



MONTHLY ECONOMIC UPDATE | August

Economy at a glance for August 2020

Recovery continues after slow start.

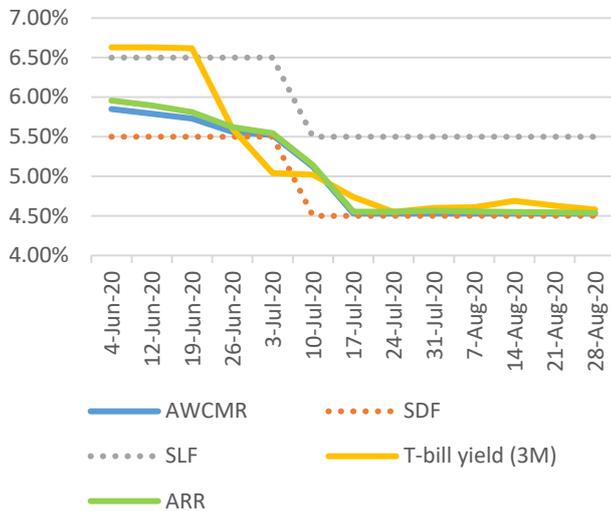
Highlights

- Activities in the economy especially in the industrial and services sectors, slowed down during the first half of August due to elections and as the businesses awaited cabinet appointments and the policy direction of the new government.
- AWPR, which represents short-term lending to highly creditworthy borrowers such as the state, continued to fall gradually in August (~81 bps).
- Wages made a further recovery in July on account of wage growth recorded in Agriculture and Services sectors but continued remained under the inflation rate.
- CCPI Headline inflation slid to 4.1% (Y-o-Y) in August driven by the deceleration in Non-food inflation which is now under 1%.
- ASPI gained 4% while CSE's most liquid S&P SL-20, gained 8.26% in August as the investors parsed the landslide victory of the ruling party, SLPP.
- The net outflow of foreign capital from the G-sec market was comparatively low (LKR 575 Mn) while the same for equities were LKR 8 Bn.
- The yields on SLISBs continued to decline in August apart from the ones that are expected to mature in October this year.
- Both exports and worker remittances continued to recover and recorded highest year-to-date values in July, however, total aggregate figure of January to July period are still lower than that of the last year.

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

The call and repo rates were steady and lingered about 3 to 4 bps above the floor policy rate throughout the August amidst burgeoning liquidity levels which momentarily crossed LKR 200 Bn towards the tail end of the month. Interbank call market volumes were thin while repo market remained relatively liquid. However, the volumes in both markets gradually faded towards the month end. The CBSL kept the policy rates unchanged in August Monetary Policy Review meeting on 20th despite the fact that the money market rates were no longer able to adjust downward as they were bounded by the floor rate.

No open market auctions were held during the month. Instead, the CBSL bought close to LKR 10 Bn G-secs on 7th August probably through the primary auction held on 5th as the market participants remained on the sideline on the day of the general election. In succeeding weeks, the

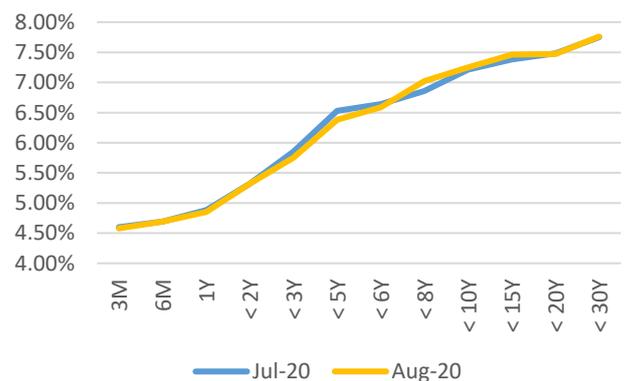
CBSL unloaded over LKR 25 Bn of its G-sec holdings.

