ICRA LANKA

Insights

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Commodity price deflation is over! What next for Sri Lanka?

Key Takeaways

- With gradual recovery of economic activities, a rise in domestic demand for oil is likely to increase the import bill and thereby can inflict further pressure on the currency.
- Increase in petroleum prices will exert stress on the financial position of utility companies in the short-run.
- Energy price revision may have a cascading effect on many sectors of the economy. Most importantly, it could trigger a broad-based rise in general price levels.
- Downstream sector products such as kerosene, heating oil, fuel oils, lubricants, waxes, asphalt, and other petrochemicals would also revise prices affecting multitude of industries.
- Many large-scale construction contractors are less likely to experience margin erosions due to raw material price increases. However, small-to-medium scale contractors who generally enter into fixed price contracts, may have to absorb some losses.
- When the global metal prices collapsed in 1Q 2020, the local importers did not drop the prices but in fact increased due to import restrictions. Hence, they may have developed some loss absorbing capacity to hold the prices in the medium term.
- Local farmers are set to experience about 3-to-4% increase in costs of fertilizers in 2021.
- Tea, rubber, and coconut are projected to have healthy demand through 2021. Though rubber prices are expected to maintain the momentum, tea price may grow only by about 1% in 2021.

Commodity Outlook

Year 2020 marks the lowest global commodity prices in the recent history as a result of extraordinary events that unfolded with the onset of COVID outbreak towards the end of 1Q. The oil prices plummeted to historic lows, even turning negative momentarily for the first time in history. Other commodities met with similar fate with base metal prices steeply declining as major industrial powerhouses scaled down operations. Sri Lanka was able to exploit the low oil prices that prevailed during 2020, amidst weaker domestic demand to ease some pressure off the rupee by cutting the petroleum import costs by around 30% in 2020 compared to 2019. Nevertheless, with commodity prices set to increase in 2021, Sri Lanka may face challenges in several fronts.

Primarily, an import dependent country, Sri Lanka has been continuously running current account deficits since the late 1970's. With the imposition of import restrictions, the current account deficit has narrowed by about USD 4 Bn in 2020. Sri Lanka imports around USD 20 Bn worth of goods per annum. Intermediate goods, including petroleum and related products, metals, fertilizers and chemicals which are essentially inputs for domestic industries account for more than 50% of the country's import bill.

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Table 1: Price projections for key commodity prices - 2021

Commodity	Unit	2020	2021	Change (%)
Crude oil, average	USD/bbl	41.0	55 to 65	34.1 to 58.5
Tea, average	USD/kg	2.75	2.77	0.7
Coconut oil	USD/mt	930	937	0.8
Rice, Thailand, 5%	USD/mt	500	498	-0.4
Maize	USD/mt	155	160	3.2
Wheat, U.S., HRW	USD/mt	205	207	1
Shrimp	USD/kg	12.75	12.87	0.9
Suger, World	USD/kg	0.28	0.29	3.6
Rubber, RSS3	USD/mt	1.62	1.68	3.7
DAP	USD/mt	310	318	2.6
Phosphate rock	USD/mt	75	78	4.0
Potassium Chloride	USD/mt	220	228	3.6
TSP	USD/mt	260	268	3.1
Aluminum (LME spot)	USD/mt	1,701	1,950	14.6
Copper (LME spot)	USD/mt	6,181	7,200	16.4
Iron ore (China import iron ore fines 62%, CFR)	USD/mt	108	125	15.7

Source: World Bank, Fitch Ratings, Goldman Sachs

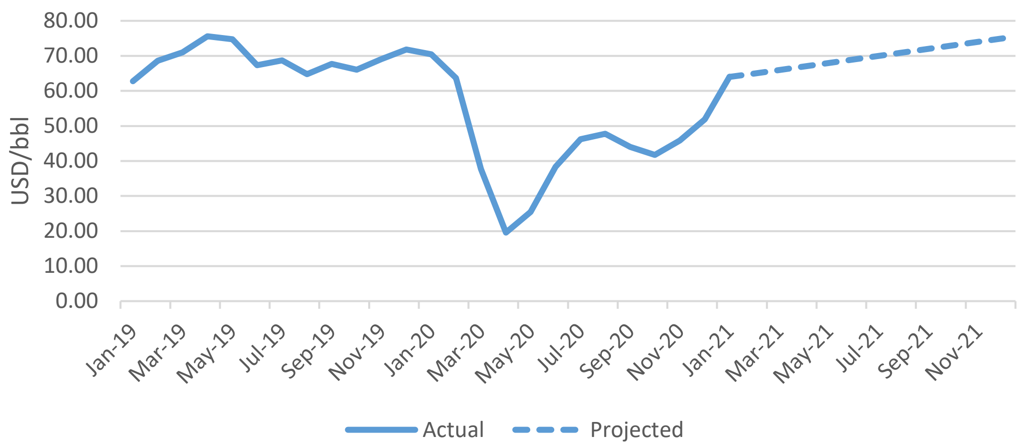
Crude Oil

As per the procurement plan of the CPC for 2021, cost of imports of crude oil & refined products is projected to be USD 2.5 Bn roughly benchmarking USD 59 a barrel of crude oil.

Sri Lanka imported around 13.5 million barrels of crude oil (20% of the total import bill) worth around USD 3.9 Bn in 2019 and the decline in global oil prices coupled with slump in domestic consumption helped to save around USD 1.3 Bn in 2020. As per the procurement plan of the CPC for 2021, cost of imports of crude oil & refined products is projected to be USD 2.5 Bn [1] roughly benchmarking USD 59 a barrel of crude oil.

