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Policy rates to be maintained, following last month's hikes

PRE-POLICY ANALYSIS

27TH DEC 2018

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Policy rates to continue, allowing to materialise the impact of last month's hikes

- Unexpected Policy Decision on 14 Nov 2018
  - Contrary to our expectation of an unchanged policy stance, Monetary Board announced a rate hike as they believed a policy intervention is required to address the liquidity shortage thus SRR was reduced by 150bps. As the Monetary Board was of the view of continuation of policy rates and in order to neutralize the impact, SDFR was increased by 75bps and SLFR by 50bps thus narrowing the policy corridor to 100bps. However, we believe that political unrest prevailed during the period and the sovereign maturity in Jan 2019 led the policy rate hike.
- Changes took place during the period;
  - In spite of the reinstating the Prime Minister and subsequent appointment of the Cabinet, the turmoil prevailed in the political front continues as the divergence between the President and the UNF continue to persists.
  - Foreigners have been net sellers from capital markets with LKR 5.7Bn outflow from equity market and LKR 33.4Bn from debt market while USD:LKR weakened by 3% to close at 181.65 on 26 Dec 2018.
  - Amidst the turmoil prevailed in the political front, credit rating agencies Moody's, Fitch and Standard & Poor's downgraded Sri Lanka, citing refinancing risks and an uncertain policy outlook.
  - The overall yield curve experienced a volatility amidst the political uncertainty. However, as the uncertainty eased off with the reinstatement of the Prime Minister, the yield curve experienced a parallel downward shift across all maturities with mid tenure maturities experiencing a steep decline of 23-40bps.
- Unwarranted rate hike in Nov 2018 is expected to address risks associated in the political and economic front. However, with the increase in policy rates in Nov 2018 coupled with Fed signaling the pause of monetary tightening by forecasting two rate hikes in 2019 from previous anticipated 3 hikes, we expect the foreign outflow to moderate and convert into possible inflows beyond 1Q2019 which in turn is expected to reduce the pressure on the LKR. Further, below par GDP growth level and lower credit growth are likely to warrant a rate cut towards the 2Q2019.
  - First Capital Research believes that **policy rate change is not required**.
- Expectations for 2019
  - We are of the view that monetary loosening is likely to take place in 2019 with two rate cuts of 25bps each thus bringing down the policy rates back to the pre Nov 2018 levels.

Expected Monetary Policy Stance

First Capital Research expects the Monetary Board to hold rates, as CBSL's unwarranted rate hike in Nov 2018 is expected to address the relatively lower reserve position of USD 7.0Bn, higher foreign debt repayment that falls during 1Q2019 and the effect of the rating downgrade. However, probability of a rate cut exists beyond 1Q2019 to boost the overly sluggish credit growth and below par GDP growth.

Expected Monetary Policy Stance by CBSL	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	***100%***
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

Reduced from 35% amidst sluggish credit growth and below par GDP growth.

Increase from 65% allowing the impact of rate increase in Nov 2018 to materialize.

Current Policy Rates	
Standing Deposit Facility Rate (SDFR)	8.00%
Standing Lending Facility Rate (SLFR)	9.00%
Statutory Reserve Ratio (SRR)	6.00%

