MONTHLY ECONOMIC UPDATE July

ICRA LANKA

Economy at a glance for July 2022

Trade Surplus improves sentiment

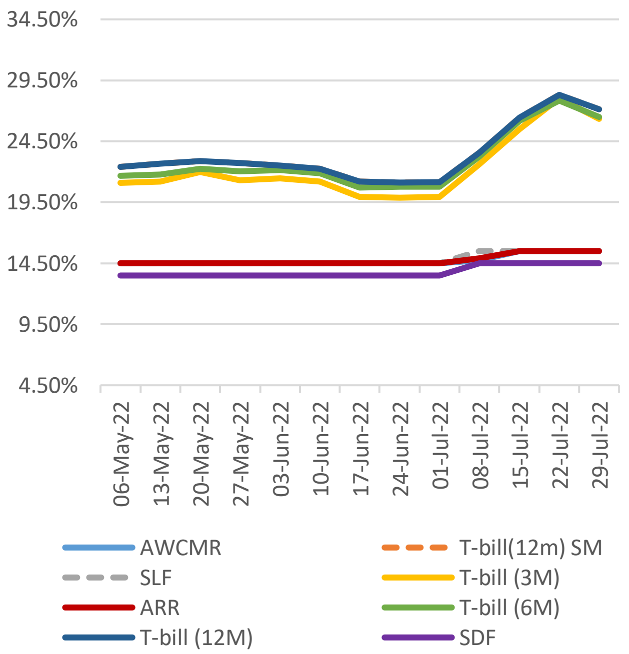
Highlights

- The Central Bank of Sri Lanka opted to raise the policy rates by 100 bps which caused call and repo rates to adjust upwards towards the new upper bound of the policy corridor.
- Yields in the Primary auctions shot up by over 800 bps (short term instruments) following heightened public tensions due to sever fuel shortages which led to mass scale protests.
- Overall private credit growth declined by 40 Bn (M/M) In June as rising rates coupled with worsening economic situation most likely deterred borrowings and AWPR increased by 267 bps in July following the increase in the lending rates.
- Sri Lanka recorded a surplus in the trade balance in June 2022 for the first time in 20 years as a result of high export earnings and a continued decline in import expenditure.
- Inflation levels rose again in July (Y/Y) as headline inflation increased to 60.8%. Food inflation increased to 90.9% while non-food inflation increased to 46.5%.
- The stock market closed with a 5.3% gain in the ASPI while the S&P20 closed with 4.88% gain in July.
- Global brent crude oil prices experienced a sharp fall during the month following strong recessionary pressures due to the persistence of high inflation.
- Gold prices slid at the start of month as investors rallied towards a potential interest rate hike by the Fed Reserve
- The PMI for manufacturing recorded a contraction in July due to subdued demand conditions prevalent in the food and beverage sectors. The PMI for services also declined for the fourth consecutive month.

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

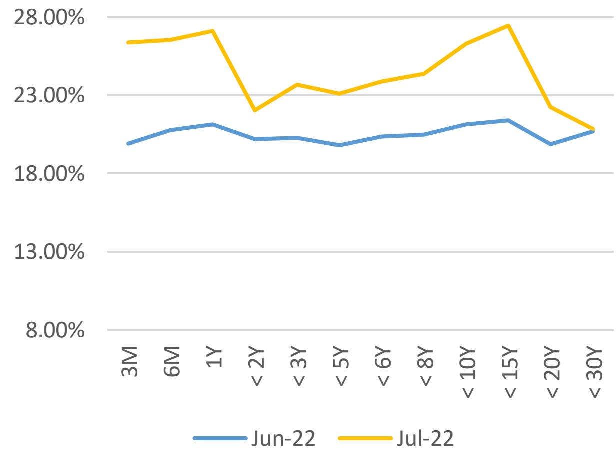
In July, the Central Bank of Sri Lanka opted to raise the policy rates by 100 bps which caused call and repo rates to adjust upwards towards the new upper bound of the policy corridor. Call volumes continued to remain at near zero levels while the repo volumes grew marginally.

Overnight liquidity deficit levels improved during the month, even reaching around LKR 380 Bn during the month. Borrowings through the Standing Lending Facility remained at elevated levels, however showed improvement compared to previous months. The Central Bank stock of Treasury bills increased by LKR 175 Bn in July. There were no short-term repo auctions during the month, but the government absorbed around LKR 26 Bn worth of long-term repos.

