



First Capital

First Capital Research

Inevitable rate cut

PRE-POLICY ANALYSIS

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Rate cut could be inevitable to revive overly sluggish economic and credit growth

Previous Pre-Policy issue; CBSL gives forward looking guidance

- Monetary Board observed that the continuation of the current monetary policy stance is appropriate while providing forward-looking guidance of a possible monetary easing.

Macro economic fundamentals steadily improve

- ❑ CBSL maintaining foreign reserve position above USD 7.0Bn (USD 7.2Bn by end Apr 2019) is noteworthy considering the major outflows in Apr 2019. IMF approved the 6th tranche of USD 164.1Mn while granting a one year extension until June 2020 providing a cushion to country's economy to recover from the recent attacks.
- ❑ Falling below the CBSL credit growth projection of 13.5%, private sector credit growth decelerated at an alarming rate to record a YTD growth of 0.5% during the first quarter leading to a **contraction in financial sector asset base**.
- ❑ USD:LKR continued to strengthen to close at 176.24 on 22 May 2019 supported by foreign remittance conversions and foreign inflows during the festive seasons. However, REER continued to remain undervalued at 94.74 in Mar 2019.
- ❑ A sustained positive liquidity position was created after lapse of 6 months resulting from multiple SRR cuts and government making the long delayed payments providing the ability for CBSL to discontinue daily reverse repo auctions and term reverse repo auctions.

Easter Sunday attack dampens growth prospects

- ❑ Easter Sunday attack is expected to have a detrimental impact on the economy possibly further slowing down the sluggish economy. We expect the recovery would require at least 1-Yr period forcing a downward revision to our 2019 GDP growth projection to below 3.0% from previous 4.3%.
- ❑ First Capital Research allocates a **95% probability for a policy rate cut** in May 2019 as we are of the view that policy intervention is inevitable to revive the overly sluggish economy and credit growth. Despite the Road Map towards a single policy rate, we believe a rate cut in both SLFR and SDFR is more appropriate considering the severity of the situation. However, in the case of a 75bps or a 100bps rate cut consideration, though remote, CBSL may consider a lower cut for SDFR.

Expected Monetary Policy Stance

First Capital Research believes policy intervention is required to revive the overly sluggish GDP growth and protracted slow credit growth. We are of the view that 60% probability exists for a rate cut by 50bps and a lower 20% probability exists for a 75bps cut. In the case of a 75bps or a 100bps rate cut it may only be limited to SLFR as CBSL may consider a lower cut for SDFR.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	5%
Cutting Policy Rates by 25bps	10%
Cutting Policy Rates by 50bps	60%
Cutting Policy Rates by 75bps	20%
Cutting Policy Rates by 100bps	5%

