



MONTHLY ECONOMIC UPDATE

October

Economy at a glance for October 2021

Rising inflation overshadows recovery

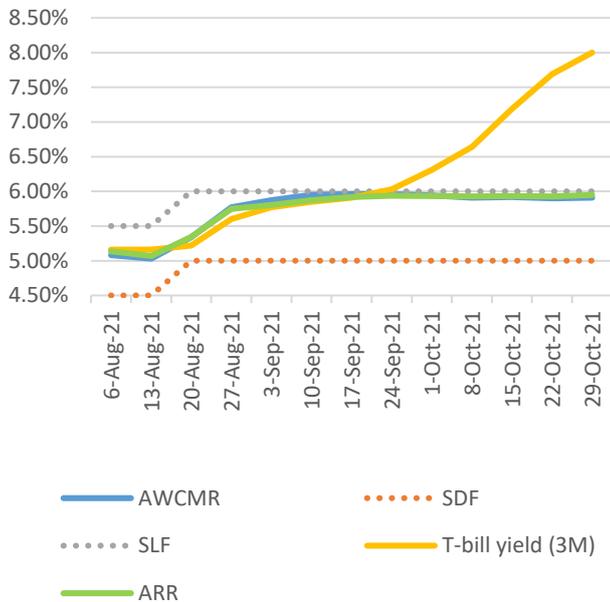
Highlights

- The PMI index for both services and manufacturing sectors grew in October helping the economy to recover.
- The CBSL maintained policy interest rates at their current levels. Call and repo rates remained close to the upper bound of the policy corridor.
- T-bill yields in both markets saw a large increase amounting close to 200 bps.
- The yields of the SLISBs were on decline for a good part of the month but were reversed following Moody's downgrade of the country's sovereign rating to Caa2.
- Tourist arrivals picked up generating nearly USD 31 Mn in receipts.
- The total official reserves slid to USD 2.3 Bn after the settlement of forex obligations pending which was around USD 493 Mn.
- Volumes in the interbank spot and forward markets improved amid some degree of movement in the exchange rate.
- Headline inflation shot up to 7.6%(Y/Y) due to broad-based increase in both food and non-food inflation.
- The stock market maintained its momentum with ASPI and S&P recording 7.4% and 4.9% gains respectively.

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 CBSL maintained policy interest rates at their current levels in October. Call and repo rates remained close to the upper bound of the policy corridor while repo rates overtook the call rates during the month. Tighter liquidity in the second-half of the month pushed the rates up further. Notable surge in call volumes and moderate repo volumes were observed during the month as overnight liquidity level continued to remain negative. The CBSL was seen employing both short-term and long-term repos to absorb liquidity from the market.

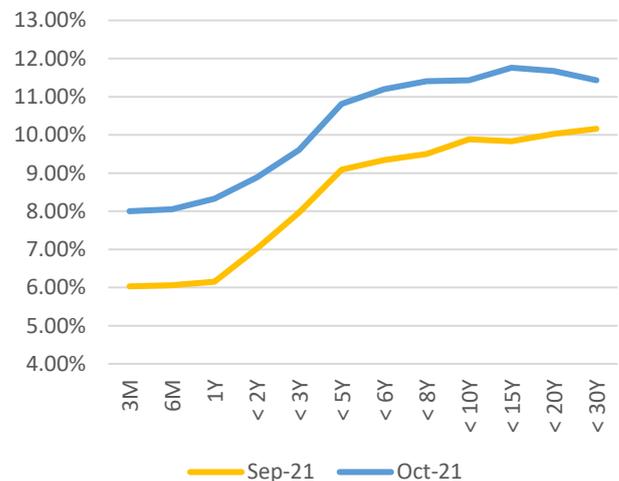
In the first-half of the month overnight liquidity improved to just under LKR 50 Bn/day as the CBSL bought over LKR 100 Bn treasuries. But as the month wore on, the deficit reverted to LKR 130-150 Bn/day levels. Amidst tighter liquidity, banks continued to utilize the Standing Lending Facility more extensively.

Net forex purchases and treasuries of the CBSL may have added up around LKR 150 Bn to the money supply.

Activity levels in both the primary and secondary treasury markets rose. T-bill yields in both markets saw a large increase amounting close to 200 bps during the month. Removal of yield caps greatly improved the auction performance but still the offer-to acceptance ratio of 6M and 12M T-bills remained abysmal.