Yields in the Primary auctions shot up by over 800 bps (short term instruments) following heightened public tensions due to sever fuel shortages which led to mass scale protests. The 3M T-bills continued to attract the highest demand over 6M and 12M. Rates in the secondary market saw a similar revision leading to a further inversion in the yield curve.

Long-term rates

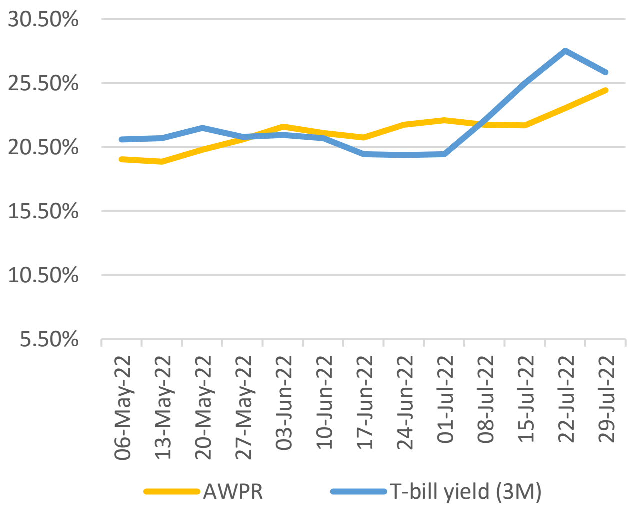
Figure 2: Yield curve of treasuries



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

Yields of longer-term maturities also rose during the month as a result of the increase in policy rates coupled with the rising economic tensions. The market absorbed around LKR 43.5 Bn in new Bond issuances while the volumes in the secondary market increased gradually.

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

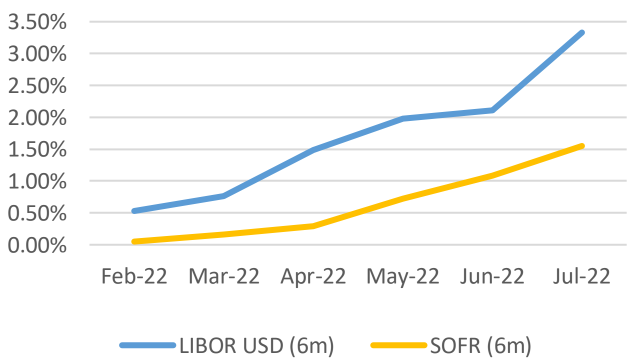


Note: T-bill yield for secondary market, Source: CBSL

Overall private credit growth declined by 40 Bn (M/M) In June as rising rates coupled with worsening economic situation most likely deterred borrowings. Reserve money contracted by 1.2% and AWPR increased by 267 bps in July following the increase in the lending rates coupled with tightening monetary conditions.

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 month of July saw the yield curve inverting following the discovery of a new subtype of the Omicron variant which caused China to re-impose restrictions. Additionally new pricing data released shows US inflation surging to a new 41 year high of 9.1% in June. Hence the short-term end of the yield curve expanded as markets expected another increase in interest rates by the Fed. Treasury yields remained at elevated levels as increasing US wholesale prices caused markets to expect more aggressive rate hikes by the Fed. Longer dated treasury yields continued to decline to almost two months with Jobless claims increasing, signaling that the US economy could slip into a recession. Towards the end of the month, the Fed responded by lifting the Fed-funds rate by 75 basis points. However, analysts suggest that the Fed is likely to considerably slow the pace of rate hikes in the upcoming months in order to facilitate economic growth.

Following a 75-bps rate hike by the Fed Reserve, the USD linked LIBOR increased by around 122 bps and SOFR rose by 46 bps

External Sector

Sri Lanka recorded a surplus in the trade balance in June 2022 for the first time in 20 years as a result of high export earnings and a continued decline in import expenditure. Merchandise exports (YOY) in the textile and garments sector grew by 37% and gems and precious stones grew by 65.7%. Overall import bill saw a significant decline during the month with a 61.6% decline in medical and pharmaceuticals, 42.2% decline in machinery and equipment and a 42% decrease in building material.