Reserve money (i.e. currency in circulation and deposits held by the commercial banks) expanded by over LKR 16 Bn in the first three weeks mainly due to increase in currency in circulation signaling improving activity levels in the real economy but was somewhat offset by the decline of the same in the last week. Several reverse repos were also matured leading to drain on reserve money.

The spread between T-bills (which has a term spread) and repo rate continued to remain slim while the spread between 3M and 12M T-bills (~26 bps) remained tighter indicating milder inflation expectations in the near-term. The T-bill auction held on the day of the election (5th August) saw yields edge up by ~10 bps. Main contributing factor was the supply bulge¹ of LKR 105 Bn bonds auctioned on 30th July which its settlement date fell on 4th August, day before the weekly T-bill auction. In the week after the election, the secondary treasury market liquidity dropped causing the yields to swell temporarily but the market remained relatively tepid for the rest of the month. In spite of weaker volumes, the bid-ask spreads tightened towards the end of the month.

Long-term rates

Figure 2: Yield curve of treasuries

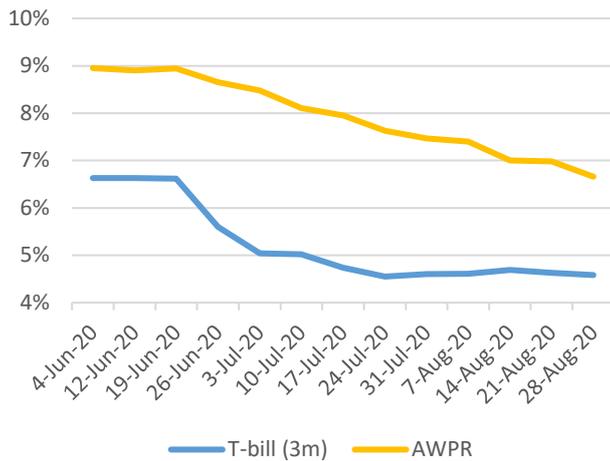


Notes: Yields are based on the weekly average prevailed at the last week of the month, Shorter end – less than 2Y, mid/intermediate tenor – 2 to 10Y, longer tenor – above 10Y, Source: CBSL

¹ Generally, the CBSL conducts two bond auctions per month which the aggregate offer values come close to LKR 100 Bn. On 30th July the CBSL offered overwhelming LKR 105 Bn in a single auction.
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The CBSL did not hold any bond auctions in August. The secondary market performance was lukewarm. The yields of the most mid tenor maturities declined by about 5 to 15 bps and the longer end of the curve remained relatively illiquid as seen from yields rising over 4 bps. Bid-ask spreads of some mid-tenor maturities (e.g. 2021A, 2023A) and longer tenor maturities slid.

Figure 3: Secondary market T-bill yields and AWPR²



Source: CBSL

Average Weighted New Lending Rate (AWNLR) fell 133 bps to 9.85% over the course of the month of July. AWPR, which represents short-term lending to highly creditworthy borrowers such as the state, continued to fall gradually in August (~81 bps). In its Monetary Policy decision, the CBSL decided to slap caps on interest rates on credit cards to 18%, on pre-arranged temporary overdrafts to 16% and on pawning facilities to 10%.

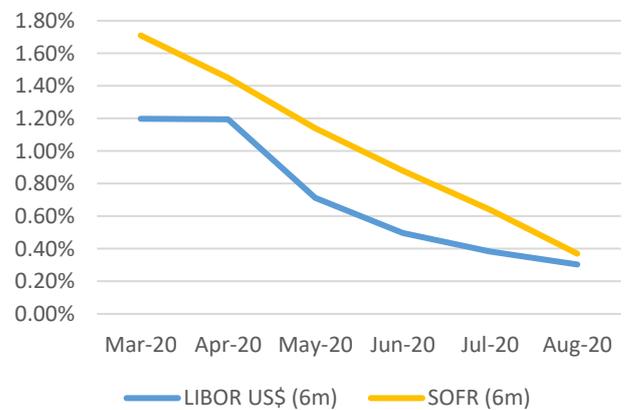
In July, credit to private sector continued to contract for the third straight month while the same for the public sector expanded by LKR 172 Bn (38%/ M-o-M). Lack of vigor in private credit growth for past few months could be explained by few factors; (1) private sector refinancing their existing liabilities to bring the interest cost down, (2) drop in revenues triggered release of existing working capital that would help the companies to manage the liquidity without acquiring new credit, (3) private sector opting to bring the overheads down to