Long-term rates

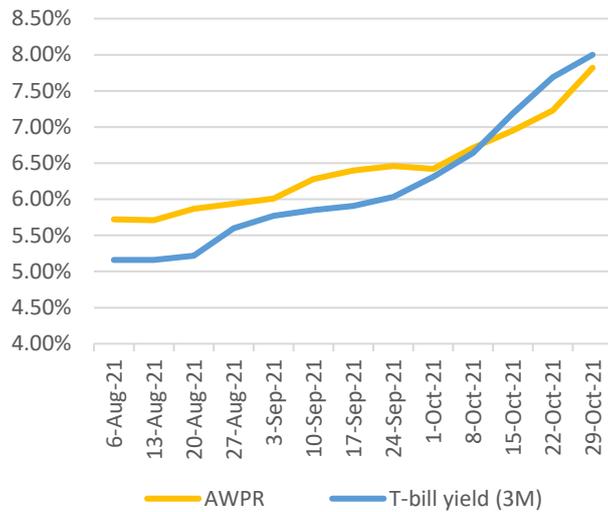
Figure 2: Yield curve of treasuries



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

Treasury yields spiked ahead of the Monetary Policy Review on 14th October possibly in expectation of increase in policy rates. There was a decent appetite for fresh bond issues in October and the market absorbed close to LKR 100 Bn during the auctions.

Figure 3: AWPR¹ and 3M T-bill yield



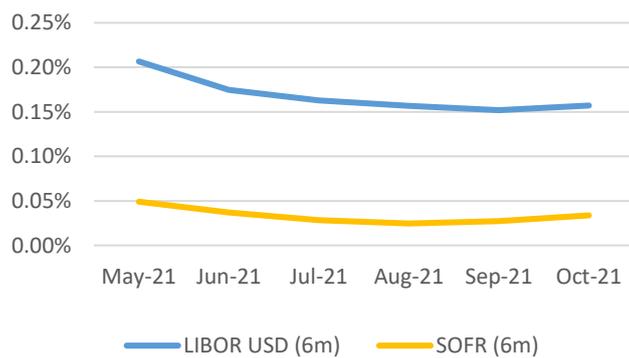
Note: T-bill yield for secondary market, Source: CBSL

The private sector credit increased by LKR 29 Bn in September, the lowest monthly increase since January 2021 amidst monetary tightening.

AWPR rose by about 140 bps in October. In the meanwhile, reserve money contracted by about LKR 10 Bn. Thus, it is likely that credit slowdown may have continued well into October too.

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

Growing concerns about inflation drove US bond yields higher as long dated treasury yields climbed

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. Page | 3

to their highest levels in over three months. US consumer price rose to a 30-year high of 5.4% in September, rising several folds than the Fed's target rate of 2%. Highest increases were observed in prices of Food, Shelter and Gasoline. US weekly jobless benefit claims sank to its lowest levels since the start of the pandemic. Yields started to move up towards the end of the month as the Fed announced that they would begin tapering QE in November.

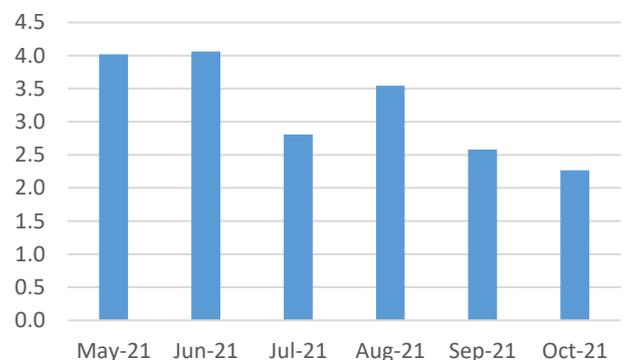
The yields of the SLISBs were on decline for a good part of the month but were reversed following Moody's downgrade of the country's sovereign rating to Caa2.

External Sector

Sri Lanka managed to record a marginal improvement in trade deficit of about USD 495 Mn in September compared to August owing to a decline in imports. Y-o-Y increase in trade deficit is primarily driven by fuel, textiles and textile articles, and machinery and equipment. Foreign remittances which have experienced a gradual decline since April this year stood around USD 353 Mn in September.

Tourist arrivals picked up in October generating nearly USD 31 Mn in receipts. Capital flight from the treasuries market was negligible while the same from the equities was around USD 7 Mn during the month.

