ICRA LANKA

June 2020

Monthly Economic Update

Economy at a glance for June 2020

Recovery continues

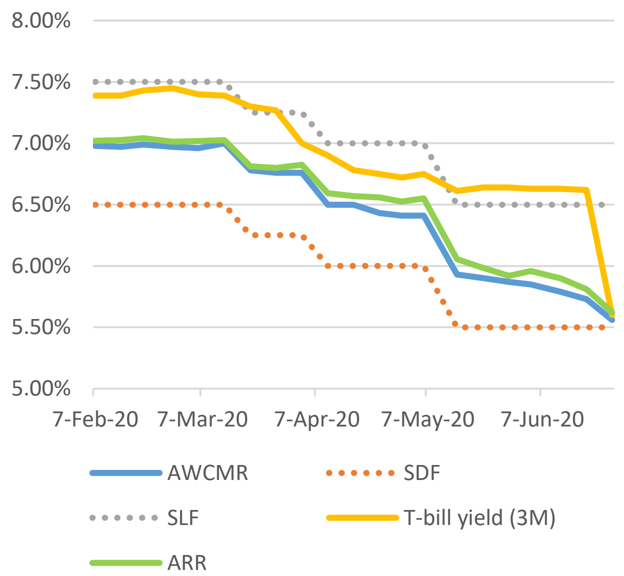
Highlights

- The activities in the economy, especially the industry and services sector, further improved in June as evident by increasing power demand which is almost on par with June 2019 average.
- Sri Lanka achieved a trade surplus in June because of the import controls, helped by modest level of exports (USD 1.02 Bn) almost on par with June last year.
- In the first two weeks of June, excess liquidity gradually started to build up and the CBSL's SRR cut (200 bps) on 16th caused the outstanding overnight market liquidity to spike to LKR 196 Bn immediately.
- Rupee started appreciating in the first half of the month, which helped the CBSL to accumulate forex reserve. But subsequent to the SRR cut rupee gradually depreciated which was later moderated by the CBSL intervention.
- Defying the earlier expectations of modest inflation during the aftermath of COVID-19 pandemic, the data indicates the CCPI has declined to 3.9% (Y-o-Y) amidst falling aggregate demand in June, which is now below the lower bound of the CBSL's inflation target.
- The SRR cut and strengthening of rupee triggered a foreign outflow close to LKR 2 Bn in the last two weeks of June.
- The reserve position improved by USD 193 Mn in June mainly as a result of increase in foreign currency reserves (USD 427 Mn) owing to rupee-dollar swap and purchase of dollars from the forex market.

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

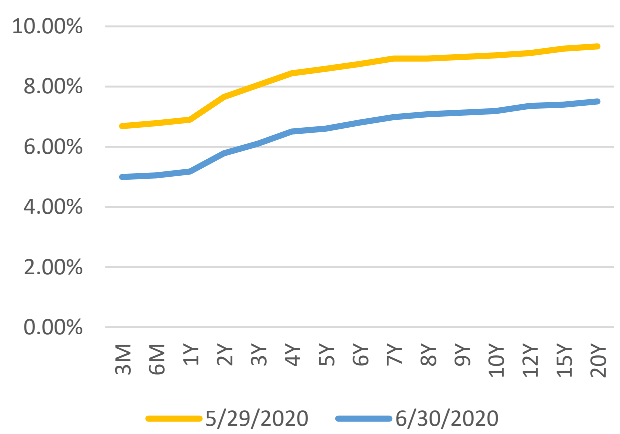
In the first two weeks of June, excess liquidity gradually started to build up and the CBSL's SRR cut (200 bps) on 16th June caused the outstanding overnight market liquidity to spike to LKR 196 Bn immediately. Nevertheless, by the end of the month the outstanding liquidity moderated to LKR 170 Bn. Liquidity injections were conducted mostly through term reverse repo auctions (LKR 36.3 Bn). Upon the SRR cut, secondary government securities market volumes swelled helping to ease off the yields across the board. From 22nd to 30th June, the CBSL aggressively participated in the secondary government securities market contributing to further decline in yields. By the end of the month the CBSL's possession of outstanding government securities went up by close to LKR 6 Bn compared to the beginning of the month. The reserve money (i.e. currency in circulation and deposits held by the commercial banks) contracted by over LKR 120 Bn mainly due to the SRR cut which caused the commercial bank deposits to drop by about LKR 115 Bn. This money is expected come to circulation with a lag thereby expanding the reserve money. However, given the subdued economic activity, this may take a longer time to take place. In addition, maturing long-term reverse repos issued in May and June and the CBSL selling forex reserves (~USD 9 Mn) in June also contributed to the contraction in reserve money.

