MONTHLY ECONOMIC UPDATE July

ICRA LANKA

Economy at a glance for July 2021

Economy reels from the Delta surge.

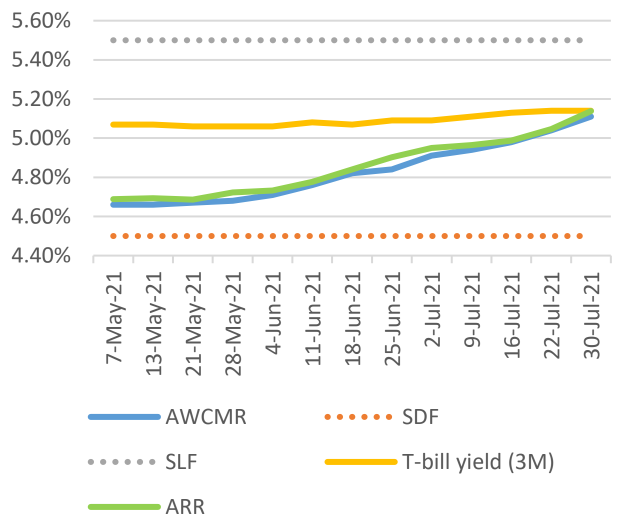
Highlights

- Call and repo rates climbed ~19 bps converging on 3M T-bill yield as excess liquidity in the money markets continued to dry up during the course of the month. The main reason for this liquidity squeeze was heavy borrowing by state banks averaging around LKR 80 Bn a day via the Standing Lending Facility window.
- The yield cap on 12M notes, which the CBSL allegedly uses as a tool to guide the market, was relaxed but as the CBSL prefers to accept 3M notes often above and beyond the respective initial offer quantities to meet borrowing targets, the acceptance rate of 6M and 12M notes remained strikingly low.
- we observe a significant contraction in the reserve money in July due to the decrease in currency in circulation and deposits held by the commercial banks with the Central Bank. Therefore, we infer that private credit expansion may have witnessed a notable moderation in July.
- The yields on SLISBs continued to surge in July with yields on issues reaching maturity in 2022-23 breaching 25%. This came after Moody's placed Sri Lanka's Caa1 rating under review for downgrade.
- About 1.5 Bn in forex obligations, of which 1 Bn was for maturing SLISBs, were due in July and were honoured. This weakened the overall reserve position to USD 2.8 Bn.
- Headline and core inflation accelerated to 5.9% and 3.7% respectively in July as the upward revision of fuel price was working its way through various sectors of the economy.
- Equities ended stronger in July with CSE recording a fourth straight month of gains ending ASPI 3.61% and S&P SL20 3.16% higher from June.

Interest Rates

Short-term rates

Figure 1: Treasury bill yield and money market rates



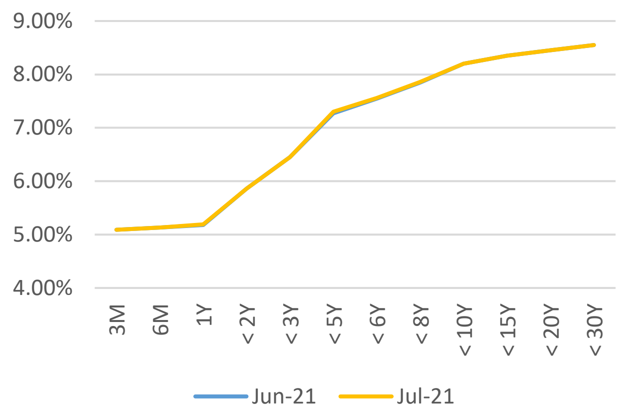
Notes: AWCMR- Average Weighted Call Money Rate, SDFR- Standing Deposit Facility Rate, SLFR- Standing Lending Facility Rate, T-bill yields are for the secondary market, ARR – simple average of daily repo rates Source: CBSL

Call and repo rates climbed ~19 bps converging on 3M T-bill yield as excess liquidity in the money markets continued to dry up during the course of the month. The main reason for this liquidity squeeze was heavy borrowing by state banks averaging around LKR 80 Bn a day via the Standing Lending Facility window. Call and repo market volumes remained elevated throughout the month. In the meanwhile, the CBSL added about LKR 222 Bn through its treasury purchases. Furthermore, purchase of USD 38 Mn from the open market may have added somewhere around LKR 7.6 Bn to the money supply.