manage existing cash flows so that they do not have a requirement for additional liquidity, (4) private sector unwilling to expand their businesses given the weaker demand, and (5) overall subdued business outlook.

In the meanwhile, by 18th August, the banks have extended over LKR 68 Bn loans to individuals and businesses under the *Saubagya* COVID-19 renaissance facility where borrowers were granted subsidized interest rate of 4% with a repayment period of 2 years.

International rates

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

Fed maintained its key benchmark interest rates at 0-0.25% in August. US treasury yields rose as the market was struggling to absorb the influx of debt in the first half but later retreated on the back of some positive news on the developments in the US economy. Towards the end August, longer-dated treasury yields rose to two month high, as the Fed's chief, Jeromy Powell announced that the Fed aims to tweak its policy framework to allow for a sustained overshoot of its inflation target [1]. During August, the yield differential between 3M US and domestic treasury declined as shorter-dated domestic yields continued to slip.

² AWPR is calculated based on the submissions made by the commercial banks to the CBSL on the rates offered to customers who borrowed more than LKR 10 Mn for less than three months.

Knock-on effect of rock-bottom Fed funds rate drove LIBOR US\$ and its replacement rate, SOFR, lower.

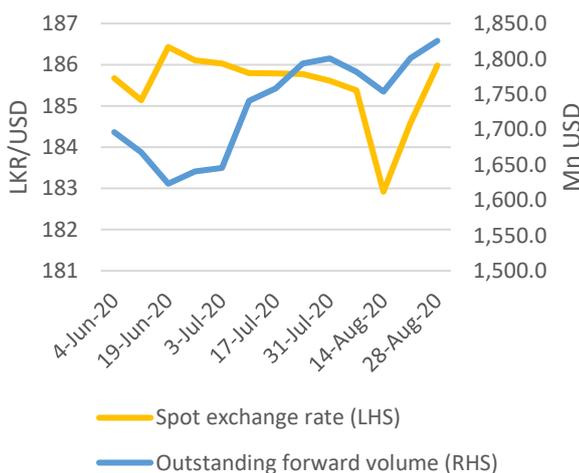
The yields on SLISBs continued to decline in August apart from the ones that are expected to mature in October this year. Typically, the yields come down as the bond price closes in on the par value closer to maturity. But the perceived risk of default may drift the price of a bond away from the par.

In the last SLDB auction held during July 22-27, the CBSL was able to secure better rates than the June auction. However, SLDB Floating Rate Notes, which is linked to 6-month LIBOR, had only very little demand from the investors. LIBOR is set to phase out by the end of 2021 and ICRA Lanka has previously observed the progress of the transitioning out from LIBOR in Sri Lanka to be not satisfactory. In August, Singapore become one of the first countries to auction debt worth USD 366 Mn linked to an alternative benchmark [2].

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

External Sector

Figure 5: Exchange rate and outstanding forward volume



Source: CBSL

Both exports and worker remittances continued to recover and recorded the highest year-to-date

³ A rising REER typically means that a country's goods are becoming more expensive, and therefore less competitive (i.e. stronger rupee), Page | 4

values in July, however, total aggregate figure of January to July period are still lower than that of the last year. Remittances marked USD 702 Mn merchandise exports crossed USD 1 Bn. The main source export markets were the US, Europe, South Asia, and the Middle East. Export earnings were driven by personal protective equipment such as face masks, cash crops; tea, coconut, rubber & related products, and some perennial crops; cinnamon & pepper. Meanwhile the imports, declined 25% (Y-o-Y) USD 1,294 Mn. In August, the merchandise exports fell 8.8% (Y-o-Y) to USD 948 Mn mainly on account of drop in apparel and tea exports.

