

Monthly Economic Update

Economy at a glance for May 2020

A month with a mild recovery

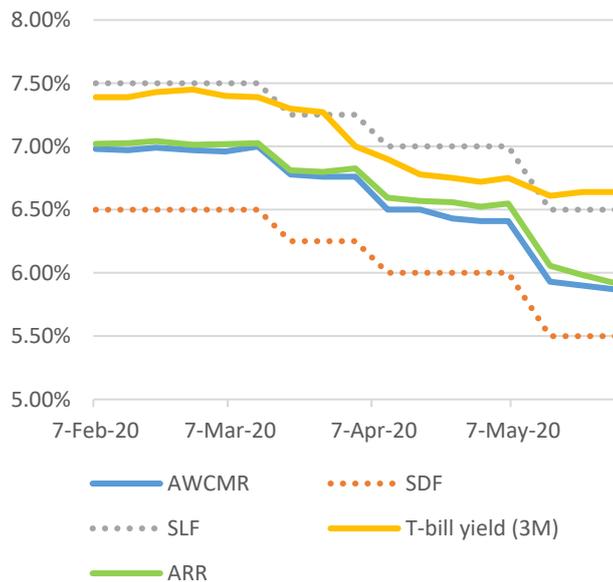
Highlights

- The activities in the economy, especially the industry and services sector, improved marginally in May. However, the economy was still operating with excess capacity.
- CSE resumed trading on 11th May. ASPI rose 6% during the month, more as a correction from the steep fall witnessed earlier as investors picked up undervalued stocks. Foreign participation in the equities was mild and foreigners were net sellers.
- Data indicates the CCPI has declined to 4% in May, which is now on the lower bound of the CBSL's inflation target.
- After almost 4 months of consecutive foreign capital outflows, in the last week of May debt market reported its first major weekly inflow. Rupee demonstrated a steady appreciation of about 4% throughout the course of the month helped by weaker imports. However, the reserve position deteriorated by USD 716 Bn mainly as a result of foreign currency loan payments.
- Higher excess liquidity levels that prevailed during the previous month started to gradually decline throughout May. Money supply decreased by nearly LKR 22 Bn mainly on account of maturing long-term reverse repos issued in April and first half of May. Policy rate cut by the CBSL further eased the interest rates in the money markets.
- The long-term rates also declined but, the spread between T-bill and AWPR widened marginally and was still higher than the pre-crisis level indicating the risk appetite of banks had not improved despite the efforts by the CBSL to maintain excess liquidity in the money markets.

Interest Rates

Short-term rates

Figure 1: Treasury bill yield and money market rates



Notes: AWCMR- Average Weighted Call Money Rate, SDFR- Standing Deposit Facility Rate, SLFR- Standing Lending Facility Rate, T-bill yields are for the secondary market, ARR – simple average of daily repo rates

Source: CBSL

Higher excess liquidity levels that prevailed during the previous month started to gradually decline throughout May. The outstanding liquidity stood at LKR 45 Bn by the end of the month. Liquidity injections were conducted mostly through short-term reverse repo auctions. The CBSL bought close to LKR 19 Bn (LKR 12.75 Bn via outright auctions) government securities during the month leading to permanent increase in money stock by the same amount. This was set off by the decrease in reserve money (i.e. currency in circulation and deposits held by the commercial banks) in the last two weeks of May by nearly LKR 22 Bn mainly as a result of maturing long-term reverse repos issued in April and first half of May. In addition, if the CBSL has sold its forex reserves to defend the currency, that would also lead to a crunch in money supply. But no reserves were sold in May.