Throughout June the CBSL maintained the policy rates at all-time low. Call and repo rates dropped appreciably (~25 bps) towards the lower bound of the policy corridor. The volatility in these markets declined markedly. However, the SRR cut thinned down the interbank market volumes to lowest levels witnessed so far in the current year. In contrast, the repo market displayed just the opposite behavior as banks channeled excess liquidity towards the repo market. In the process, the spread between call and repo rates narrowed towards the month end.

The SRR cut translated to about 30 – 50 bps drop in yields immediately in the primary T-bills market while the same in the secondary market was much weaker (1 – 2 bps). In addition, the spread between primary and secondary T-bill yields diverged while the T-bills in the primary market remained overpriced. Demand for T-bills remained healthy throughout the month and the volumes improved to record levels in the last two weeks. Along with this in the last week of the month, the secondary market yields dropped significantly, as the buying pressure mounted. Bid-ask spread, the most commonly used measure of market liquidity, widened in the last two weeks despite the market's record volumes.

Long-term rates

Figure 2: Yield curve of treasury bonds

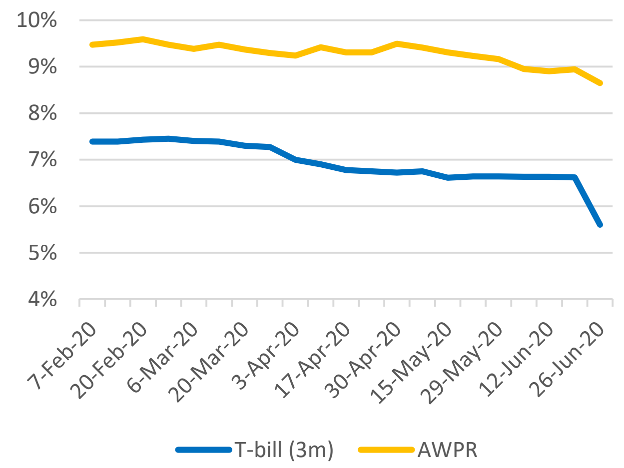


Source: First Capital Research

The CBSL held two bond auctions in June and was oversubscribed. In both occasions, the CBSL accepted the total amount offered in full.

The secondary bond market was quite active in June. The yield curve shifted down across all maturities (~175-200 bps) as a result of the policy rate cut and improved market activity. The bid-ask spreads increased sharply by the end of the month despite the record volumes.