Receipts from tourism increased marginally after sharply declining the previous months due to fuel shortages and mass protests. However, tourism is expected to pick up over the next months as tensions ease. Worker remittances has declined by 42.7% to USD 274 Bn in June (Y/Y).

The yields on ISB's increased across all maturity periods following the continued economic downturn.

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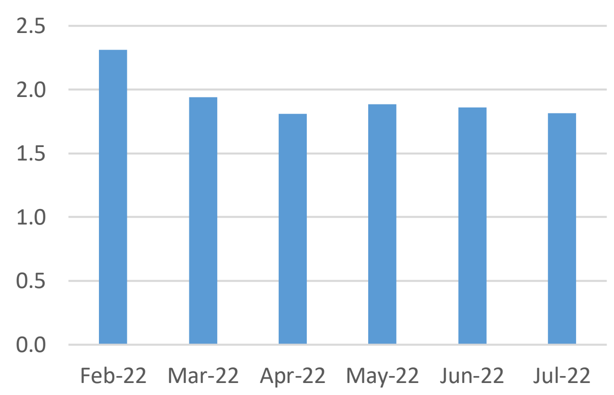
[1] AWPR is calculated based on the submissions made by the commercial banks to the CBSL on the rates offered to customers who borrowed more than LKR 10 Mn for less than three months.

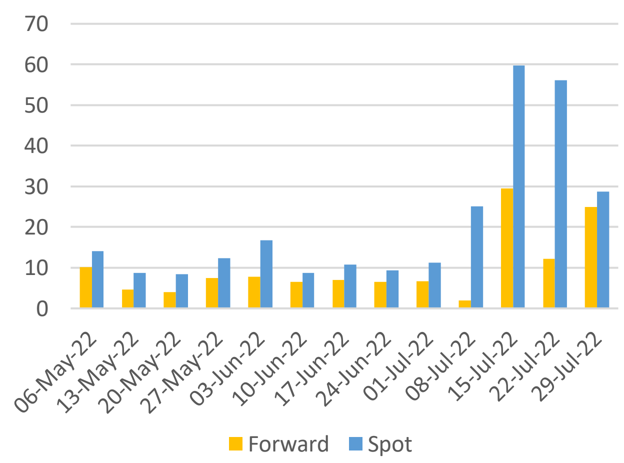
Figure 5: Gross official reserves (Mn USD)



Source: CBSL

Total gross official reserves declined by USD 44 Mn to USD 1.815 Bn towards the end of July, mainly since the CBSL remained a net seller of foreign currency to local banks and financial institutions.

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

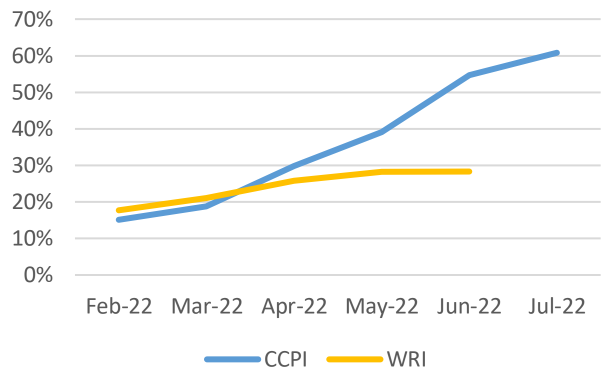


Source: CBSL

Interbank spot volumes increased sharply during the month, as business sentiment improved following the higher availability of foreign currency in the financial system. Forward volumes also improved during the same time period.

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

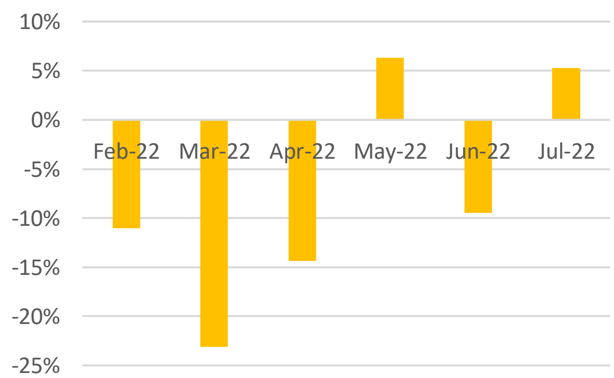
Private Wage growth continued to increase and posted a 28.3% increase (Y/Y) in June, while public sector employees' wages posted a 16.1% growth (Y/Y) during the same period.