T-bill yields in both primary and secondary markets saw ~2-to-5 bps increase during the month. The yield cap on 12M notes, which the CBSL allegedly uses as a tool to guide the market, was relaxed but as the CBSL prefers to accept 3M notes often above and beyond the respective initial offer quantities to meet borrowing targets, the acceptance rate of 6M and 12M notes remained strikingly low.

Long-term rates

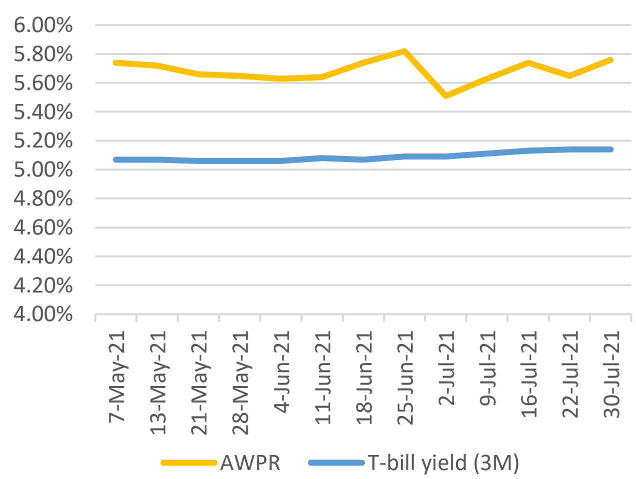
Figure 2: Yield curve of treasuries



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

There were two fresh bond issuances followed by a direct placement in July. Despite the market's reasonable level of buying interest, the CBSL left a sizable portion of the issues unfilled during the second auction. The yield curve remained more-or-less unaltered.

Figure 3: AWPR[1] and 3M T-bill yield



Note: T-bill yield for secondary market Source: CBSL

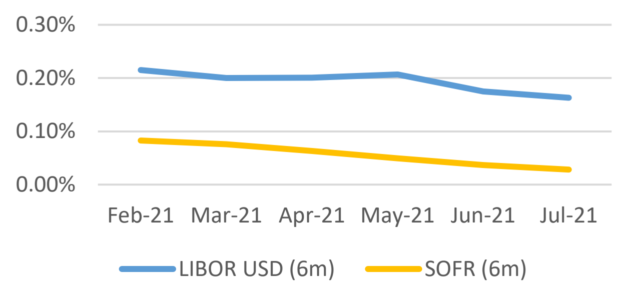
[1] AWPR is calculated based on the submissions made by the commercial banks to the CBSL on the rates offered to customers who borrowed more than LKR 10 Mn for less than three months.

Prime lending rate (AWPR), jumped 25 bps to 5.76% in the last week of July compared to the first week. Rising money market rates, falling excess liquidity, and surging infection rates may have contributed to this rise.

Private credit grew 12.9% in June reflecting a low base that prevailed around the same time last year. Nevertheless, the same rose by LKR 83.4 Bn (M/M), an upside surprise to our earlier expectation. But we observe a significant contraction in the reserve money in July due to the decrease in currency in circulation and deposits held by the commercial banks with the Central Bank. Therefore, we infer that private credit expansion may have witnessed a notable moderation in July.

