

# Monetary Policy Review: November 2017

## Rates on hold; stage set for loosening monetary policy in 1Q CY18E

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The CB released the November 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 remain strong at ~4.5 mts of imports, 2) credit growth continues to slowdown, and 3) the stabilizing of macro conditions sets stage for the loosening of monetary policy in 1Q CY18E. We expect GDP growth in the second half of CY17E to be somewhat stronger than 1H CY17 and thereby maintain our CY17E GDP growth forecast of 4.4% YoY and 5.0% for CY18E while the CB's aggressive stance on strengthening reserves lead us to forecast reserves to cover 4.1 months of imports by December. 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 17bps since September, coming in at -7.86% in October indicating the use of CB's policy tools to encourage lending by commercial banks. This was 94bps lower YoY compared to the -8.08% repo rate in October 2017.

**Credit growth slows down; indicates headroom for loosening monetary policy**  
Broad money, driven by credit growth remained flat at 20.3% YoY in September (+21.3% YoY in August 2017). Given the tight policy measures implemented, private sector credit growth declined by 0.5pp to 17.5% YoY in September (+18.0% in Aug '17, +20.4% in Dec '16). Credit to public corporations also declined by 3.9pp to 10.0% in September (+13.9% YoY in Aug '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.

**CCPI picks up as food inflation peaks to 12-month high**  
Inflation picked up by 0.7pp in October to come in at 7.8% YoY (7.1% YoY in September). Food inflation spiked up to 12.6% YoY the highest recorded so far this year. Meanwhile, non-food inflation increased to 5.8% YoY (5.5% YoY in Sept). We expect food inflation to taper down in the coming months owing to a somewhat normalization in food supply of key food items.

**GSP+ helps apparels while fuel demand dampens trade balance**  
The trade balance continued to widen, recording a 12.2% YoY growth for 8M CY17. The positive impact of the reinstatement of GSP+ was evident with garment exports to the EU improving by 12.2% YoY, contributing ~68.0% towards the growth of garment exports. For 8M CY17 imports grew by 9.6% YoY, with refined petroleum imports increasing by 54.0% YoY. Gross official reserves were at USD 7.5bn by October, covering ~4.5 months of imports. We note that on average, USD 90mn of foreign inflows into Government securities have also helped boost reserves during the month.

**Outlook - 1) improving macro indicators and a slowdown of credit growth sets stage for a loosening of monetary policy in 1Q CY18E**- With 2Q CY17 growth improving by just 0.2pp QoQ, together with lower inflation combined with strengthening reserves and a slowdown in credit growth leads to our view that the CB will keep rates on hold in December and set the stage for a loose monetary policy in 1Q CY18E.

**2) Inflationary pressure to taper down 2017E** - The shortfall of rice supply combined with the seasonality impact in December leads us to our forecast of 5.8% YoY for 2017E, 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 4.4% in 2017E** - We maintain our forecast for 2017E from at 4.4%, while we expect 3Q CY17 GDP growth to come in at a stronger 4.6% compared with the 4.0% recorded in 2Q CY17.

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

*The reinstatement of GSP+ was evident with garment exports to the EU*

## 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	4.4	5.0	5.3
Headline inflation (%)	7.6	6.9	3.3	0.9	4.0	5.8	4.5	5.2
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	149.80	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 (%)	12.30	8.87	5.99	7.30	10.17	10.00	9.24	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)	(11.6)	(11.6)
Current balance (% of GDP)	(5.8)	(3.4)	(2.5)	(2.3)	(2.4)	(2.5)	(2.3)	(2.0)
FX reserves (months of imports)	5.4	5.0	5.1	4.6	3.7	4.1	4.4	4.7
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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