Real Effective Exchange Rate (REER) index (2017=100)³, which measures the external competitiveness of the country, declined to 92.29 in July from 92.72 a month earlier. Nominal exchange rate displayed some volatility during August. During 4th to 13th, the LKR/USD appreciated sharply to 182.8 from 185.5 followed by few capricious turns before finally settle down around 186 by the month end.

The official reserve position strengthened by USD 345 Mn to USD 7.4 Bn in August. For September and October USD 2.1 Bn forex obligations including the ISBs maturing in October are pending. In August, the net FX purchases amounted to USD 93 Mn amidst import controls. Expansion in reserve money in the first three weeks of August was a likely result of the CBSL buying forex reserves. USD 100 Mn foreign currency obligations were due in August. The CBSL may have sold the government the required amount of forex causing a drain on reserve money during the last week.

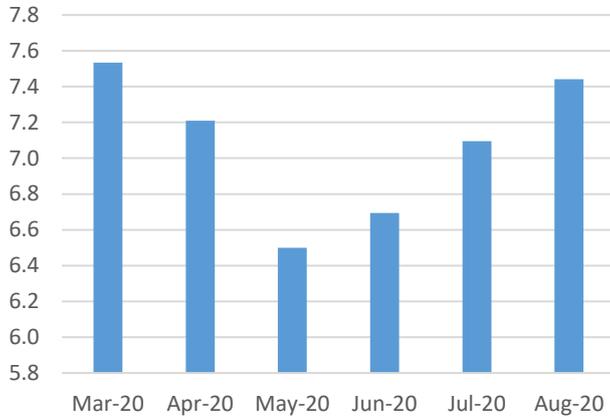
Interbank forex market was dull during the election week but recovered to modest levels subsequently. Outstanding forward volume was seen declining in the first half of the month amidst the sharp appreciation but with rupee weakening back to 186, forward volume grew to USD 1.8 Bn by the end of the month.

The net outflow of foreign capital from the G-sec market was comparatively low (LKR 575 Mn) while the same for equities were LKR 8 Bn. Both

relative to its trading partners while a declining REER indicates the opposite.

treasuries and equities has been suffering from capital flight for good part of the year so far.

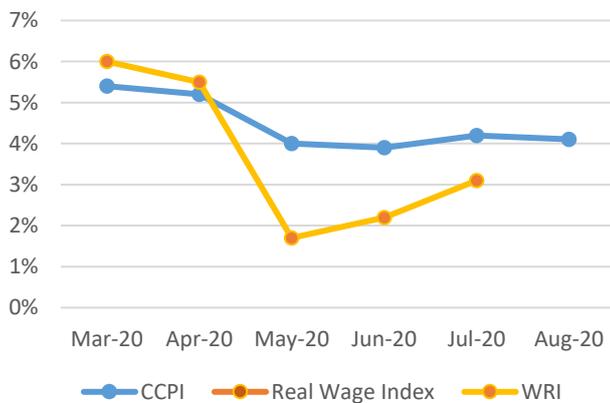
Figure 6: Gross official reserves (Mn USD)



Source: CBSL

Prices & Wages

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



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

Source: CBSL

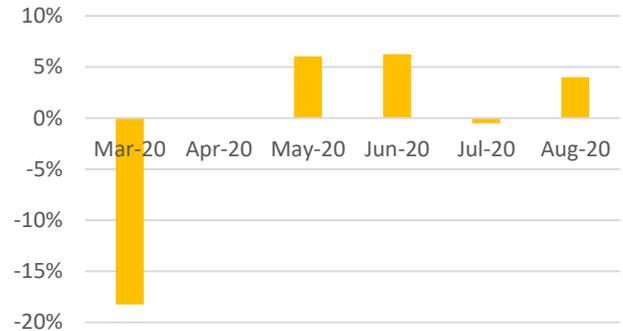
Wages made a further recovery in July on account of wage growth recorded in Agriculture and Services sectors but continued to remain under the inflation rate. These increments were a result of lower base prevailed during July 2019 due to subdued performance of Services sector post Easter Attacks and drought condition that prevailed around the same time.