Figure 3: Secondary market T-bill yields and AWPR

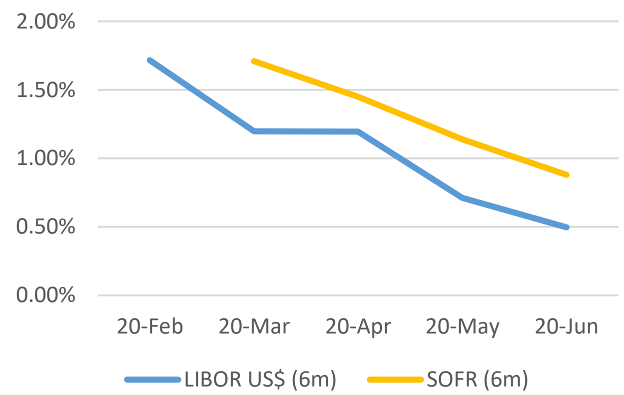


Source: CBSL

Data shows credit to private sector contracted by LKR 70 Bn (M-o-M) while, credit to government increased by LKR 164 Bn (M-o-M) in May. AWPR remained at upper single digit levels and continued to steadily decline in June (by 51 bps). However, the spread between T-bill yield and AWPR widened in the last week of June and was 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. ICRA Lanka's latest report shows that the reduction in policy interest rates beyond a certain point may not generate appreciable expansion in credit in the economy as the financial institutes' risk appetite would not improve in a state of crisis. On 28th June 2020 the CBSL announced a credit guarantee and interest subsidy scheme for businesses affected by the COVID-19. This step will likely to increase the risk appetite of the FIs as it acts as a backstop to credit risk for loans extended to individuals and businesses during the crisis. However, the success of this scheme depends on whether the banks will be in a position to enforce the guarantees and recover outstanding amounts in a timely manner in case of defaults.

Read ICRA Lanka's special release on the CBSL's COVID response

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 declined in June on the back of better than expected US labour market data [1]. Fed also confirmed that it would maintain its monthly purchases of Treasury bonds and mortgage-backed securities to drive the asset prices. The yield differential between US 3m T-bill and LKR 3m T-bill declined significantly.

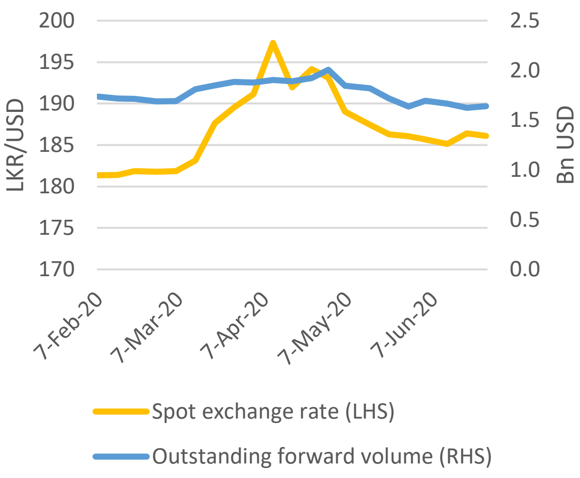
Fed anticipates the Fed funds rate to remain at zero for the rest of the year. With Fed funds rate hitting almost the rock-bottom, LIBOR US$ rates continued to decline. SOFR, its replacement rate following the LIBOR phase out in 2021, has also declined gradually. Bank of England Governor Andrew Bailey reinforced the case for abandoning LIBOR, noting that LIBOR was largely guesswork at the height of market volatility in March [2]. ICRA Lanka previously highlighted the risks of ill prepared transition for Sri Lankan financial sector.

Read report on the implications of LIBOR transition for Sri Lanka.

The yields on SLISBs improved sharply in June as the pressure on the exchange rate was under control and after the CBSL lifted the ban for banks to buy ISBs with newly earned forex.