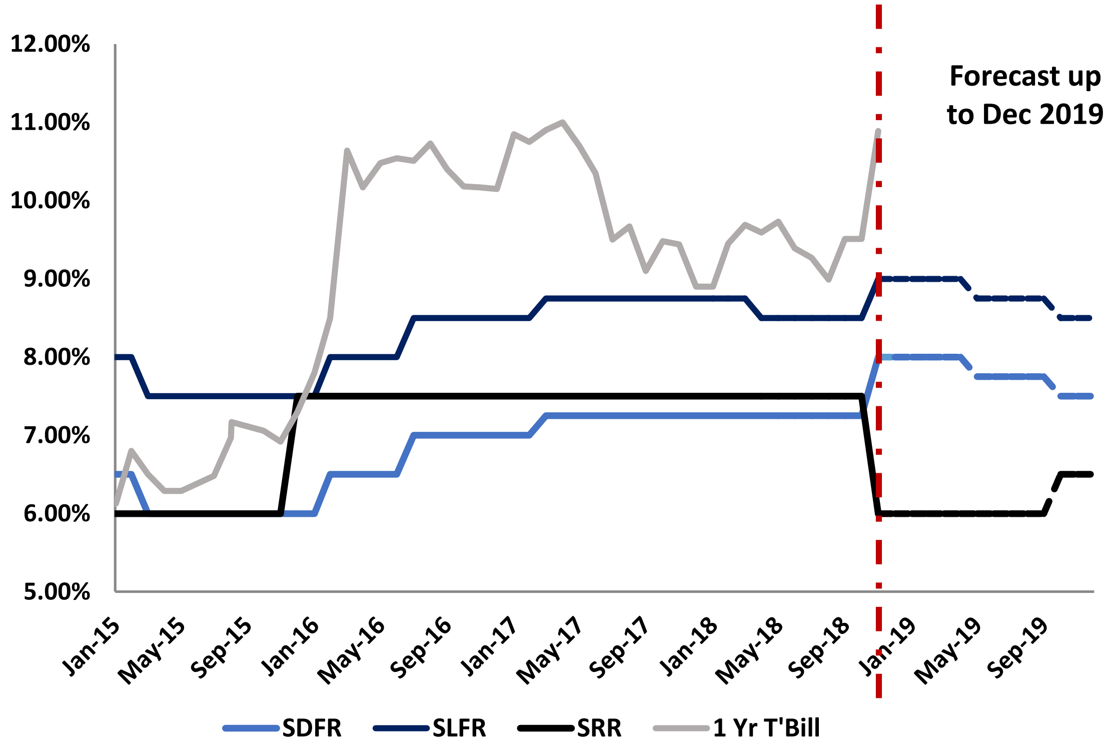
We expect the CBSL to keep Statutory Reserve Ratio (SRR) unchanged at 6.00%

Policy Expectation for 2019

Two rate cuts beyond 1Q

First Capital Research expect monetary loosening to take place in 2019 with two rate cuts of 25bps each starting from beyond 1Q2019. With below par GDP growth of 2.9% for 3Q2018 and 2018 growth rate likely to fall below the CBSL GDP growth rate expectation of 4.0% coupled with relatively lower debt maturities beyond 1Q2019 provide room for rate cuts thus warranting economic expansionary policy measures in 2019.

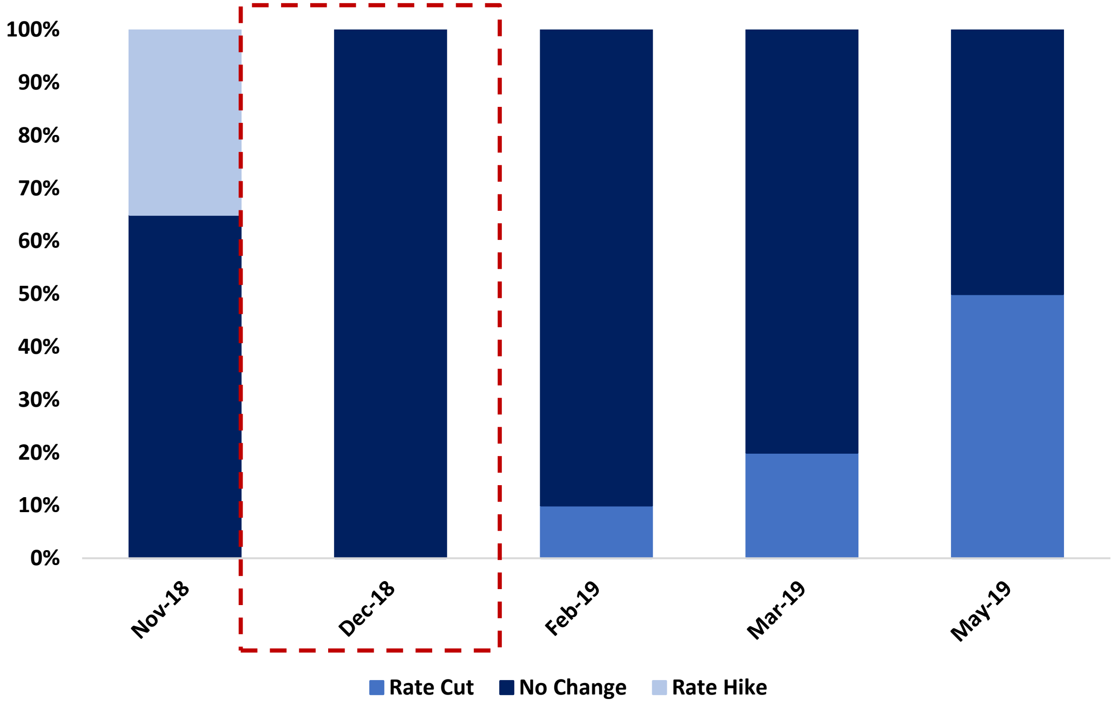
We assume the impact of the policy rate hike which took place in Nov 2018 to materialise during the 1Q2019 thus improving the overly sluggish credit growth and GDP growth levels thereby providing room for the two rate cuts in 2019.