CCPI Headline inflation slid to 4.1% (Y-o-Y) in August driven by the deceleration in non-food inflation which is now under 1%. In the meanwhile,

food inflation rose further to 12.3% as a result of supply disruptions.

Equities

Figure 8: ASPI (M-o-M)



Note: CSE was closed for the whole month of April

Source: CSE

ASPI gained 4% while CSE's most liquid S&P SL-20, gained 8.26% in August as the investors parsed the landslide victory of the ruling party, SLPP. Foreigners were on the sell side and the domestic demand was driven mainly by the retail investors. Market PBV (Price-to-book value) declined to .90 from .95, whereas market PER (Price-to-earning ratio) declined to 8.98 from 9.50.

Shipping, logistics, and tyre industry shares saw the largest gains. Food & staples retailing, and real estate sectors saw their value falling during August.

Figure 9: ASPI sector performance

Sector	Index Points Gain
Automobiles & Components	234.59
Transportation	234.36
Capital Goods	89.43
Household & Personal Products	70.06
Materials	68.74
Utilities	42.49
Banks	37.6
Health Care Equipment & Services	28.56
Energy	24.73
Commercial & Professional Services	15.67
Food, Beverage & Tobacco	13.88
Insurance	11.7

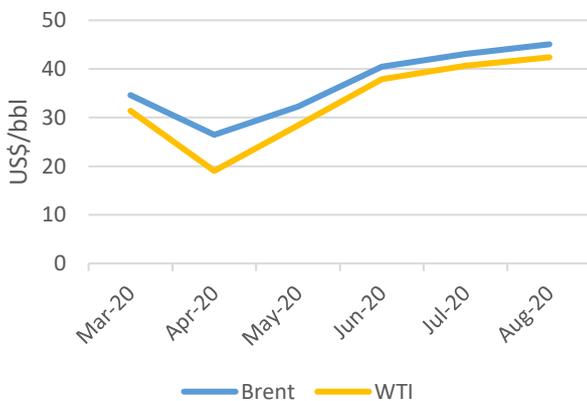
Diversified Financials	10.44
Consumer Durables & Apparel	8.35
Retailing	7.26
Telecommunication Services	5.79
Consumer Services	5.48
Pharma, Biotech & Life Sciences	0
Real Estate	-0.87
Food & Staples Retailing	-23.87

Source: CSE

On the global markets front, US markets surged as investors welcomed the news of a potential COVID-19 treatment and on the back of upbeat economic data. Most European indices displayed some bullish sentiment as well. Nevertheless, key Emerging Market indices were mixed – Hang Seng, Kospi, Nikkei, Sensex, ASX 200, and Jakarta Composite ended higher.

Commodities

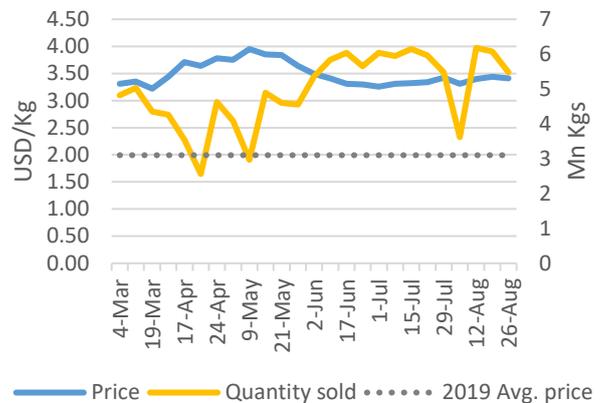
Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

Crude oil prices recovered further as expectations for shrinking American crude and gasoline stockpiles added to signals that a demand recovery may be on the horizon in the U.S. and China [3]. Accordingly, Sri Lanka's import bill may see an incremental rise in value in the coming month despite the import controls.