External Sector

Figure 5: Exchange rate and outstanding forward volume

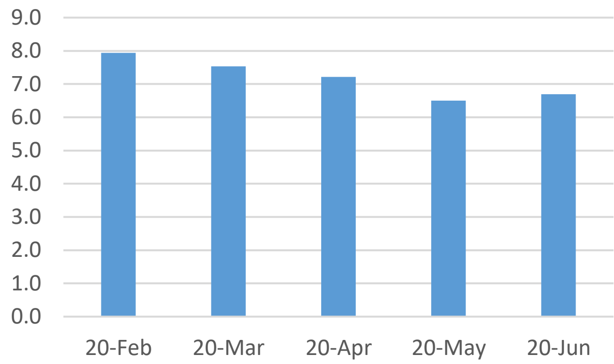


Source: CBSL

In May, the worker remittances (USD 432 Mn) recorded a decline of 23% compared to the corresponding month of the previous year. Exports bounced back in May. Two main export sectors namely tea (USD 108 Mn) and Apparel (USD 219 Mn) performed comparatively well. Sri Lanka achieved a trade surplus in June because of the import controls and helped by modest level of exports (USD 1.02 Bn) almost on par with June last year [3]. Sri Lanka extended the import controls indefinitely on 30th June. Rupee started appreciating in the first half of the month, which helped the CBSL to accumulate forex reserve. But subsequent to the SRR cut, the rupee gradually depreciated which was later moderated by the CBSL intervention. With the expectation of stability and the strengthening of the exchange rates, and the weaker international trade, the outstanding forward volumes were seen declining. Three month forward rates that prevailed towards the end of month indicates further depreciation. Interbank forex market witnesses improved volumes in June.

In the last week of May, somewhere close to LKR 400 Mn foreign capital flew back into government securities. This is the first major inflow by foreigners after almost 4 months of continuous capital outflow from the debt market. However, the SRR cut and strengthening of rupee triggered a foreign outflow close to LKR 2 Bn in the last two weeks of June. Foreign participation in the equities was moderate but were mainly on the selling side and they sold over LKR 8 Bn on net basis during the month. With this CSE is into its 10th consecutive month of net foreign selling (excluding April).

Figure 6: Gross official reserves (Mn USD)

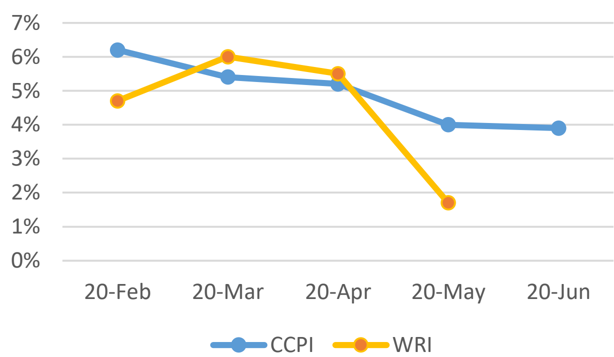


Source: CBSL

The reserve position improved by USD 193 Mn in June mainly as a result of increase in foreign currency reserves (USD 427 Mn) owing to rupee-dollar swap and purchase of dollars from the forex market. The CBSL sold down about USD 234 Mn gold reserves amidst increasing gold prices. For June the expected outflows due to forex loans amounted to USD 351 Mn. Sri Lanka has USD 783 Mn foreign currency obligations for the next 3 months (July to September). From the point of view of preserving the reserves, the GoSL is likely to meet these obligations by rolling over some of these obligations or through bilateral arrangements being negotiated or in place currently. However, the bigger challenge would be meeting obligation over USD 1 Bn ISBs maturing in October.

Prices & Wages

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



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

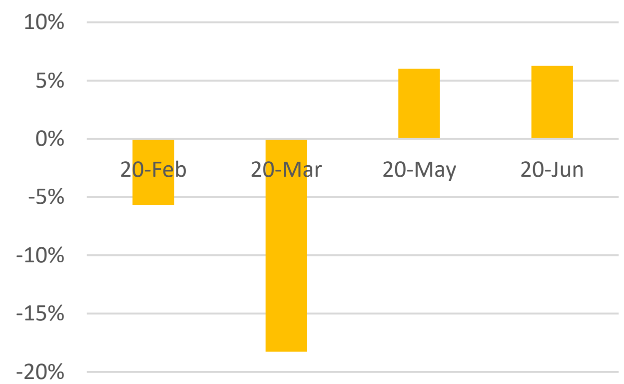
Source: CBSL

Wage growth further decelerated in May 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 could further reduce in June.