Source : CBSL and First Capital Research Estimates

Graph 1 : Policy Rate Expectations – First Capital Research

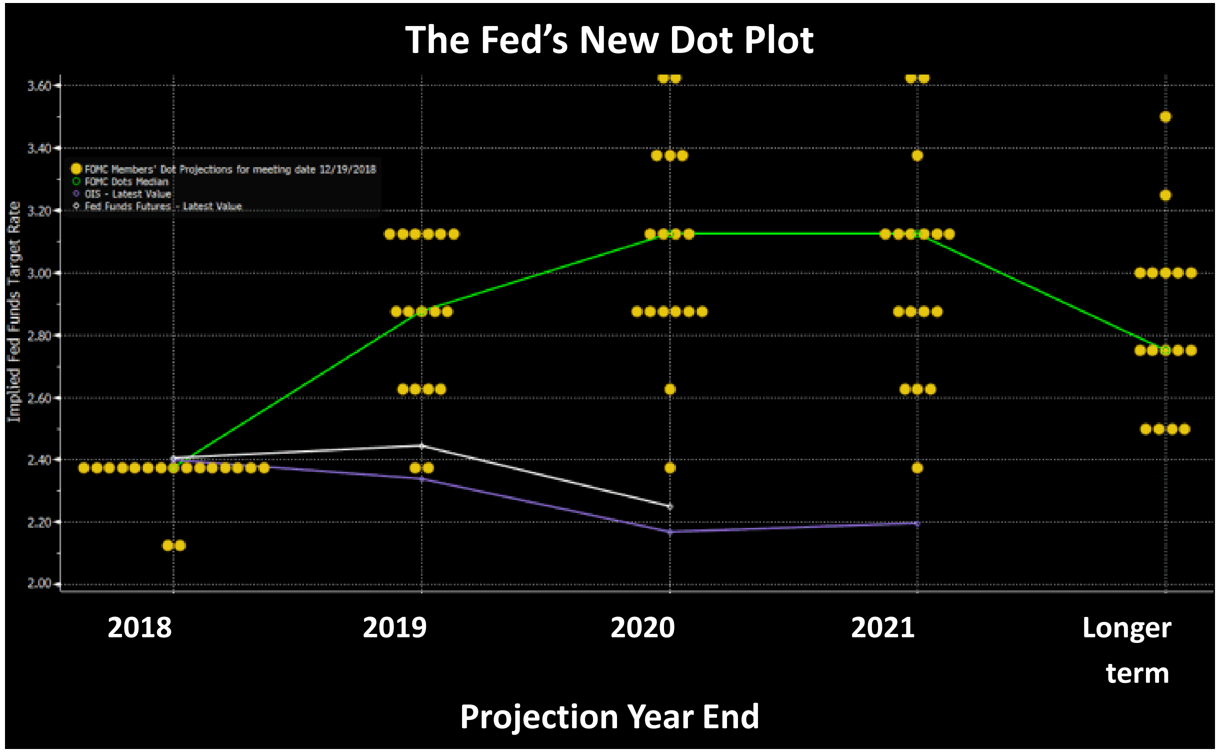
First Capital Research is of the view that a continuation of policy rates is appropriate. However, we recognize an increased probability of 10% for a rate cut beyond 1Q2019, amidst below par GDP growth and sluggish credit growth.