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

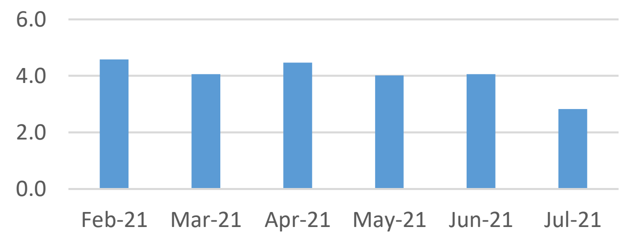
The US treasury yields were under pressure for the most part of the month as investors feared inflation to be more 'permanent' than 'transitory'. The Fed provided some consolation with the remarks on inflation to be transitory and signaling the tapering of the QE was still not in sight. Rising Delta-variant infections across Asia helped to strengthen treasuries, but was immediately overshadowed by encouraging GDP and employment statistics. In this context, the massive supply of US dollars via the QE programme pushed Eurodollar rates, LIBOR USD and SOFR down.

The yields on SLISBs continued to surge in July with yields on issues reaching maturity in 2022-23 breaching 25%. This came after Moody's placed Sri Lanka's Caa1 rating under review for downgrade [1]. Investors and analysts still seemed to be less convinced on the ability of the country to meet its debt obligations, in spite of numerous reassurances from the GoSL that it would honour all its dues on time. In this setting the entire spectrum of SLISBs now have double digit yields.

External Sector

Exports in June recorded USD 1 Bn with main contributions coming from garments (USD 376 Mn) and tea (USD 124 Mn). However, the import bill recorded USD 1.6 Bn resulting in a trade deficit of USD 652 Mn driven by accelerating commodity prices (i.e., fuel, textiles, chemicals, and base metals). Nevertheless, the robust performance of remittances (USD 478 Mn) and a forex loan(s) amounting to USD 175 Mn helped to marginally improve the current account.

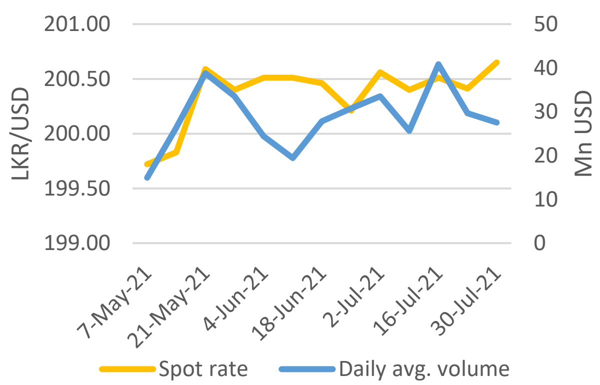
Figure 5: Gross official reserves (Mn USD)



Source: CBSL

The CBSL was able to absorb about USD 60 Mn via an SLDB auction and a supplementary direct issue, and USD 38 Mn from open market purchases. About 1.5 Bn in forex obligations, of which 1 Bn was for maturing SLISBs, were due in July and were honured. This weakened the overall reserve position to USD 2.8 Bn.

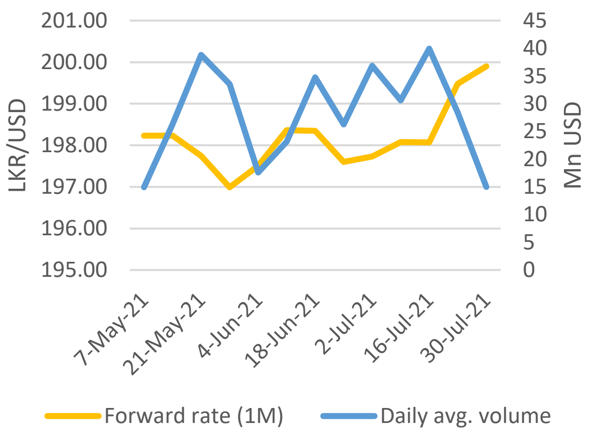
Figure 6: Interbank spot market



Source: CBSL

Activity level in the interbank spot market declined in the last two weeks of July while Sri Lanka's spot exchange rate remained pegged around 200 LKR/USD.