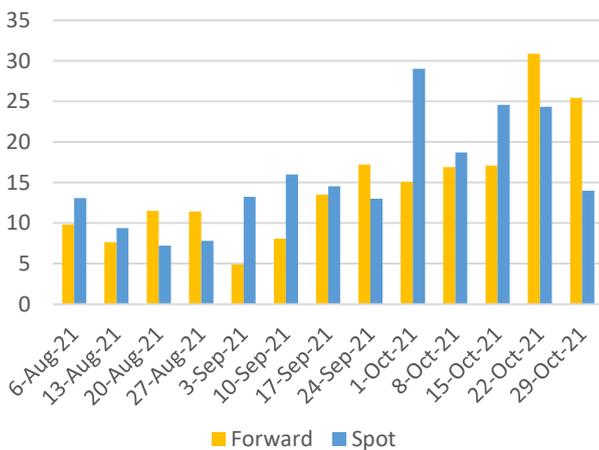
Figure 5: Gross official reserves (Mn USD)



Source: CBSL

Forex market intervention by the CBSL caused an addition of USD 79 Mn to the gross official reserves. The CBSL's issued [new rules](#) on mandatory conversion of export proceeds within the first week of each month on 29th October. The total official reserves slid to USD 2.3 Bn after the settlement of forex obligations pending which was around USD 493 Mn.

Figure 6: Interbank forex market daily avg. volumes (USD Mn)

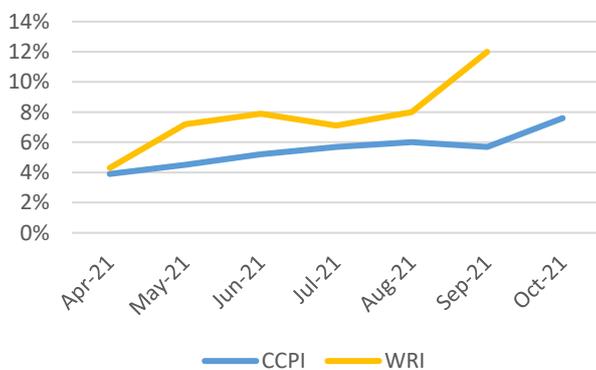


Source: CBSL

Volumes in the interbank spot and forward markets improved in October amid some degree of movement in the exchange rate. Outstanding forward volume marginally grew compared to the end-September level.

Prices & Wages

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



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

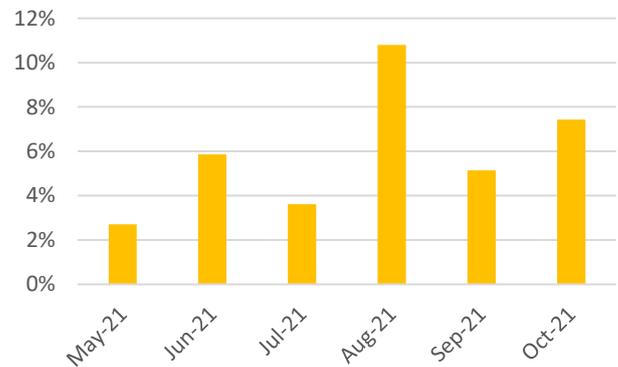
Wage growth continued to recover and posted 12% growth (Y/Y) in September as a result of normalization of economic activities as well as the low base that prevailed in the previous year.

Headline inflation shot up to 7.6%(Y/Y) in October. Food inflation rose to 12.8% from 10% due to increase in prices of rice, milk powder, coconut and fresh fish. Non-food inflation rose to 5.4% from 3.8% as a result of increases in prices of housing, water, electricity, gas and other fuels.

Equities

Domestic Market

Figure 8: ASPI (M/M)



Source: CSE

The stock market maintained its momentum during October with ASPI and S&P recording 7.4% and 4.9% gains respectively. Investor sentiment improved during the month on the back of improving economic activity. The highest performing sectors continued to be transport and diversified financials. Overall PBV (Price-to-Book-Value) increased from 1.32 to 1.42 favouring sellers.

Figure 9: GICS sector performance- October

Sector	Index Points Gained
Transportation	2824
Diversified Financials	376
Energy	121
Materials	88
Capital Goods	88
Automobiles & Components	66

Health Care Equipment & Services	61
Banks	52
Food, Beverage & Tobacco	39
Consumer Services	33
Insurance	32
Real Estate	27
Retailing	27
Consumer Durables & Apparel	21
Telecommunication Services	14
Utilities	2
Food & Staples Retailing	-42
Household & Personal Products	-51
Commercial & Professional Services	-76

gradually increased as current demand stands at just 2% below the pre-crisis level. OPEC continues to maintain a tight supply for its oil production and is expected to remain low during the rest of the year [1].