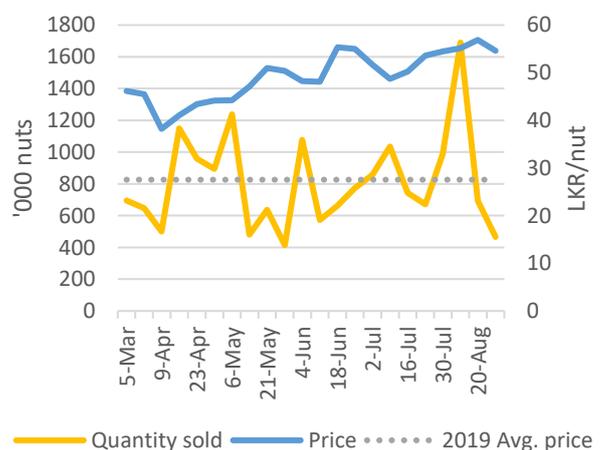
Figure 11: Tea (All Elevations) price and quantity sold at weekly auctions



Source: Forbes & Walker

Tea prices were steady averaging USD 3.40//kg. The first tea auction for August which fell on 5th, the election day, had a shorter trading day hence the trade volumes dipped notably. Despite that, rest of the auctions had healthy volumes for the month. In June and July, supply disruption due to lockdown and floods in Assam and West Bengal in India triggered Black tea prices to surge by 42% [4]. Thus, tea prices are expected sustain in the short-term.

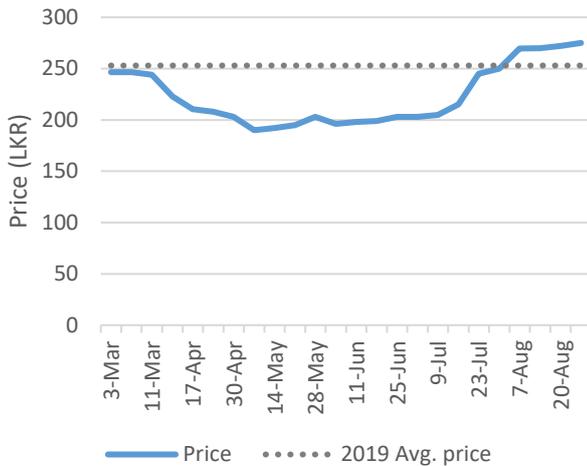
Figure 12: Coconut price and quantity sold at weekly auctions



Source: CDA

During the first auction held in August, which commenced after two weeks gap in between due to elections, the quantity sold jumped over 1.6 Mn nuts. Though the prices remained buoyant, the trade volumes were weak as the supply was affected by the dry weather.

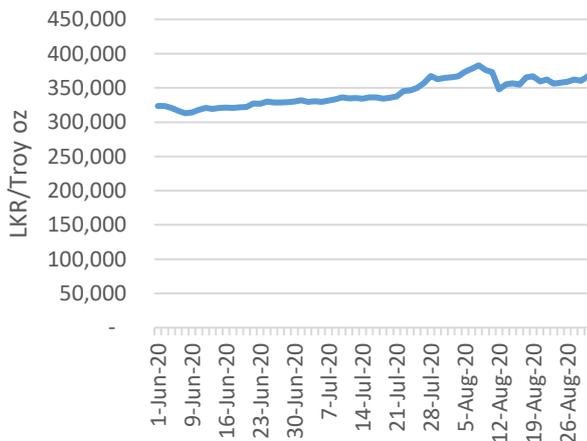
Figure 13: Rubber price weekly auctions



Source: RRISL

Rubber prices rallied in August on the back of uptick in demand for protective rubber gloves. Latex rubber recorded highest prices year-to-date.