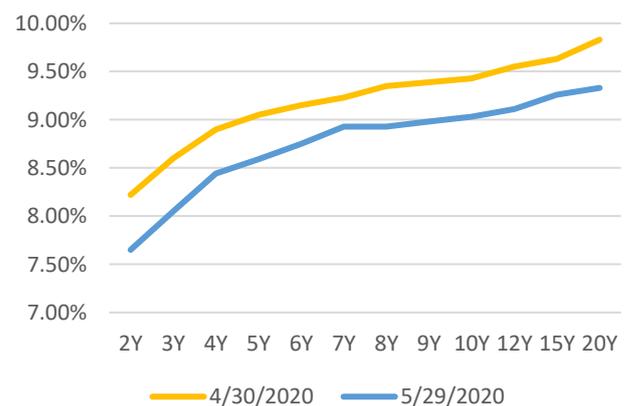
The CBSL reduced the policy rates by 50 basis points on 7th May (i.e. SDF- 5.50% & SLF- 6.50%), which is now the lowest policy rates ever recorded

in the history of the CBSL. Call and repo rates dropped appreciably. Both rates displayed little volatility following the rate cut. Repo rates are generally lower than call rates as repos are secured instruments but on and off during the past the trend has flipped. Currently, repo rates are higher than call rates and this streak began in the early part of January 2019. The spread between call and repo rates narrowed towards the month end. Both call and repo volumes improved compared to April but repo volumes (i.e. market liquidity) were still significantly below the pre-crisis levels for reasons unclear.

The transmission of the policy rate cut was about 10+bps immediately in the secondary T-bills market while the same in the primary market was weaker. Towards the end of the month it was observed that the primary and secondary market rates were converging. However, 3-month T-bill yields drifted away from the call rates maintaining a notable spread. Primary and secondary market volumes improved compared to April with a healthy demand for T-bills in the primary market. Following the rate cut the bid-ask spread narrowed indicating sufficient market liquidity for T-bills.

Long-term rates

Figure 2: Yield curve of treasury bonds



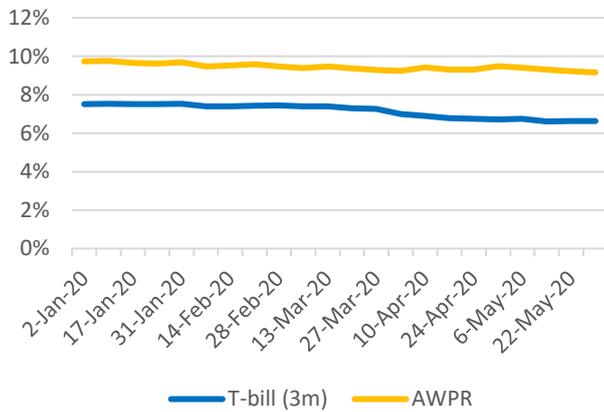
Source: First Capital Research

The CBSL held one bond auction in May and was oversubscribed, but only a fraction of the offered amount was accepted.

The secondary bond market activities somewhat improved compared to April. The yield curve shifted down across all maturities (mid tenor by 30-57 bps

and long tenor by 40-50 bps) as a result of the policy rate cut. The market liquidity, as reflected by the bid/ask spreads, is about on par with the pre-crisis level.

Figure 3: Secondary market T-bill yields and AWPR

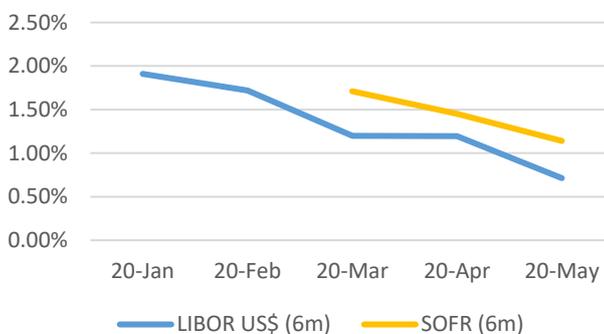


Source: CBSL

Data show weaker credit demand from private sector in April. AWPR remained at upper single digit levels and continued to steadily decline in May (by 13 bps). However, the spread between T-bill and AWPR widened marginally and was still higher than the pre-crisis level indicating the risk appetite of banks had not improved in May despite the efforts by the CBSL to maintain excess liquidity in the money markets. Subdued loan growth of the NBFIsector, which is likely to extend over the short term to medium, will provide some comfort from a liquidity point of view, for the finance companies.