Figure 7: Interbank forward market

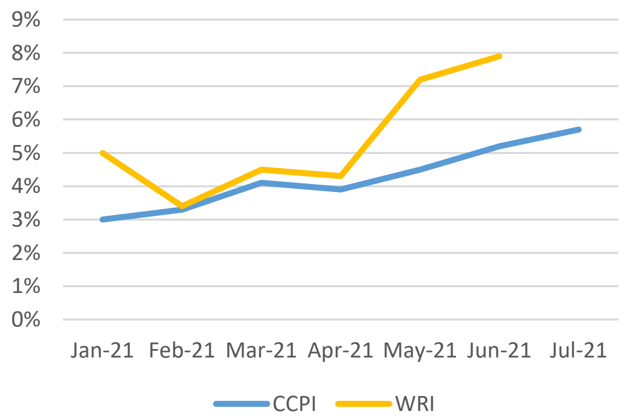


Source: CBSL

Forward premiums continued to be inverted but were nonetheless narrowing. Interbank forward market activity levels dwindled causing outstanding forward volumes to decline over the month.

Prices & Wages

Figure 8: CCPI and Nominal Wage Rate Index of the informal private sector (Y/Y)



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

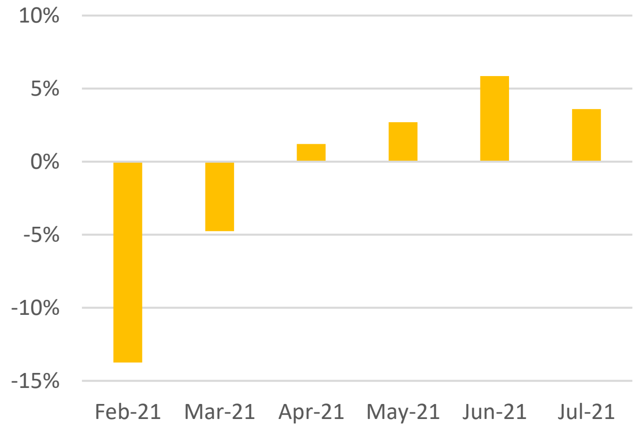
Wage growth jumped to 8% in June from its lower base that prevailed around the same time last year due to continued recovery of industry and services sectors.

Headline and core inflation accelerated to 5.9% and 3.7% respectively in July as the upward revision of fuel price was working its way through various sectors of the economy. On a year-on-year basis, food inflation remained at double digits while non-food inflation is currently the highest since December 2019.

Equities

Domestic Market

Figure 9: ASPI (M/M)



Source: CSE

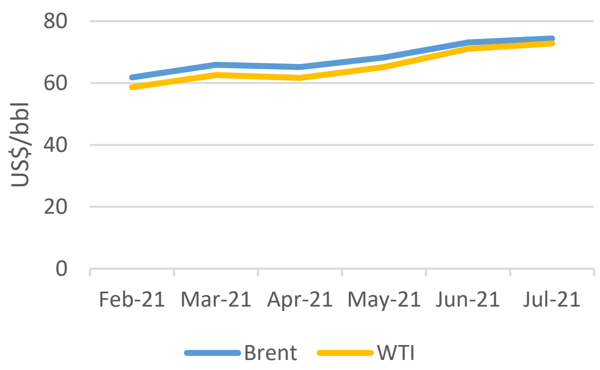
Equities ended stronger in July with CSE recording a fourth straight month of gains ending ASPI 3.61% and S&P SL20 3.16% higher from June. Foreigners were continually on the sell-side.

Global Markets

The US equities recorded solid performance overcoming investor anxiety over inflation and surging Delta-variant cases. In Europe, while France was struggling, Germany and the UK managed to post decent gains. Investors took a bearish stance in most Asian markets as the concern over the rising infections grew.