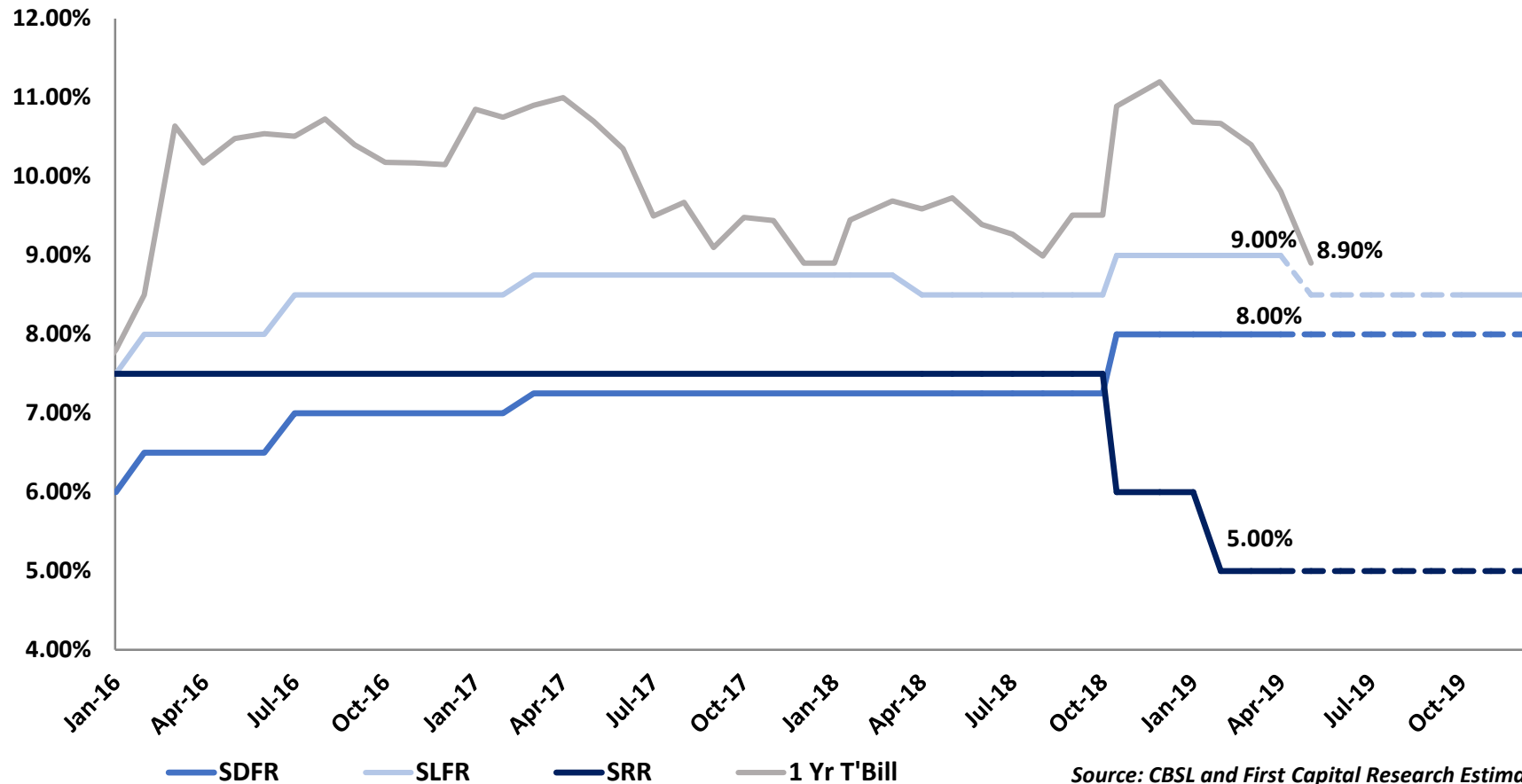
} 95%

Increased to 60% amidst overly sluggish GDP growth and below par credit growth.

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	5%
SRR to remain unchanged	95%
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Reduced by 5% amidst healthy liquidity levels.