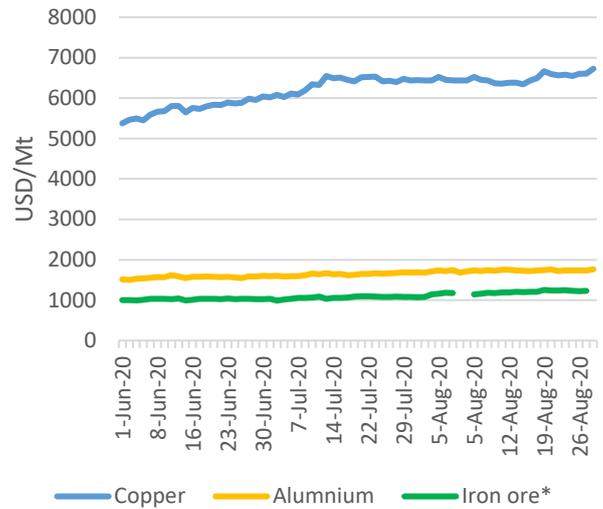
Figure 14: Gold price



Source: CBSL

Rise in US treasury in the first half of August sparked investors to sell gold halting months long rally. Gold rebounded later over weaker dollar and expectations of inflation to stay above 2% as Fed announced its new approach to monetary policy.

Figure 15: Daily key base metal prices



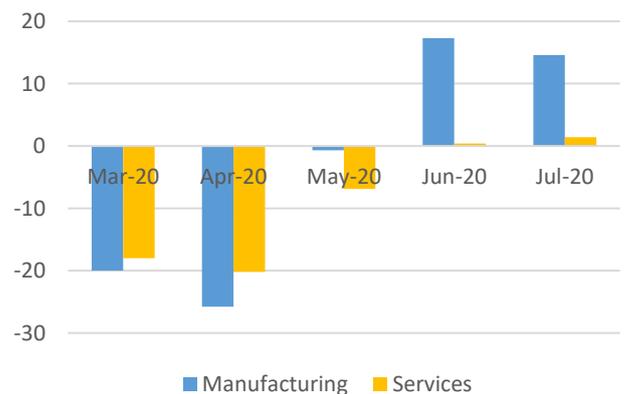
Notes: Iron ore prices are for 10 Mts

Source: dailymetalprices.com

Base metal prices continued to rise over China's recovery and restarting of industrial activities. In this onset, Copper prices surged markedly as world's largest supplier, South America, was in complete disarray as the Corona virus struck cities. Uptick in base metal prices has implications for some sectors such as cable manufacturing and construction in Sri Lanka.

Real Sector

Figure 16: PMI deviation from point of neutrality (Index points)



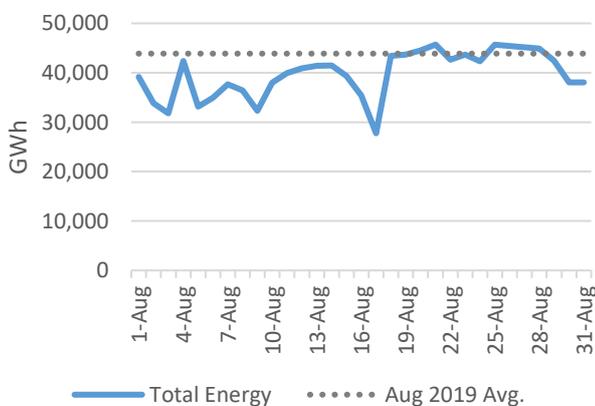
Notes- negative values indicate sector is generally contracting on a month-on-month basis while positive values indicate the sector is expanding. The strength of contraction or expansion is manifested by the magnitude of the figure.