Commodities

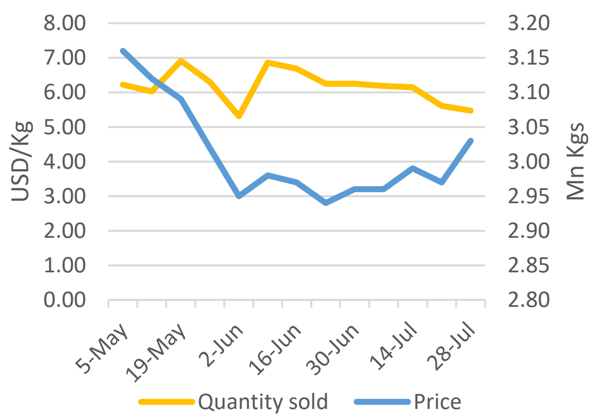
Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

Brent crude oil prices peaked at USD 77.16 at the start of July and remained high for the rest of the month. The OPEC oil output rose in July to its highest level since April 2020, as the group eased production cuts. The US oil giants such as Exxon Mobil and Chevron reported rising US rig count as demand for most oil products returned to pre-pandemic levels.

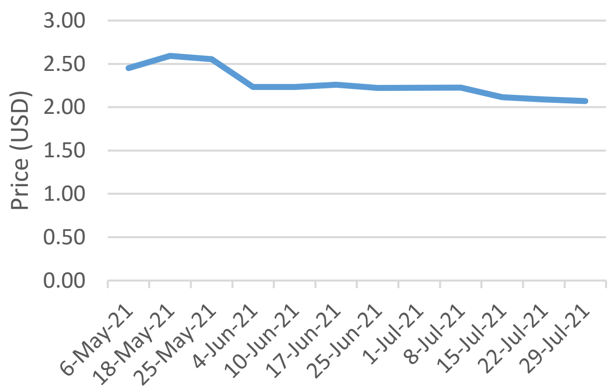
Figure 11: Tea (All Elevations) price and quantity sold at weekly auctions



Source: Forbes & Walker

Tea prices in the Colombo auction increased in July as a result of better quality from favourable weather conditions.

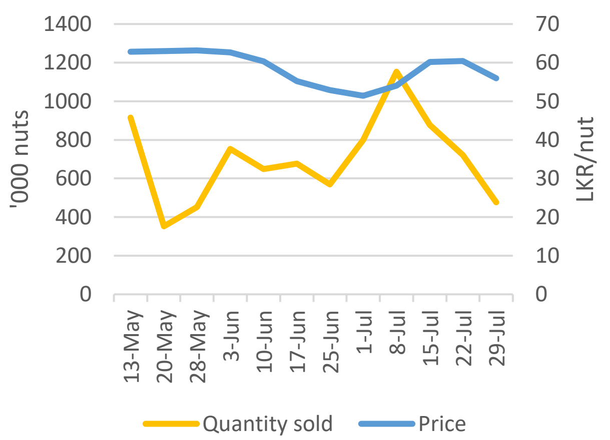
Figure 12: Rubber price weekly auctions



Note: Price of Latex 4X
Source: RRISL

Rubber prices in the Colombo auction marginally declined during the month. Global natural prices also slid as industrial demand from China and India dropped due to rising infection levels.

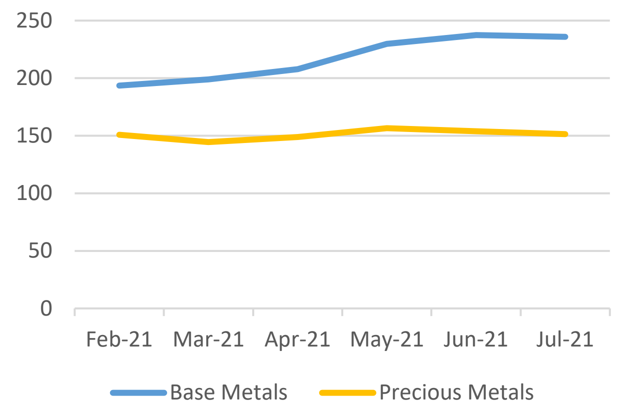
Figure 13: Coconut price weekly auctions



Source: CDA

Coconut prices recovered briefly towards mid-July before moderating by the month end. Supply also plummeted to record lows.