Defying the earlier expectations of modest inflation during the aftermath of COVID-19 pandemic, the data indicates the CCPI has declined to 3.9% (Y-o-Y) amidst falling aggregate demand in June, which is now below the lower bound of the CBSL's inflation target. The declining inflation is a result of significant slowdown in non-food inflation (1.4%) overpowering the rise in food inflation (7.2%). The coronavirus pandemic is more likely to leave a legacy of weak or falling prices for goods and services than to trigger higher global inflation, according to a majority of over 160 economists polled by Reuters [4].

Equities

Figure 8: ASPI (M-o-M)



Source: CSE

ASPI rose 6.25% in June on the back of optimism and investors lining up to buy undervalued stocks. Almost all sectors saw gains, with Insurance leading. Commercial & Professional Services shares lost value.

Figure 9: ASPI sector performance

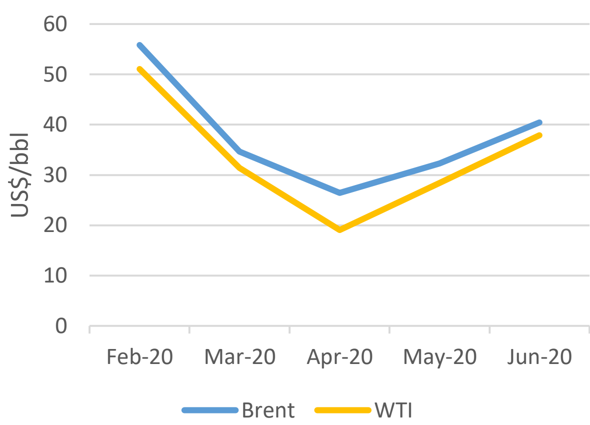
Sector	Index Points Gain
Insurance	138.33
Consumer Durables & Apparel	113.03
Transportation	100.35
Energy	88.05
Materials	77.27
Telecommunication Services	77.13
Utilities	67.42
Banks	66.33
Capital Goods	58.78
Household & Personal Products	43.12
Diversified Financials	36.81
Automobiles & Components	30.83
Real Estate	29.44
Consumer Services	15.5
Health Care Equipment & Services	14.42
Food, Beverage & Tobacco	13.87
Food & Staples Retailing	7.09
Retailing	0.96
Pharma	0
Commercial & Professional Services	-46.81

Source: CSE

In the global front, economic re-opening and accommodative central bank policies propelled markets. US stocks gained momentum. Key exchanges in European markets were mostly buoyant. Emerging markets saw gains.

Commodities

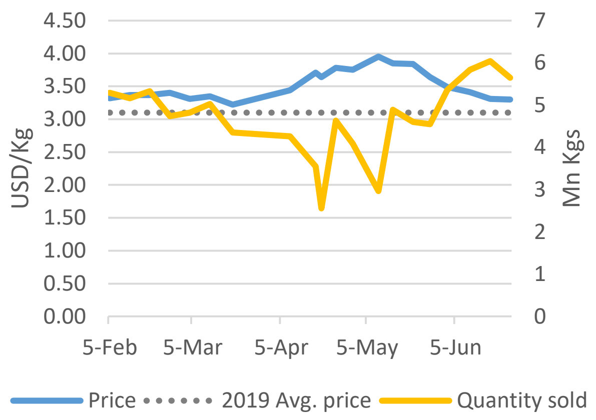
Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

With economies reopening, crude oil prices continued to rise in June. Historically low oil prices has helped Sri Lanka to bring the import bill down. In the meantime, it could also help CEB and CPC to improve their balance sheets.