Read report on the [NBFISector Outlook](#)

Figure 4: Month open international lending rates



Notes: The SOFR Averages are compounded averages of the SOFR over rolling 180-calendar day periods.

Source: New York Federal Reserve and global-rates.com

US treasury yields jumped in mid-May on the back of COVID-19 vaccine optimism [1]. As a result, yield differential between US 3m T-bill and LKR 3m T-bill declined marginally

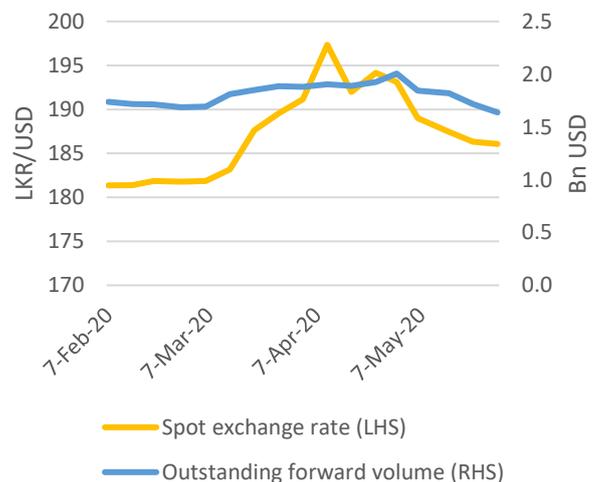
With Fed funds rate hitting almost the rock-bottom, LIBOR US\$ rates continued to decline. SOFR, its replacement rate following the LIBOR phase out in 2021, has also declined gradually. Some experts have warned that the pandemic may raise the cost of the LIBOR fallback when the transition takes place [2].

Read report on the [implications of LIBOR transition for Sri Lanka](#).

The interest rates on SLISBs has mostly remained steady in May. S&P Global Ratings lowered Sri Lanka's long-term sovereign credit rating to B from B+, with a stable outlook, citing a significant erosion in the country's political settings, deteriorating external financing conditions and reduced prospects for reform on 21st May [3]. Subsequently, the yields increased by about 2 to 3 pps.

External Sector

Figure 5: Exchange rate and outstanding forward volume



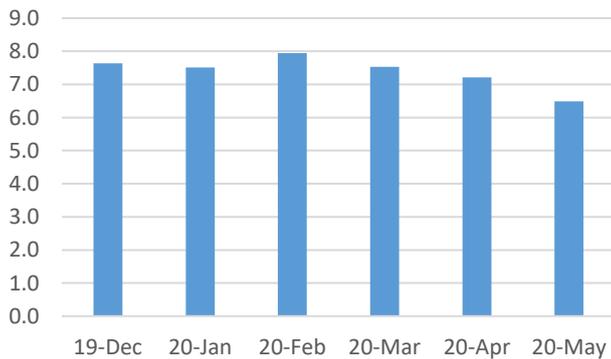
Source: CBSL

Exports recorded 42% (Y-o-Y) decline in March while imports fell by 30% for the corresponding period. In April, the worker remittances recorded a decline of 9% compared to the corresponding month of the previous year. Tourist earnings for April was nil. However, rupee demonstrated a

steady appreciation of about 4% throughout the course of the month helped by weaker imports. The CBSL intervened to purchase forex to stop rupee from further appreciating. With the expectation of stability and the strengthening of the exchange rates, the outstanding forward volumes were seen declining. One-month forward rate that prevailed towards the month end was almost flat while 3-month forward rate indicated a slightly weaker rupee. Interbank forex volumes were modest for the month.