Change in FCR policy stance

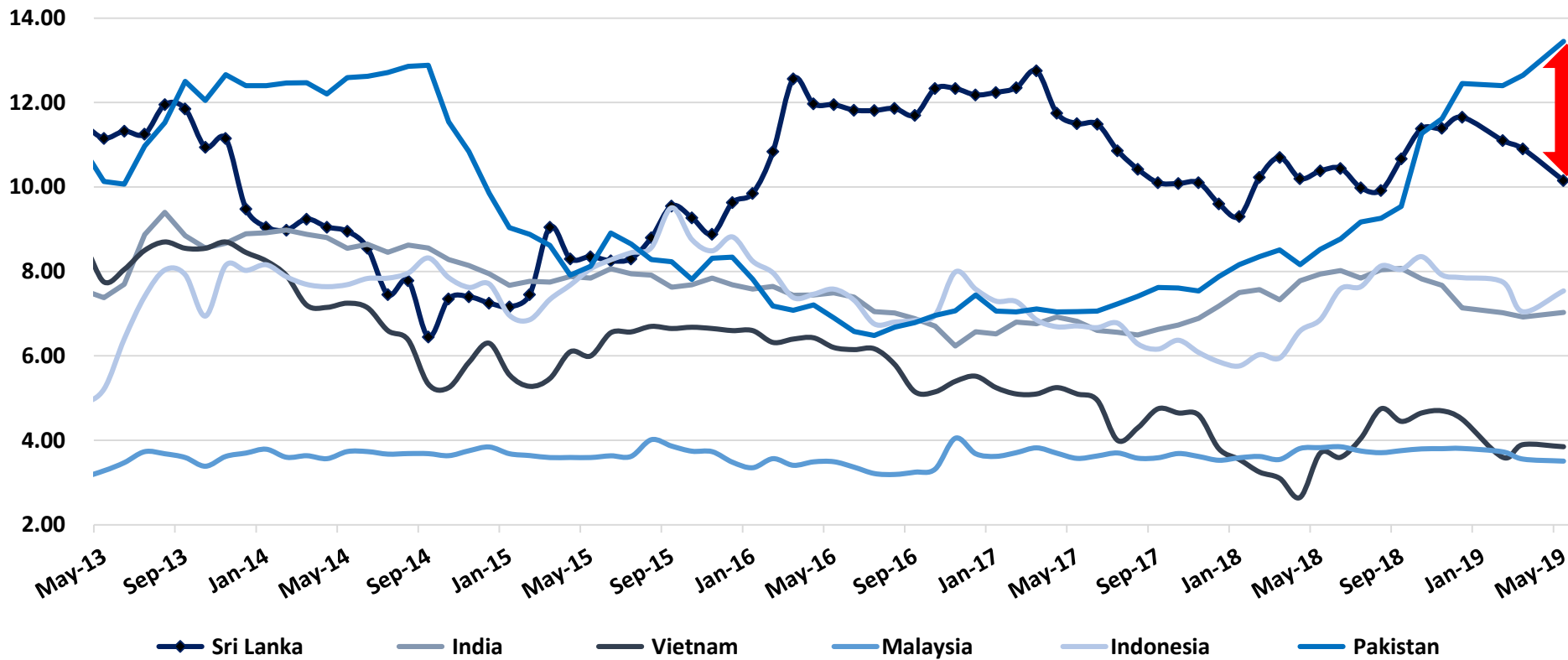


Source: CBSL and First Capital Research Estimates

Change in Policy stance:

In our Strategy Report published in Jan 2019, we forecasted two rate cuts of 25bps each in 2Q and 4Q 2019. However, considering the prevailing status of the overall economy (below par economic growth, contraction in private credit which were further aggravated by the Easter Sunday attacks) permit an immediate policy intervention to revive the economic activities. We believe a SLFR cut of 50bps in May 2019 is warranted by the recent events occurred in the economic front.