Source: CBSL

Manufacturing sector continued to expand in July, helped by the favorable performance of the merchandise exports. However, certain industries were affected by the import restrictions. The manufactures cut production in line with the slowdown in new orders while building raw material inventories amidst expectations of higher global input prices. New hires continued. Supplier delivery delays were prevalent but was showing signs of further improvement.

PMI data indicated the services sector recording a marginal recovery in July. Business activities started gaining momentum while the expectations for business activities improved. The backlogs continued to fade. However, the demand was still weak hindering hiring more employees. Pick-up of domestic tourism helped the recovery of accommodation, food and beverage sub-sectors. Moreover, business activities related to wholesale and retail trade, health services, telecommunication, and financial services sub-sectors improved.

Figure 17: Daily power generation



Source: CEB, PUCSL

Activities in the economy especially in the industrial and services sectors, slowed down during the first half of August due to elections and as the businesses awaited cabinet appointments and the policy direction of the new government. On 17th the economic activities were interrupted by the island wide power failure which lasted for 7 hours. Subsequently, the activities bounced back strongly to compensate for the slack prevailed in the first half of the month as seen from power generation data which is on par with last year August levels.

Outlook for September

With businesses having clarity on general policy direction of the government, September may see economy continuing to recover. Consumers likely to experience further increase in food prices amidst persistent supply disruptions and import controls. Non-food inflation is yet to pick-up; hence the headline inflation will continue to be mild. Given the liquidity buildup and the CBSL's decision to maintain policy rates, the short-term rates are expected to move in a tighter margin. However, long-term rates still have space to adjust downwards. For September and October, USD 2.1 Bn forex payments are pending, which are likely to be financed out of official reserves. To strengthen the reserve position, the CBSL may be a net buyer of forex and likely to hold a SLDB auction. Commodity prices are expected to rise benefiting the export-oriented industries while hurting import dependent sectors.

Rating Actions

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

Issuer	Issue	Action	Previous Rating	Current Rating
E B Creasy & Company PLC	Issuer Rating	Downgraded	[SL]BBB+ (Negative)	[SL]BBB (Negative)
E B Creasy & Company PLC	Proposed Senior Unlisted Unsecured Redeemable Debentures Programme (LKR 700 Mn)	Downgraded & Withdrawn	[SL]BBB+ (Negative)	N/A
Lankem Ceylon PLC	Issuer Rating	On Notice of Withdrawal	[SL]D	[SL]D on Notice of Withdrawal
Merchant Bank of Sri Lanka & Finance PLC	Issuer Rating	Downgraded	[SL]A- (Negative)	[SL]BBB+ (Negative)
Merchant Bank of Sri Lanka & Finance PLC	Subordinated Unsecured Redeemable Debenture (LKR 2,000 Mn)	Downgraded	[SL]A- (Negative)	[SL]BBB+ (Negative)
Merchant Bank of Sri Lanka & Finance PLC	Asset Backed Trust Certificate Programme of MBSL Trust -01 (LKR 2,000 Mn)	Downgraded & Withdrawn	[SL]A(SO) (Negative)	N/A
Commercial Credit and Finance PLC	Issuer Rating	Reaffirmed	[SL]BBB (Negative)	[SL]BBB (Negative)
Commercial Credit and Finance PLC	Commercial Paper Programme	Reaffirmed	[SL]A3	[SL]A3
Commercial Credit and Finance PLC	Listed Guaranteed Subordinated Redeemable Debenture Programme (LKR 2,000 Mn)	Reaffirmed	[SL]A+(SO) (Stable)	[SL]A+(SO) (Stable)
Commercial Credit and Finance PLC	Listed Guaranteed Subordinated Redeemable Debenture Programme (LKR 1,000 Mn)	Withdrawn	[SL]AA-(SO) (Stable)	N/A

Abbreviations

ASPI	All Share Price Index
bps	Basis points
CBSL	Central Bank of Sri Lanka
CDA	Coconut Development Authority
CSD	Census and Statistics Department
CSE	Colombo Stock Exchange
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
RRISL	Rubber Research Institute of Sri Lanka

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