In the first week of May, foreigners sold close to LKR 1 Bn government securities following the sovereign downgrade by Fitch in late April. But in the last week, close to LKR 400 Bn flew back in. This is the first major weekly inflow by foreigners after almost 4 months of consecutive capital outflow from the debt market. Foreign participation in the equities was mild and foreigners were net sellers.

Figure 6: Gross official reserves (Mn USD)

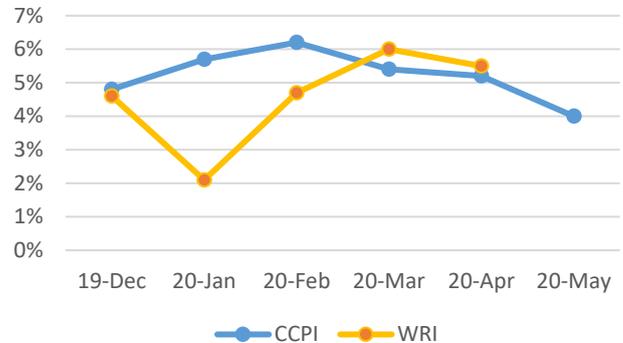


Source: CBSL

The reserve position deteriorated by USD 716 Bn in May mainly as a result of foreign currency loan payments. For May the expected outflows due to loans were USD 979 Mn. Sri Lanka has USD 912 Mn foreign currency obligations for next 3 months (June to August).

Prices & Wages

Figure 7: CCPI and Wage Rate Index of the informal private sector (Y-o-Y)



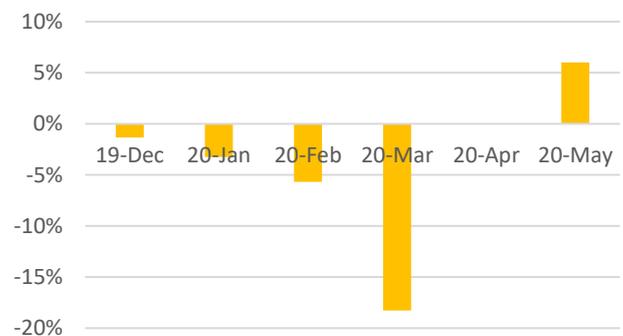
Notes: WRI (100=2012), CCPI (100=2013)
Source: CBSL

Wage growth decelerated in April as economic activities came to a grinding halt due to COVID-19. With the expected increase in unemployment induced by the COVID crisis, the wage growth can further reduce June.

Data indicates the CCPI has declined to 4% in May, which is now on the lower bound of the CBSL's inflation target. CSD has suspended fieldwork for data collection and is currently compiling data based on online sources or by phone from alternative data sources. Data show, the growth in prices of food items slowed down significantly in May, while non-food items also indicate a minor slowdown.

Equities

Figure 8: ASPI (M-o-M)



Source: CSE

CSE resumed trading on 11th May. ASPI rose 6% in May as market corrected from the steep fall witnessed before it was closed as investors picked up undervalued stocks. Almost all sector shares gained, with Telcos leading.

Figure 9: ASPI sector performance

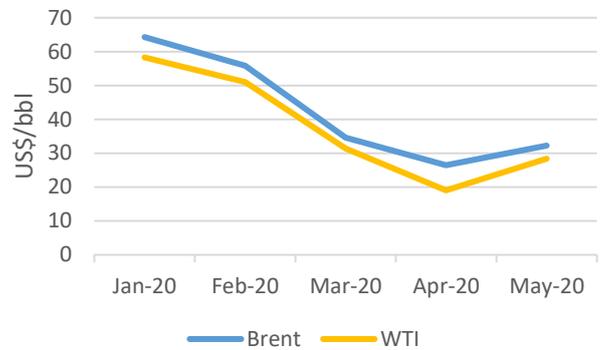
Sector	Index Points Gain
Telecommunication Services	143.14
Commercial & Professional Services	119.08
Transportation	100.36
Automobiles & Components	91.15
Materials	88.38
Health Care Equipment & Services	78.52
Utilities	78.31
Retailing	78.19
Consumer Durables & Apparel	76.15
Diversified Financials	75.37
Household & Personal Products	64.67
Insurance	39.20
Real Estate	35.88
Food & Staples Retailing	35.07
Food, Beverage & Tobacco	26.32
Energy	23.87
Capital Goods	21.39
Banks	15.38
Consumer Services	05.45
Pharma, Biotechnology & Life Sciences	0