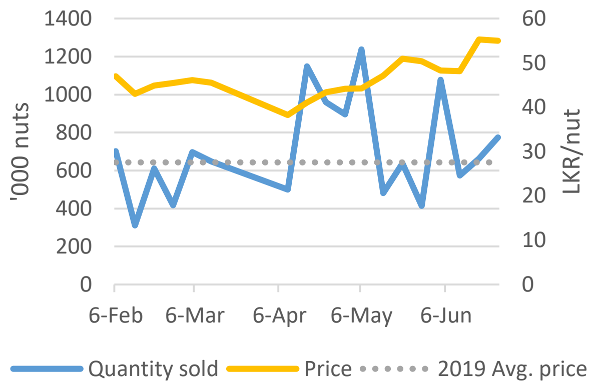
Figure 11: Tea (All Elevations) price and quantity sold at weekly auctions



Source: Forbes & Walker

Tea prices declined, but remained above the last year average as the quantity supply improved due to favourable weather that prevailed earlier.

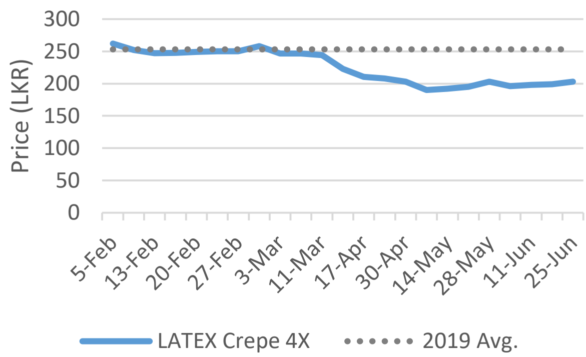
Figure 12: Coconut price and quantity sold at weekly auctions



Source: CDA

Coconut prices remained buoyant amidst volatile demand in the auctions.

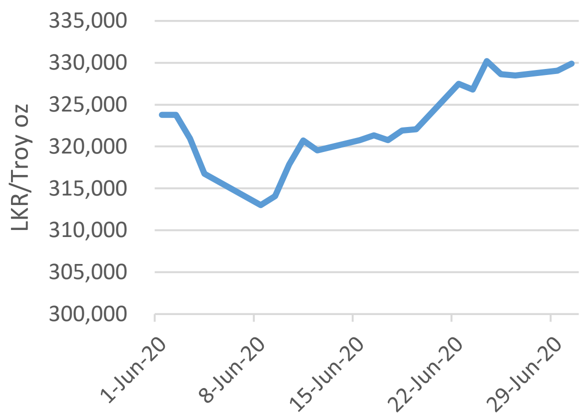
Figure 13: Rubber price weekly auctions



Source: RRISL

Price of rubber fell following the breakout of the COVID-19 pandemic. Prices recovered marginally in June.

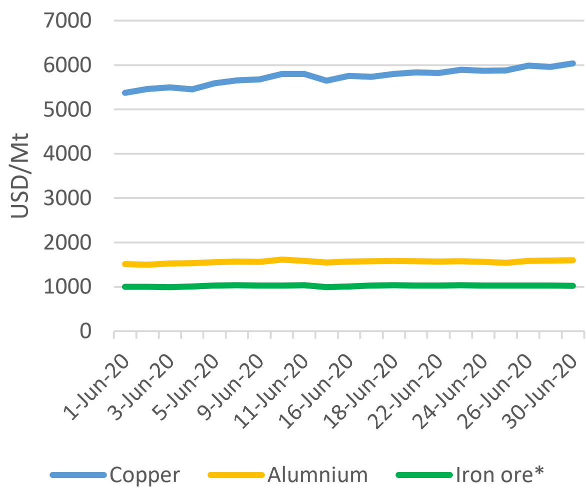
Figure 14: Daily gold price



Source: CBSL

As the uncertainty surrounding the investment climate deepened, investors sought refuge in gold investments, which lead to gradual appreciation of gold price.