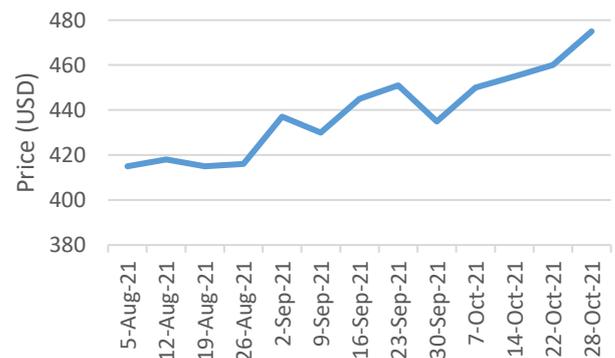
Figure 11: Tea (All Elevations) price and quantity sold at weekly auctions



Source: Forbes & Walker

Tea prices at the Colombo auction noted a sharp increase during the first half of the month due to increased demand. This was a result of minimum retail prices introduced by Kenya. Subsequently, prices moderated towards the end of the month.

Figure 12: Rubber price weekly auctions



Note: Price of Latex 4X
Source: RRISL

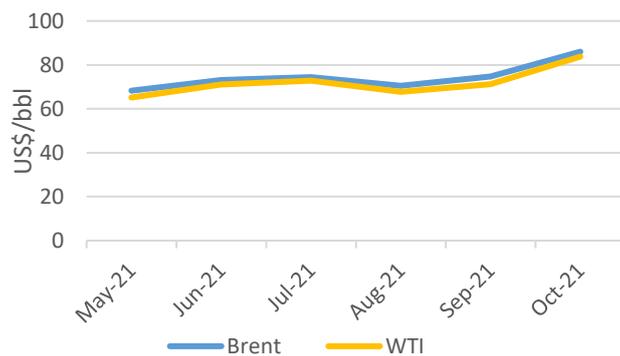
Supply bottlenecks among the natural rubber producing countries lifted rubber price further in the Colombo auctions. Prices in the global market moderated towards the end of the month on the back of improved expectations of global supply recovery over the coming months [2].

Global Markets

Global stock markets in general showed optimism during October 2021 with US equities on the lead. The NASDAQ gained 7.3% while the S&P 500 index recorded a 7% gain. Markets soared as the Fed’s tapering announcement led to 22 bps increase in 2-year Treasury instruments, the highest since March 2020. European markets mostly were mixed with France, Spain and Italy being top performers. Asian markets were also buoyant. Japan and China were the top performers while Hong Kong equities fell.

Commodities

Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

Crude oil prices which have been continuously rising over the past 12 months hit a seven-year high in October due to rebound in global demand as well as constrained supply. At the start of the year global gasoline demand was 10% below the pre-pandemic level. The demand appears to have

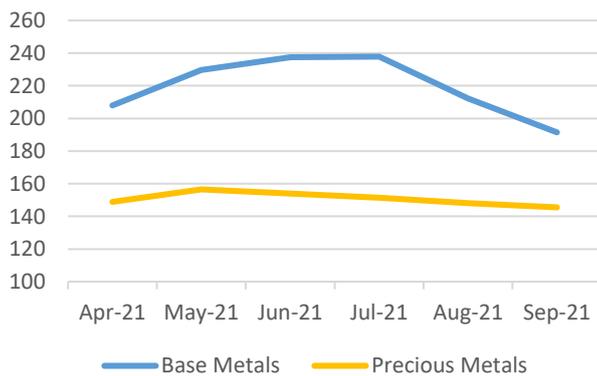
Figure 13: Coconut price weekly auctions



Source: CDA

Coconut prices at the Colombo tea auction saw a substantial increase during October amidst weaker supply.

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 prices rose marginally by around 3% in October due to solid demand as rising US inflation levels caused investors to move to gold as a hedge. Demand for gold by Jewelers also increased during October as a result of consistent price declines over past months. However, the expected monetary tightening by the Fed next year may reduce the prospects of gold prices moving higher.

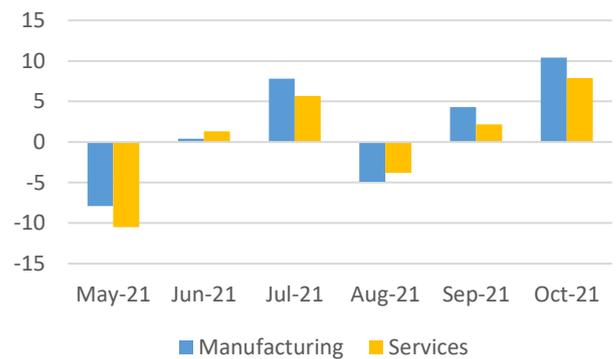
Aluminum and Coal prices dropped to an eight-week low during October after Chinese regulators cracked down on illegal hoarding in order to regulate prices. Furthermore, copper prices noted a marginal increase as supply is expected to decline

in the future due to tighter mining regulations in Peru and Chile. Iron ore prices are expected to remain stationary during the next few months.