Source: CSE

In the global front, Stocks rallied in May, fueled by a supportive Federal Reserve, expectation of re-opening, and reported progress on a COVID-19 vaccine. Key exchanges in European markets except UK's FTSE100, were buoyant. Emerging markets were mostly optimistic. However, India's Sensex and China's Hang Seng deteriorated.

Commodities

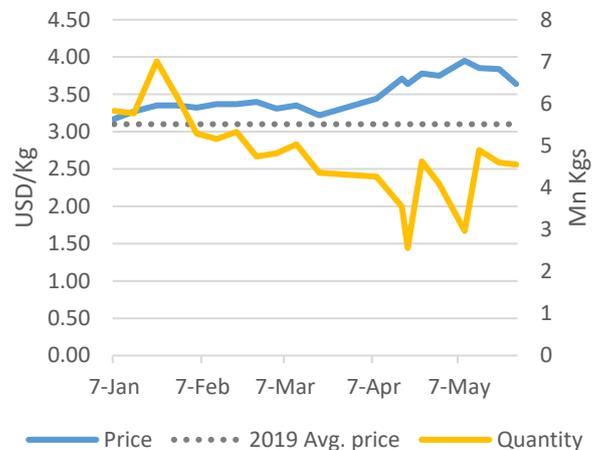
Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

Crude oil prices rebounded marginally in May. Historically low oil price has helped Sri Lanka to bring the import bill down. In the meanwhile, it could also help CEB and CPC to improve their balance sheets.

Figure 11: Tea (All Elevations) price and quantity sold at weekly auctions



Source: Forbes & Walker

Tea prices slipped, but remained above the last year average. Supply was steady averaging just over 4 Mn Kgs per auction.

Figure 12: Coconut price and quantity sold at weekly auctions



Source: CDA

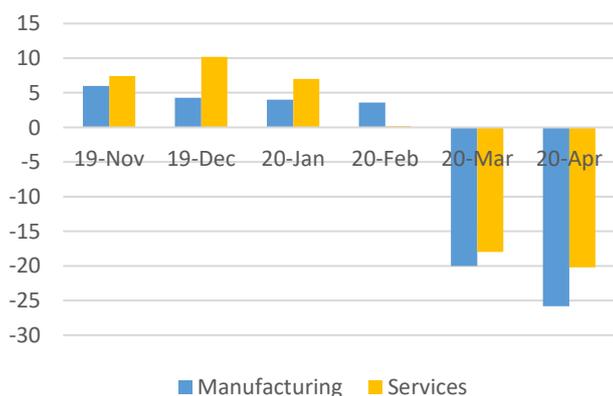
Coconut prices remained buoyant supported by strong demand. However, in the last auction for May, only 44% of the quantity offered was sold.

Key base metal prices are currently at their 2 year lows but the prices show a steady increase in May. This will have some cost implications for the construction sector.

Read the report on [Construction Sector Outlook](#).

