posted a revenue growth of 17.5%YoY to LKR 760.9Bn and contracted its budget deficit by 33.0%YoY to LKR 86.6Bn during 1st 2 month of 2025. Given the stable macro situation, and to offer direction for future auction bids, we believe a rate cut is possible at the next policy meeting.

Source: Fed, ECB, BoE, Reuters, First Capital Research

Factors in consideration at the policy review

Inflation
CCPI -2.0% for Apr-25

Foreign Reserves
USD 6.3Bn by Apr-25

GDP Growth
+5.4% in 4Q2024

03M T-Bill rate
7.85% as of 14th May-25

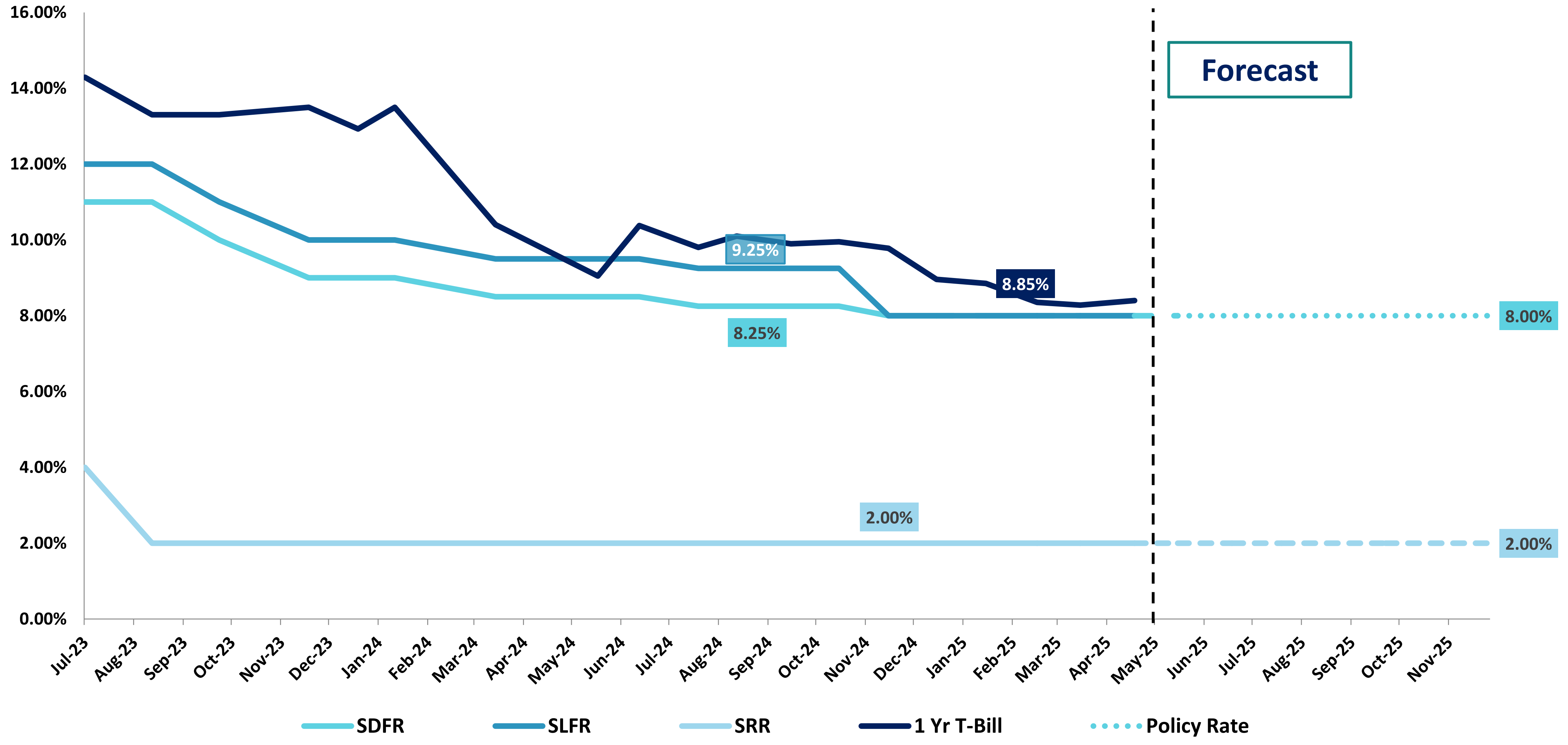
Private Credit increased by LKR 173.2Bn in Mar-25

Liquidity and CBSL Holdings
LKR 194.5 and LKR 2.5Tn

BOT
USD -395.6Mn for Mar-25

Monetary Policy Rates

First Capital
A Janashakthi Group Company



Source: CBSL, First Capital Research

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