Sri Lanka's 5-Yr Bond Yield Premium re-adjusting

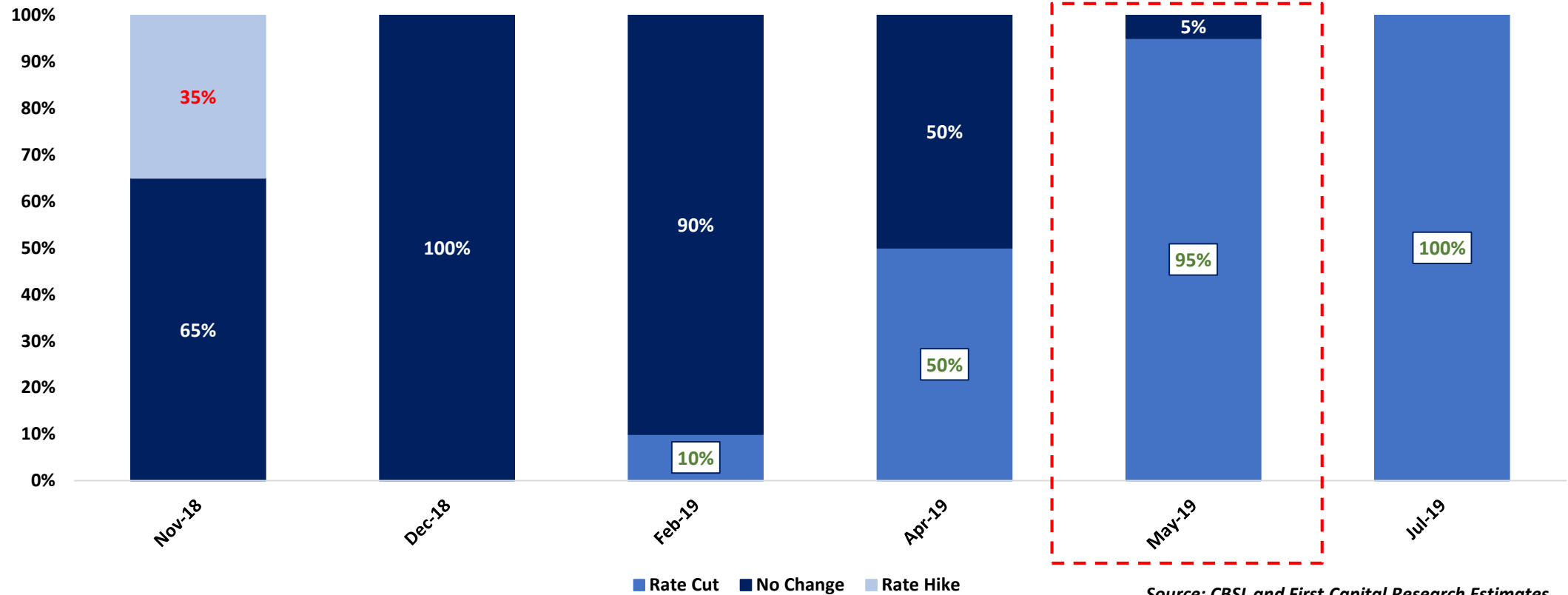


5-Yr bond yield tumbling: Considering the steep depreciation of USD:PKR, inflationary pressure and elevated fiscal deficit, the State Bank of Pakistan (SBP) announced a 150bps hike in policy rates at the 20 May 2019 Monetary Policy Committee meeting resulting in 5-Yr bond yield increasing by 80bps to 13.45% on 22 May. Sri Lanka's strengthened macro economic fundamentals led the yield of 5-Yr bond to decline paving way for a possible policy rate cut.

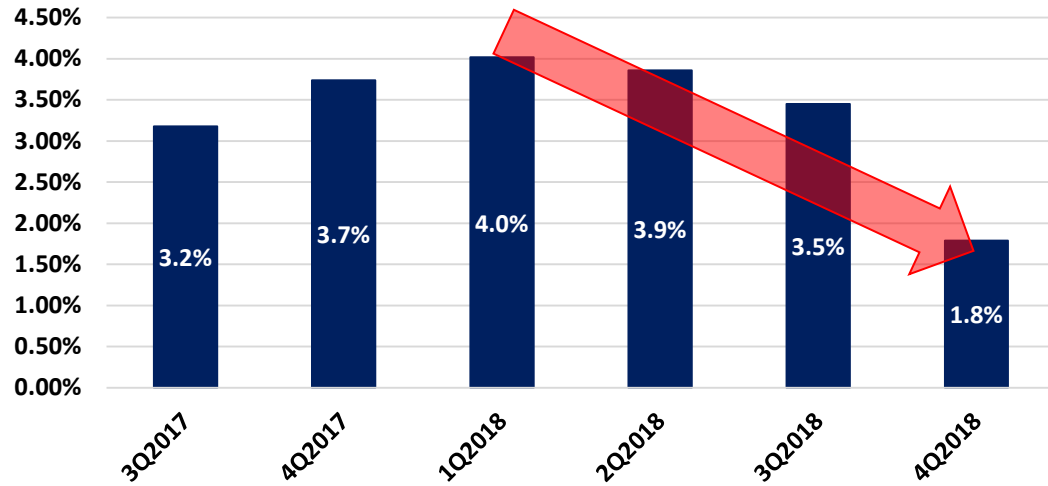
Source: Bloomberg

FCR Policy Rate Forecast – Nov 2018 to Jul 2019

First Capital Research expects a possible rate cut with increased probability of 95% to revive the prolonged below par growth in economic activities and slowdown in credit growth.