Inflation levels rose again in July (Y/Y) as headline inflation increased to 60.8% from 54.6%. Food inflation increased to 90.9% from 80.1% due to rising prices of fresh fish, vegetables, coconut, coconut oil and milk powder. Non-food inflation increased to 46.5% from 42.4% as a result of increased prices of fuel, housing, water, electricity, gas and electricity.

Equities

Domestic Market

Figure 8: ASPI (M/M)



Source: CSE

The stock market remained bearish during the month, as a change in the President, caused markets to close posting the largest single gain in two months. Hence the ASPI closed with a 5.3% gain while the S&P20 closed with 4.88% gain in July.

Most sectors made gains with transportation, energy and consumer durables being best performers. Net foreign purchases remained strongly positive and over PBV (Price-to-Book-Value) rose from 0.80 to 0.83 favoring sellers.

Figure 9: GICS sector performance- July

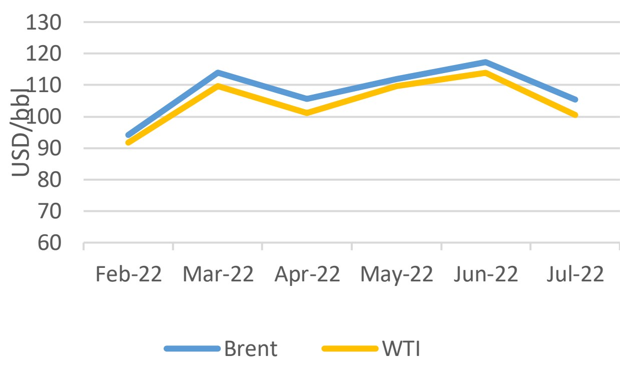
Sector	Index Points Gained
Transportation	411
Energy	298
Consumer Durables & Apparel	241
Household & Personal Products	174
Materials	135
Software Services	100
Utilities	58
Food, Beverage & Tobacco	56
Health Care Equipment & Services	47
Telecommunication Services	39
Automobiles & Components	28
Capital Goods	25
Consumer Services	24
Retailing	21
Banks	12
Food & Staples Retailing	6
Real Estate	2
Insurance	-5
Diversified Financials	-14
Commercial & Professional Services	-84

Global Market

Stocks markets which were down during the first half of the month, rebounded strongly towards the second half, leading to strong gains. The Dow Jones gained 6.73%, while the S&P 500 index rose 9.11% and the Nasdaq picked up by 12.35%. Despite looming threats of high inflation, investors saw falling energy prices as a hopeful sign. Furthermore, consumer and business activity had also started to pick up by effectively navigating inflation and various supply chain challenges. All sectors made gains, but consumer discretionary and technology remained the top performers. European markets also remained positive with Germany, France and Spain experiencing gains. All Asian market made gains besides China which saw the reimpositions of COVID restrictions due to increasing case numbers.

Commodities

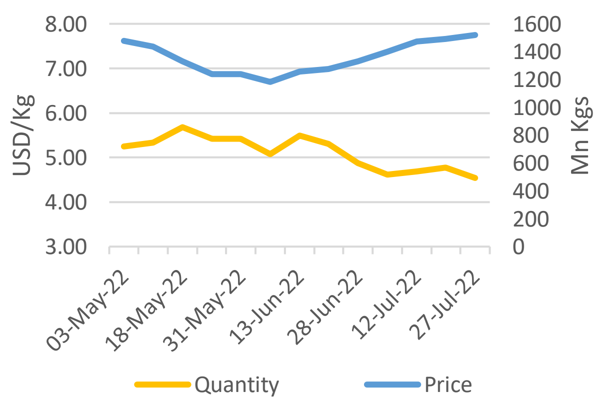
Figure 10: Crude oil price



Source: Bloomberg quoted in CBSL

Global brent crude oil prices experienced a sharp fall during the month following strong recessionary pressures due to the persistence of high inflation. Oil prices were also impacted by a discovery of a new COVID strain in China which led to lockdowns, impacting demand. Prices collapsed again towards the end of the month following a rate hike by European Central Bank along with the resumption of gas imports to Europe easing supply restrictions.