However, OPEC's intention to cut output in February and March this year has lifted prices above USD 60 a barrel for the first time in over a year. The rapid economic recovery of China is also keeping the oil prices buoyant. Goldman Sachs predicts brent crude oil prices to hit USD 65 a barrel during the year [2] while the US Energy Information Administration (EIA) expects a lower USD 55 a barrel stemming from slowing pace of global oil inventory withdrawals [3].

Figure 1: CPC Import Prices



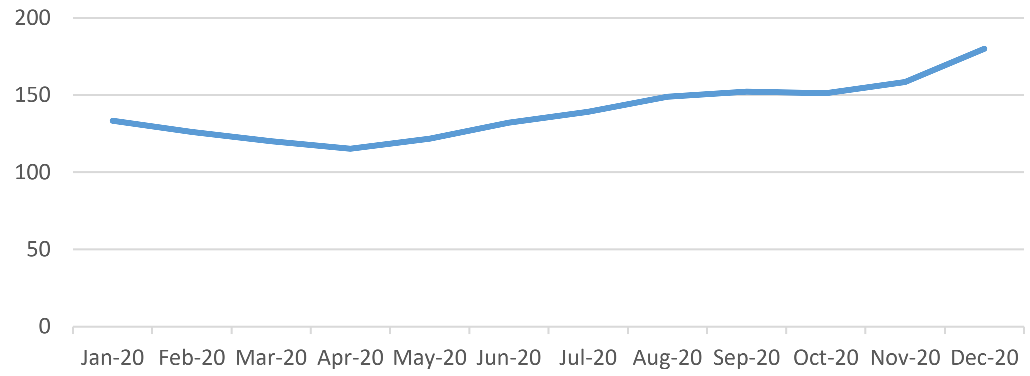
Note: Price with cost, insurance, and freight, projection is made assuming Brent would reach USD 65/bbl by the end of 2021
Source: CBSL, ICRA Lanka Research

With gradual recovery of economic activities, a rise in domestic demand for oil is likely to increase the import bill and thereby can inflict further pressure on the currency. In addition, increase in petroleum prices will exert stress on the financial position of utility companies in the short-run.

Energy price revision may have a cascading effect on many sectors of the economy. Most importantly, it could trigger a broad-based rise in general price levels. Furthermore, downstream sector products such as kerosene, heating oil, fuel oils, lubricants, waxes, asphalt, and other petrochemicals would also revise prices affecting multitude of industries.

Base Metals

Figure 2: Base metal price index (2016=100)



Notes: Base metals index includes Aluminum, Cobalt, Copper, Iron Ore, Molybdenum, Nickel, Tin, Uranium, and Zinc
Source: IMF

Many large-scale construction contractors are less likely to experience margin erosions due to raw material price increases while small-to-medium scale contractors may have to absorb some losses.

Base metal markets are expected to return to normalcy in 2021 supported by the increase in investment expenditure by governments around the world and recovering global industrial activity. As per the forecasts copper, aluminum, and iron ore – key industrial metals – will see their prices increasing by around 14-to-16% this year.

Sri Lanka imported around USD 563 Mn worth of base metals in 2019. Rising industrial metal prices poses several implications especially for the construction industry. Item rated contracts have provisions that would enable the construction companies to claim raw material cost increases based on the monthly published price indexes. Therefore, many large-scale construction contractors are less likely to experience margin erosions due to raw material price increases. However, small-to-medium scale contractors who generally enter into fixed price contracts, may have to absorb some losses.

When the global metal prices collapsed in 1Q 2020, the local importers did not drop the prices but in fact, increased due to import restrictions. Hence, they may have developed some loss absorbing capacity to hold the prices in the medium term.

Agricultural Commodities

Local farmers are set to experience about 1-to-4% increase in costs of the certain inputs in 2021.

Agriculture sector also consumes a substantial amount of imported intermediate goods such as fertilizers (USD 221 Mn in 2019) and wheat and maize (USD 346 Mn). Local farmers are set to experience about 1-to-4% increase in costs of the aforementioned inputs in 2021.

Commercial crops, tea, rubber and coconut take up a substantial share of the export basket of Sri Lanka (USD 1.7 Bn in 2019). Sri Lanka has been able to benefit from robust agricultural commodity prices that prevailed since the advent of COVID crisis. Tea, rubber, and coconut are projected to have healthy demand through 2021. Though rubber prices are expected to maintain the momentum, tea price may grow only by about 1% in 2021.

Sugar (USD 200 Mn imports in 2019), is a major consumer commodity which is predicted to go up by over 3% in 2021.

Conclusion

At macro level, the gains from increased export commodity prices will be overshadowed by the increase in import commodity prices. Hence Sri Lanka will continue to experience deterioration in terms-of-trade in the near-term. Commodity price increases, especially crude oil, will be problematic from the exchange rate standpoint given the weaker external position of the country. Increase in energy and farmgate prices can trigger broad-based increase in prices levels.

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To subscribe to ICRA economic updates, contact
Lalinda Sugathadasa
Head of Research & Business Development
Call: +94 77 478 1343
Email: research@icralanka.com

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ICRA LANKA

Subsidiary of

ICRA Limited

CORPORATE OFFICE
Level 10, East Tower, World Trade Center, Colombo 01, Sri Lanka
Tel: +94 11 4339907; Fax: +94 11 2333307
Email: info@icralanka.com; Website: www.icralanka.com

Contacts

W Don Barnabas
Managing Director/CEO
+94-11-773417517
wdbarnabas@icralanka.com

Lalinda Sugathadasa
Head of Research &
Business Development
+94-11-774781343
lalinda@icralanka.com

Rasanga Weliwatta
Head of Financial Sector Ratings
+94-11-773553564
rasanga@icralanka.com

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