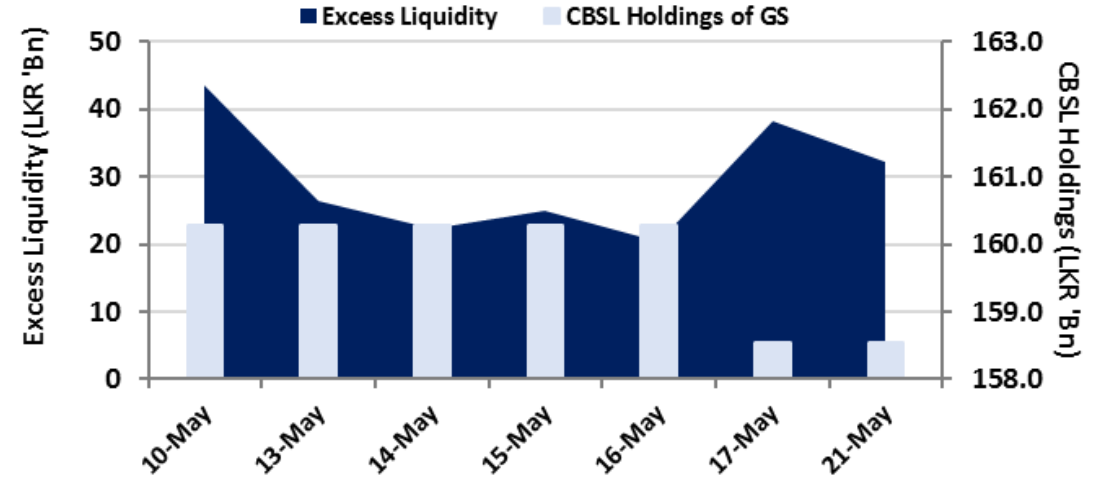


Graph 1 : GDP growth



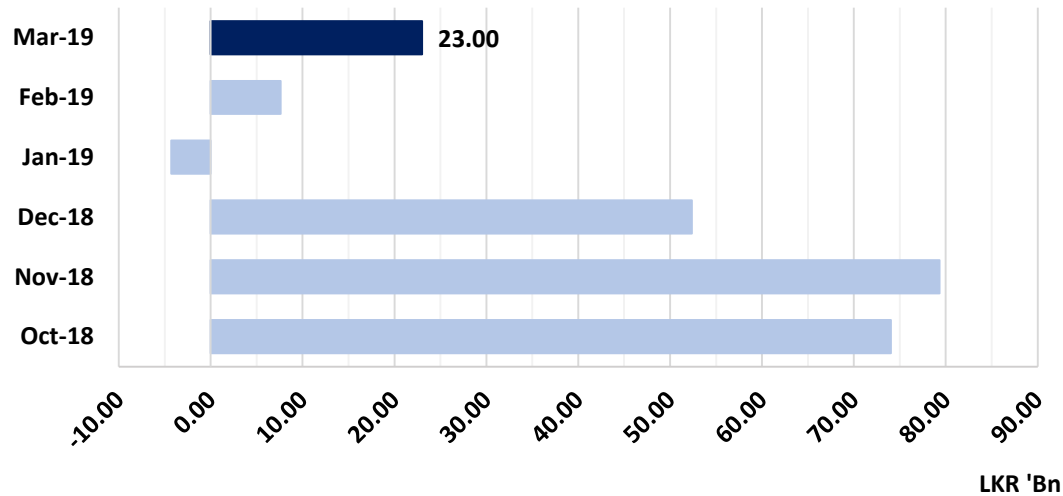
Source: Census & Statistics

Graph 2 : Excess Liquidity and CBSL Holdings of Gov. Securities



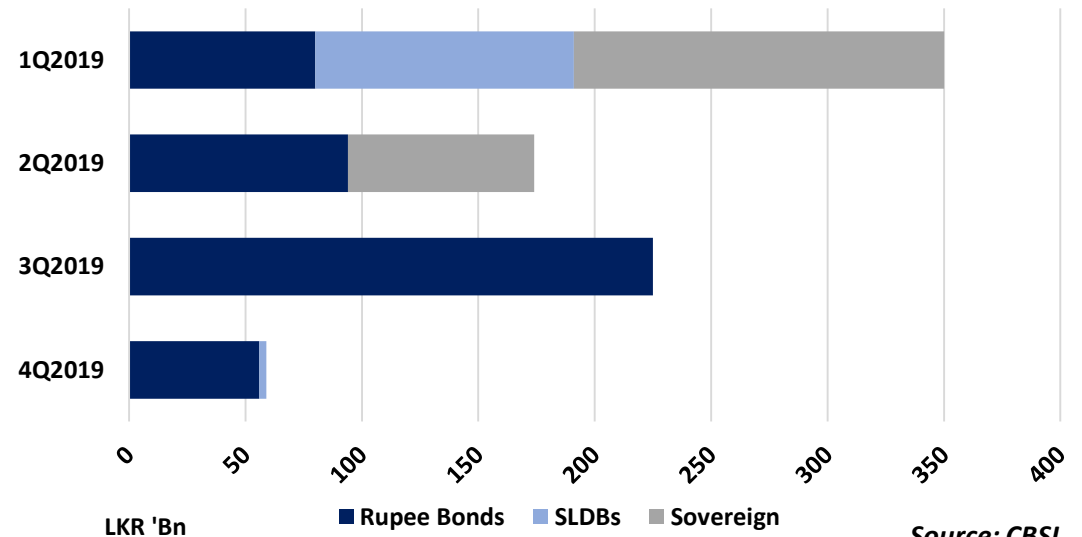
Source: CBSL

Graph 3 : Private Sector Credit (Oct 2018 to Mar 2019)