Figure 15: Daily key base metal prices

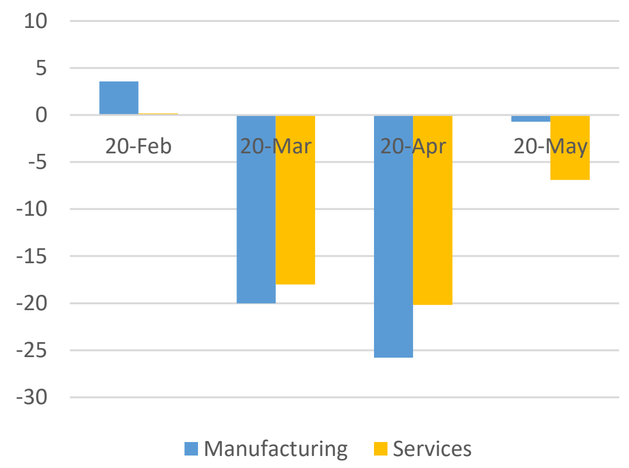


Notes: Iron ore prices are for 10 Mts
Source: dailymetalprices.com

Key base metal prices are currently at their 2 year lows but the prices continued to increase steadily in June.

Real Sector

Figure 16: 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

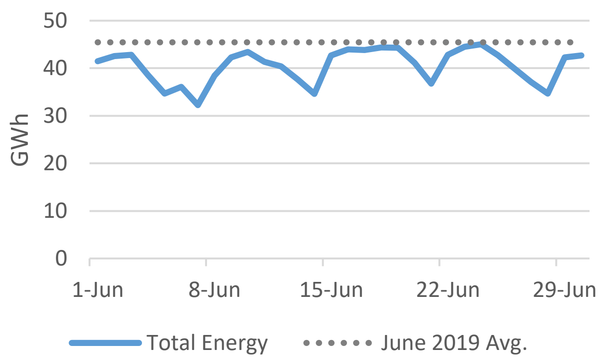
Both Manufacturing and Services sector showed noteworthy recovery in May. With partial lifting of the lockdown, the economic activities resumed helping the production activities in the manufacturing sector. Employers were seen reinstating some of the jobs they previously cut. The order books showed improvement. With volumes picking up (especially in food & beverages, and textile & apparel sectors), manufacturers engaged in building input stocks. The supply disruption caused by the COVID pandemic seemed to be fading out slowly.

With improved mobility following the lockdown, trade and transportation sectors saw business activities picking up. Employment in troubled leisure and tourism sectors were seen contracting for yet another month. Backlogs started to deescalate as business is returning to normalcy.

The activities in the economy, especially the industry and services sector, further improved in June as evident by increasing power demand which is almost on par with June 2019 averages. 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](#).

Figure 17: Daily power generation



Source: CEB, PUCSL

Outlook for July

Activities in the real economy is expected to be moderate while inflation to remain benign. Interest rates are likely to remain low. Rupee will broadly remain stable but, mild depreciation is likely. Wages may continue to grow at slower pace. Equities may record modest gains. Commodity prices are expected to maintain the momentum.

Rating Actions

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

Issuer	Issue	Action	Previous Rating	Current Rating
Nawaloka Hospitals PLC	Issuer rating	Downgraded	[SL]BBB Negative	[SL]BBB- Negative
Nawaloka Hospitals PLC	Senior Unsecured Redeemable Debenture (LKR 186.6 Mn outstanding)	Downgraded	[SL]BBB Negative	[SL]BBB- Negative
Nawaloka Hospitals PLC	Senior Unsecured Redeemable Debenture (LKR 270.6 Mn outstanding)	Withdrawn	[SL}BBB Negative	N/A
Softlogic Life Insurance PLC	Insurance Financial Strength rating	Reaffirmed	[SL]A Stable	[SL]A Stable
Rainco (Private) Limited	Issuer rating	On Notice of Withdrawal for 30 days	[SL]D	N/A

Abbreviations

bps	Basis points
CBSL	Central Bank of Sri Lanka
CDA	Coconut Development Authority
CSD	Census and Statistics Department
CPC	Ceylon Petroleum Corporation
GoSL	Government of Sri Lanka
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
RRISL	Rubber Research Institute of Sri Lanka

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