Real Sector

Figure 13: PMI deviation from point of neutrality (Index points)

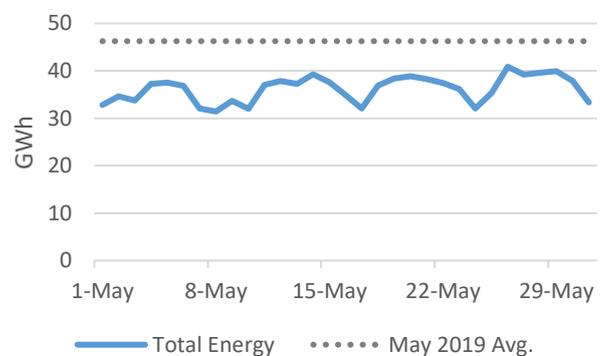


Notes- negative values indicate sector is generally contracting on a month-on-month basis while positive values indicate the sector is expanding. The strength of contraction or expansion is manifested by the magnitude of the figure.

Source: CBSL

The COVID-19 induced downturn in the Sri Lankan manufacturing and services sector deepened during April marking the lowest index values on record. Employers were seen cutting down and freezing temporary/casual jobs as they were operating below the capacity. Apparel manufacturers experienced low orders from US and European clients. In addition, as the manufacturers experienced longer lead-times due to delay in shipments and local logistics. The leisure/tourism industry grounded to a halt as travel restrictions were imposed. Trade sector was also affected due to import restrictions.

Figure 14: Daily power generation



Source: CEB, PUCSL

The activities in the economy, especially the industry and services sector, improved marginally in May as evident by increasing power demand. However, the economy was still operating with excess capacity. In this backdrop, ICRA Lanka expects the real GDP of Sri Lanka in Q2 to record a contraction of around 4.5%.

Read report on [the economic impact of COVID-19](#).

Outlook for June

The activities in the real economy are expected to continue to pick up. Both short and long-term interest rates are likely to remain low, amidst weaker credit demand. Rupee is likely to display stability as forecasted by the forward rates. Wage growth may slowdown. In this context, inflation is likely to be well within 4 to 6%.

Rating Actions

Following rating actions were taken by ICRA Lanka during the month of **May**. Visit <https://www.icralanka.com/ratings/> to read the rating rationales.

Issuer	Issue	Action	Previous Rating	Current Rating
Commercial Leasing and Finance PLC	Issuer rating LKR 5,000Mn listed senior unsecured redeemable debenture	Reaffirmed, rating watch with developing implications removed	A (Under watch with developing implications)	A (Stable)
LOLC Finance PLC	Issuer rating	Reaffirmed, rating watch with developing implications removed	A (Under watch with developing implications)	A (Stable)
LOLC Finance PLC	LKR 3,500Mn listed senior unsecured redeemable debenture	Reaffirmed, rating watch with developing implications removed	A- (Under watch with developing implications)	A-(Stable)
LOLC Holdings PLC	Issuer rating LKR 5,000Mn listed senior unsecured redeemable debenture LKR 2,000Mn listed senior unsecured redeemable debenture	Reaffirmed, rating watch with developing implications removed	A (Under watch with developing implications)	A (Stable)
LOLC Holdings PLC	LKR 1,000Mn commercial papers	Reaffirmed, rating watch with developing implications removed	A1	A1
LOLC Development Finance PLC	Issuer rating	Reaffirmed, rating watch with developing implications removed	A- (Under watch with developing implications)	A-(Stable)

Abbreviations

bps	Basis points
CBSL	Central Bank of Sri Lanka
CDA	Coconut Development Authority
CSD	Census and Statistics Department
CPC	Ceylon Petroleum Corporation
SLDB	Sri Lanka Development Bonds
SLISB	Sri Lanka International Sovereign Bonds
SOFR	Secured Overnight Financing Rate
PMI	Purchasing Managers Index
PUCSL	Public Utilities Commission of Sri Lanka
pps	Percentage points

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- [3] S & P Global Ratings, "S&P downgrades Sri Lanka with stable outlook," S & P Global Ratings, 21 May 2020. [Online]. Available: <https://www.spglobal.com/marketintelligence/en/news-insights/trending/22vlck1jcctxqwu-rayepq2>.

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