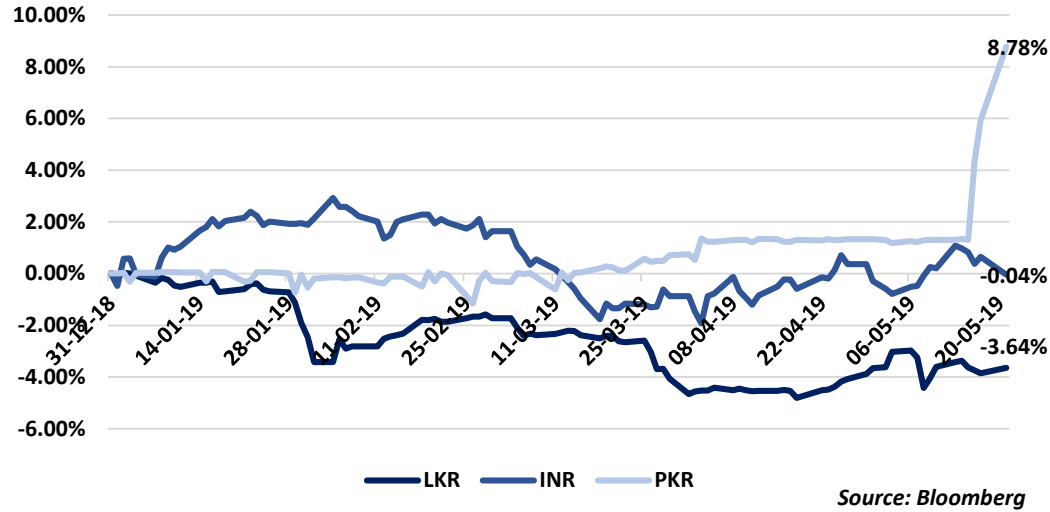
Source: CBSL

Graph 4 : Sri Lanka's Foreign debt repayments – 2019

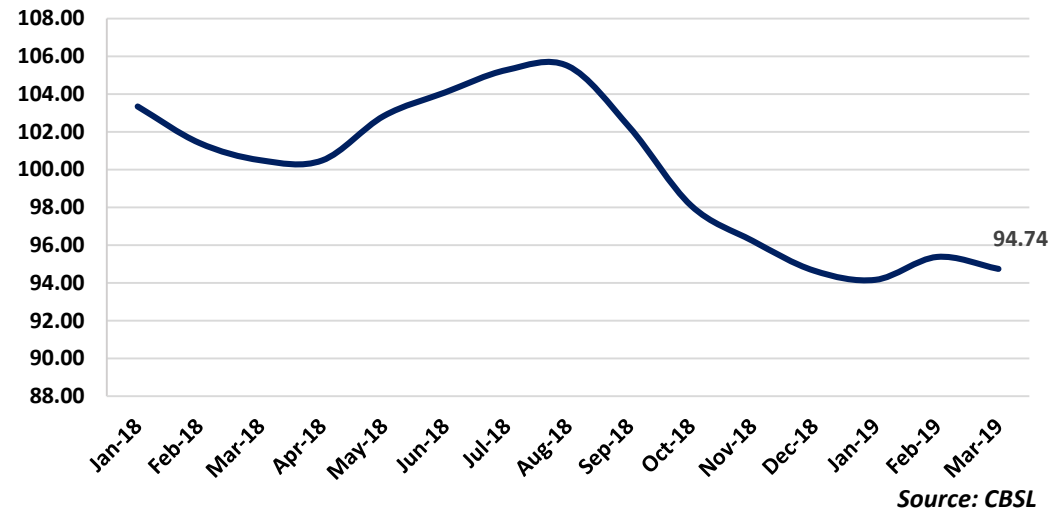


Source: CBSL

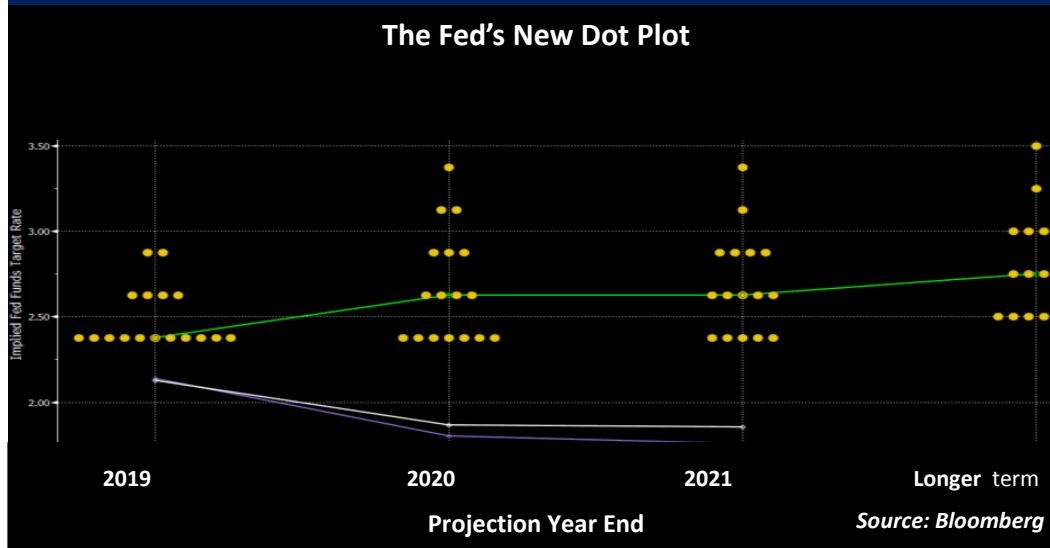
Graph 5 : Notable appreciation in LKR against USD while steep depreciation in PKR and marginal appreciation in INR on a YTD basis