Source: First Capital Research Estimates

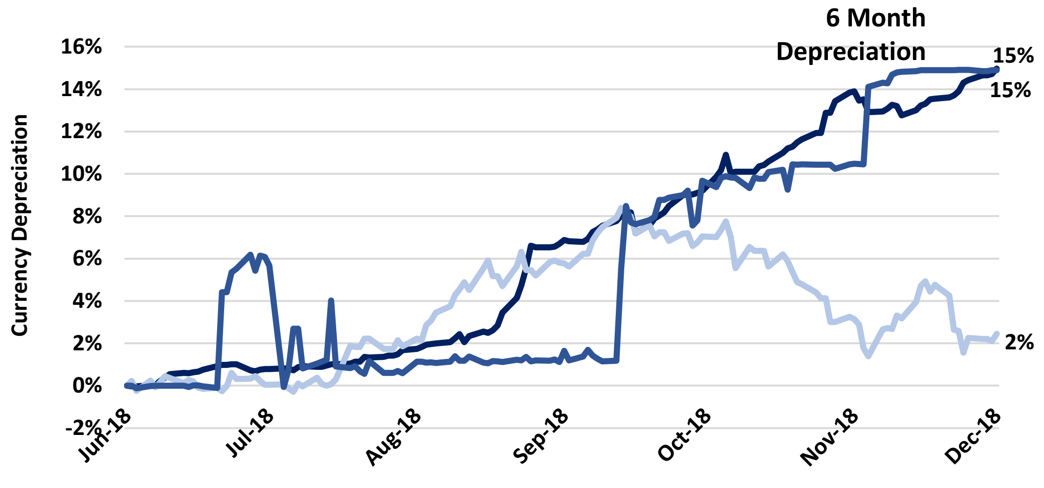
Graph 2 : Fed Rate Hike Expectations – up to 2022

Fed reserve officials raised interest rates for the fourth time in 2018 by increasing the rate by 25bps boosting the benchmark federal rate to 2.50% in Dec 2018. Policy makers signaled they may soon pause their monetary tightening campaign by trimming the number of rate hikes they foresee in 2019, to two from three.