Figure 14: Metal price index (2016=100)



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

Gold price crashed in June as strong US job data fueled fears of an earlier-than-expected interest rate hike in the US. As July wore on, the price recovered slightly.

Base metal prices eased as intervention by the Chinese authorities to curb speculative buying started to take effect. However, global iron ore prices continued to remain elevated, driven by robust steel demand from both China and the rest of the world. In the meanwhile, Indian steel manufacturers were seen cutting prices to spur demand.

Read ICRA Lanka's report on the implications of rising commodity prices for Sri Lanka.

Outlook for August-September

Rapid escalation of the Delta-variant is the number one concern for the economy right now. Though the vaccination drive is currently in full swing, effectiveness of vaccines against the Delta-variant still remains to be seen. In this context, in contrast to our previous expectations, the activity level in the economy may remain subdued for at least till the end of September.

Heightened public debt financing, impaired state revenues, and accelerating inflation will continue to put pressure on the money market rates to move up. Hence, we expect the retail lending rates to plateau over the next month or two.

With gloomy outlook and mounting uncertainty of how the pandemic is going to evolve in the next few weeks, banks will not be very enthusiastic in extending credit to the private sector nor will the businesses be overly interested in investments. Therefore, we expect the private credit to continue to slowdown in August/September.

Sri Lanka's fragile state of the external sector puts the country on a tight-rope having to primarily rely on bilateral sources to manage its balance of payment crisis given its explicit resistance to seek the IMF assistance. Some of the bilateral swaps that were under negotiation earlier may materialize in the near-term, giving temporary relief to yields on the SLISBs.

The effects of the surge in global commodity prices are beginning to be felt in the day-to-day lives of people. The situation is further aggravated by supply shocks emanating from various factors. With no end to pandemic in sight, continuation of import controls will only drive prices up. Therefore, we expect the inflation rate to be moderate but on an upward trajectory in the medium term.

Read ICRA Lanka's Midyear Economic Update.

Rating Actions

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

Issuer	Issue	Action	Previous Rating	Current Rating
Bank of Ceylon	Basel III Compliant Additional Tier 1 Capital Bond Programme (LKR 8 Bn)	Assigned	N/A	[SL]AA(hyb) (Negative)
UB Finance Company Limited	Issuer Rating	Reaffirmed	[SL]BB (Negative)	[SL]BB (Negative)
LCB Finance Limited	Issuer Rating	Revised	[SL]B (Stable)	[SL]B+ (Stable)
E B Creasy & Company PLC	Issuer Rating	Notice of Withdrawal	[SL]BBB (Negative)	[SL]BBB (Negative)
Orient Finance PLC	Issuer Rating	Revised	[SL]BB (Negative)	[SL]BB (Stable)
Unions Capital Leasing Limited	Issuer Rating	Withdrawn	[SL]BBB (Negative)	N/A
Trade Finance and Investment PLC	Issuer Rating	Withdrawn	[SL]BBB (Negative)	N/A
Nawaloka Hospitals PLC	Issuer Rating	Revised	[SL]BBB (Negative)	[SL]BBB (Stable)

Abbreviations

ASPI	All Share Price Index
bps	Basis points
pps	Percentage points
CBSL	Central Bank of Sri Lanka
CDA	Coconut Development Authority
CSD	Census and Statistics Department
CSE	Colombo Stock Exchange
GICS	Global Industry Classification Standard
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
RRISL	Rubber Research Institute of Sri Lanka
YTD	Year-to-date

References

[1] Moody's Investors Service, "Rating Action: Moody's places Sri Lanka's Caa1 rating under review for downgrade," 19 July 2021. [Online]. Available: https://www.moodys.com/research/Moodys-places-Sri-Lankas-Caa1-rating-under-review-for-downgrade--PR_450080.

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Published date: August 16, 2021
Document #: meuaugl21

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