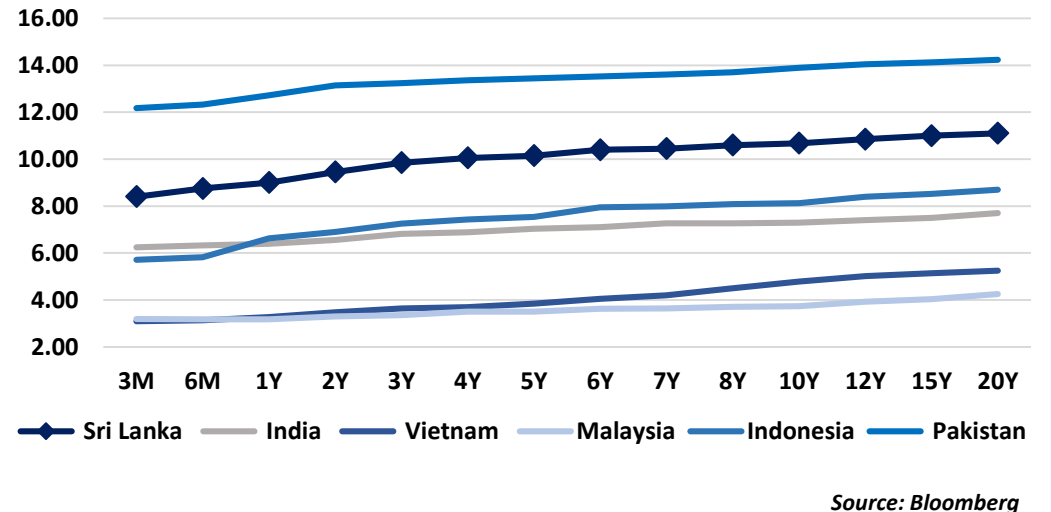
Graph 6 : Real Effective Exchange Rate continued to be undervalued at 94.74 in Mar 2019



Graph 7 : Fed reserve officials decided to keep rates unchanged at the meeting held in Apr 2019



Graph 8 : Comparative Yield curve as at 22 May 2019



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