

Monetary Policy Review: December 2017

Rates on hold; reserves look to end the year in a strong position

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The CB released the December monetary policy review today, where key policy rates were left unchanged since March 2017. SDFR stands at 7.25%, and SLFR at 8.75%. Our key takeaways are: 1) reserves to strengthen further with IMF EFF and H'tota lease payments, 2) credit growth continues to slowdown, and 3) the stabilizing of macro conditions and slow growth sets stage for the loosening of monetary policy in 1Q CY18E. The weak 3Q CY17 GDP growth numbers lead to our growth forecast of 4.0% for CY17E and 4.8% for CY18E. We expect the LKR/USD to be at LKR 155.00 by CY17E, depreciating by 3.5% YoY.

Rates left unchanged; decline in repo signals higher excess liquidity in near term
Key policy rates were left unchanged following the 25bps hike in March 2017. Since then, credit growth has shown a downward trend. The domestic money market weighted average repo rate declined by 8bps since November, coming in at -7.53% in December indicating the use of CB's policy tools to encourage lending by commercial banks. This was 106bps lower YoY compared to the -8.59% repo rate in December 2016.

Credit growth slows down; indicates headroom for loosening monetary policy
Broad money, driven by credit growth declined to 17.9% YoY in November (+19.2% YoY in October 2017). Given the tight policy measures implemented, private sector credit growth declined by 0.8pp to 15.4% YoY in November (+16.2% in Oct '17, +21.9% in Dec '16). Credit to public corporations also declined by 0.6pp to 2.9% in November (+3.5% YoY in Oct '17, -5.3% YoY in Dec '16). The declining trend of credit growth for most of 2017 indicates some headroom for the CB to loosen monetary policy in 1Q CY18E.

Inflation eases from 1-yr high despite high food inflation
Inflation declined by 0.5pp in November to come in at 7.6% YoY. Food inflation spiked up to 13.8% YoY; the highest recorded so far this year. Meanwhile, non-food inflation came in at 5.0% YoY (5.8% YoY in October).

Slowdown in industries, negative agri weighs on 3Q CY17 GDP
3Q GDP came in at a concerningly low 3.3% YoY (+4.0% in 2Q CY17) on the back of moderate growth in both the service and industries sectors combined with the seventh consecutive quarter of negative growth in the agri sector. As such, we revise our GDP growth forecast downward from 4.4% to 4.0% for CY17E and from 5.0% to 4.8% for CY18E.

Outlook - 1) improving macro indicators and a slowdown of credit growth sets stage for a loosening of monetary policy in 1Q CY18E - With 3Q CY17 growth declining by 0.7pp QoQ, together with lower inflation combined with strengthening reserves and a slowdown in credit growth leads to our view that the CB will be in a position to loosen monetary policy in 1Q CY18E.

2) Inflationary pressure to taper down - While we expect food inflation to decline owing to a somewhat normalization in food supply of key food items, we expect food inflation to remain at somewhat elevated levels. This would result in a higher than the 5.8% forecasted rate of inflation for CY17E, breaching the IMF's center point of 5.1% for 2017 but, remaining within the inner band threshold of 6.6% YoY.

3) GDP growth to come in at 4.0% in 2017E - Given the slower than expected 3Q CY17 growth, specially in the construction sector combined with the prolonged negative impact of extreme weather conditions, we expect CY17E GDP growth to come in at 4.0% YoY and CY18E at 4.8% YoY.

4) Reserves to remain strong on Dollar inflows - With the inflow of the fourth tranche of the IMF EFF, first tranche of the H'tota lease payment and USD 1.7bn of net foreign exchange purchases by the Central Bank, we believe reserves will end the year in a stronger than the forecasted level of covering 4.1 months of imports.

Credit growth has slowed down for most of 2017 setting the stage for a loosening of monetary policy in 1Q CY18E

Slow GDP growth signals a loose monetary policy in 1Q CY18E

Summary of Key Economic Indicators

Key indicators	2012	2013	2014	2015	2016	2017E	2018E	2019E
Real GDP growth (%)	6.3	3.4	5.0	4.8	4.4	4.0	4.8	5.0
Headline inflation (%)	7.6	6.9	3.3	2.2	4.0	5.8	5.2	5.1
Core inflation (%)	7.6	2.1	3.2	4.5	4.4	5.2	4.2	5.0
LKR/USD	127.16	130.75	131.05	144.06	149.75	155.00	160.00	165.80
Depreciation (%)	11.6	2.8	0.2	9.9	3.9	3.5	3.2	3.6
Unemployment (%)	4.0	4.4	4.3	4.7	4.4	4.5	4.5	4.3
12M government bond yield (%)	11.70	8.30	6.00	7.30	10.17	9.60	8.90	9.00
Fiscal balance (% of GDP)	-5.5	-5.4	-5.7	-7.6	-5.4	-5.1	-4.7	-4.5
Trade balance (% of GDP)	-13.8	-10.2	-10.4	-10.4	-11.2	-11.7	-11.5	-11.3
Current balance (% of GDP)	-5.8	-3.4	-2.5	-2.3	-2.4	-2.5	-2.6	-2.5
FX reserves (months of imports)	5.4	5.0	5.1	4.6	3.7	4.1	4.4	4.5
Debt/GDP (%)	68.7	70.8	71.3	77.6	79.3	79.2	78.6	78.0
Foreign debt (% of total debt)	31.7	30.9	30.0	32.4	34.2	33.4	30.4	31.5

Source: CBSL, DoCS, MoF, Asia Securities | E: Baseline estimate Note: Historical data have been amended to reflect latest CB report

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