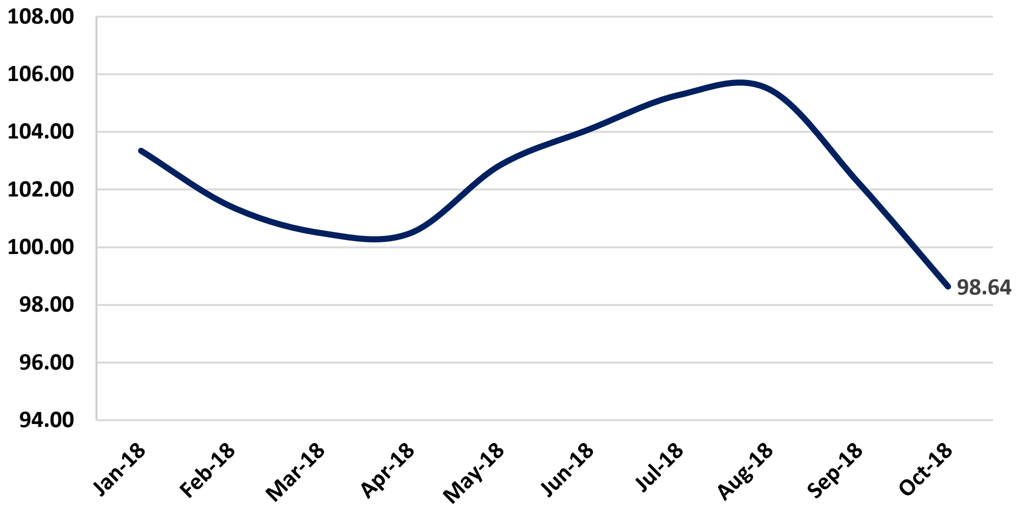
Source: Bloomberg

Graph 3 : LKR, INR and PKR weakened on the back of strengthening of USD



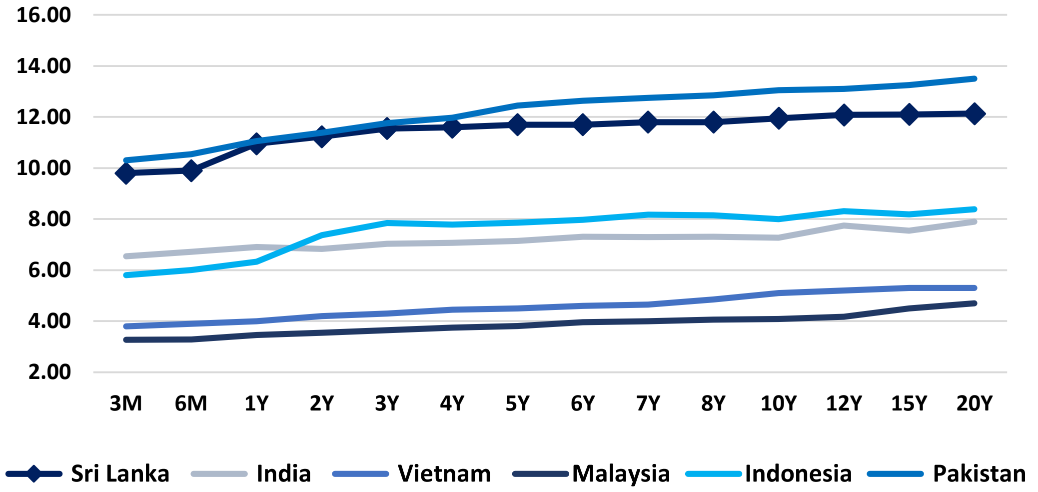
Source: Bloomberg

Graph 4 : Real Effective Exchange Rate reached 98.64 in Oct 2018



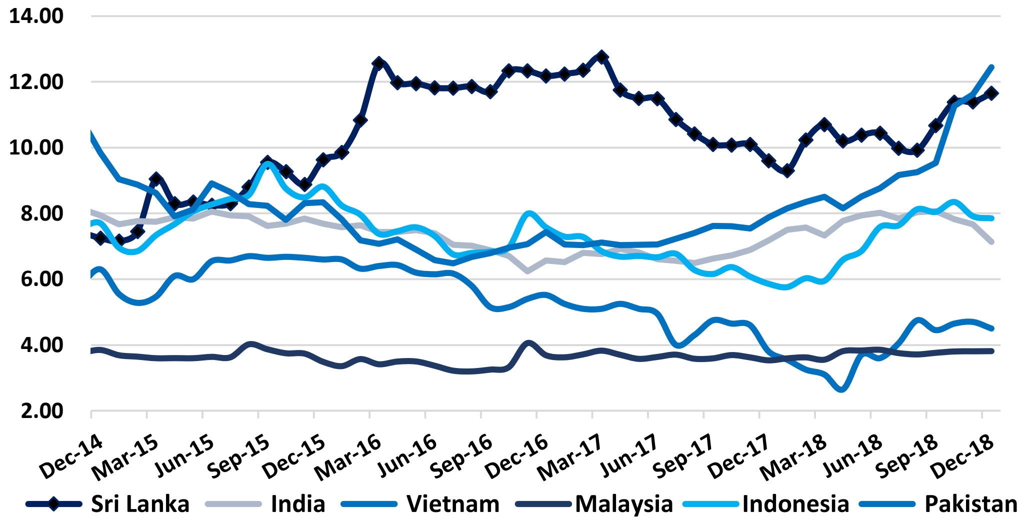
Source: CBSL

Graph 5 : Comparative Yield curve as at Dec 2018



Source: Bloomberg

Graph 6 : Sri Lanka's 5-Yr Bond Yield Premium readjusting



Source: Bloomberg

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