Read ICRA Lanka's report on the [implications of rising commodity prices for Sri Lanka](#).

Real Sector

Figure 15: PMI deviation from point of neutrality (Index points)



Notes- negative values indicate the 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 PMI index for both services and manufacturing sectors grew in October helping the economy to recover. Employment in the manufacturing sector recorded another month of expansion helping to recover wages. But the supply lags still show no sign of improvement. The services sector continued to experience a rise in new businesses while expecting more business activities in the near-term.

Read ICRA Lanka's take on what lies [beyond the pandemic for Sri Lanka](#)

Outlook for November - December

As evident from the PMI index for October, the economy got into a good start and enroute to a better quarter to end 2021. There is a slight uptick in the daily caseload but we feel authorities will most likely be able to keep it under control in the coming few weeks.

The government presented its budget last week setting the tone for a challenging 2022 and is likely to turn out to be a year of some restraint.

Read ICRA Lanka's [initial observations of the Appropriation Bill](#).

Forex reserves have fallen to alarmingly low levels and forex inflows are urgently required to replenish reserves and restore confidence in the currency. The CBSL recently highlighted in a [progress report](#) a number of expected inflows.

Though still below the pre-crisis levels, tourist arrivals are encouraging. We expect to see a gradual recovery in tourism in the next two months.

The short-term interest rates still have some room to move up. Therefore, we may see these adjustments taking place in the market in the next few weeks. Retail lending rates will also further adjust up, slowing credit in the process.

Inflation will remain around the upper bound (i.e., 6%) of the CBSL's inflation target. As signaled during [budget speech](#), the government may follow hands-off policy when it comes to prices of commodities and essential goods. Therefore, we may continue to witness elevated inflation level for the rest of the year.

Rating Actions

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

Issuer	Issue	Action	Previous Rating	Current Rating
Hayleys PLC	Issuer Rating	Revised	[SL]A+ (Negative)	[SL]A+ (Stable)
Hayleys PLC	Senior Unsecured Listed Redeemable Debenture Program (LKR 3,527 Mn) – Issued Aug 08, 2018	Revised	[SL]A+ (Negative)	[SL]A+ (Stable)
Hayleys PLC	Senior Unsecured Listed Redeemable Debenture Program (LKR 3,000 Mn) – Issued Aug 26, 2019	Revised	[SL]A+ (Negative)	[SL]A+ (Stable)
Ceylon Tea Brokers PLC	Issuer Rating	Reaffirmed	[SL]BBB (Stable)	[SL]BBB (Stable)
Associated Motor Finance Company PLC	Issuer Rating	Revised	[SL]B+ (Negative)	[SL]B+ (Stable)
Prime Lands (Pvt) Ltd.	Issuer Rating	Reaffirmed	[SL]A- (Stable)	[SL]A- (Stable)
Prime Lands Residencies PLC	Issuer Rating	Reaffirmed	[SL]A- (Stable)	[SL]A- (Stable)
Nawaloka Hospitals PLC	Senior Unsecured Redeemable Debenture (LKR 164.5 Mn) – Aug 30, 2015	Withdrawn	[SL]BBB- (Stable)	[SL]BBB- Withdrawn
Commercial Credit and Finance PLC	Issuer Rating	Reaffirmed	[SL]BBB (Stable)	[SL]BBB (Stable)
Commercial Credit and Finance PLC	Guaranteed Redeemable Debenture Program (LKR 2,000 Mn)	Reaffirmed	[SL]AA(CE) (Stable)	[SL]AA(CE) (Stable)
Commercial Credit and Finance PLC	Commercial Paper Program (LKR 1,000 Mn)	Reaffirmed	[SL]A3	[SL]A3
Asia Asset Finance PLC	Proposed Secured Asset Backed Trust Certificates (LKR 600 Mn)	Assigned	N/A	[SL]A-(SO) (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] IEA, "Oil Market Report - October," International Energy Agency, October 2021. [Online]. Available: <https://www.iea.org/reports/oil-market-report-october-2021>.
- [2] A. & Kottayam, "Spot rubber lost ground on Monday," The Hindu, 20 September 2021. [Online]. Available: <https://www.thehindubusinessline.com/markets/commodities/spot-rubber-lost-ground-on-monday/article36572839.ece>.

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Published date: November 16, 2021
Document #: meunov21

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