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

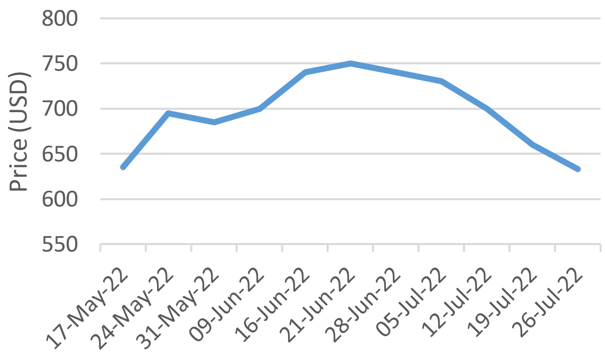


Source: Forbes & Walker

Adverse weather conditions due to heavy rains in all areas of the country caused overall output to fall, leading to a price increase in the Colombo auctions. International auctions performed well with Bangladesh, Malawi and Kolkata auctions fetching high prices.

Read ICRA Lanka's report, [Sri Lanka plantations at a fork in the road, thrive or survive?]

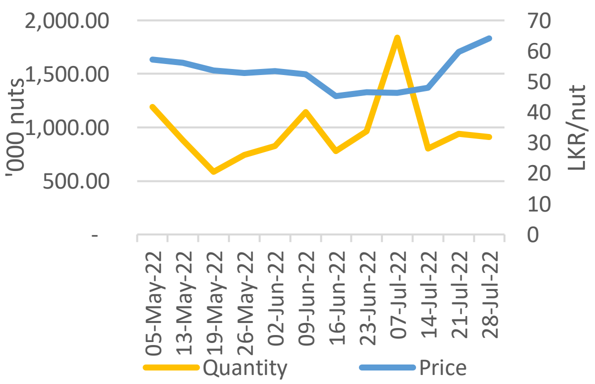
Figure 12: Rubber price weekly auctions



Note: Price of Latex 4X
Source: RRISL

Prices at the Colombo rubber auctions saw prices decline following the imposition of lockdown restrictions, hindering industrial activity in China which is the largest consumer of Natural rubber.

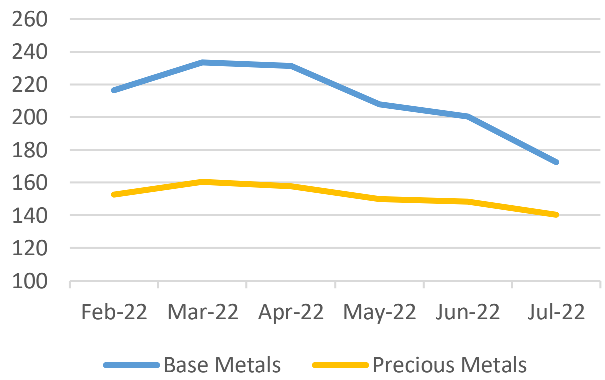
Figure 13: Coconut price weekly auctions



Source: CDA

Coconut supply remained low following continued to power cuts along with adverse weather conditions which caused prices to spike in the auctions compared to the previous month.

Figure 14: Metal price index (2016=100)



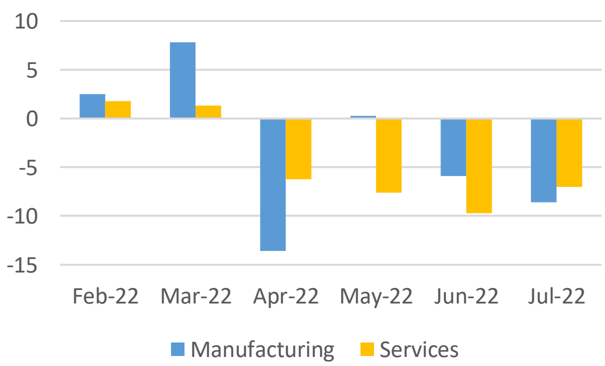
Notes: Base metals index includes Aluminum, Cobalt, Copper, Iron Ore, Molybdenum, Nickel, Tin, Uranium, and Zinc, precious metals index includes Gold, Silver, Palladium, and Platinum
Source: IMF

Gold prices slid at the start of month as investors rallied towards a potential interest rate hike by the Fed Reserve in order to combat rising inflation. However, the potential fear of a global economic slowdown resulting from steep interest rate hikes renewed investors faith in the precious metal towards the tail end of the month. Additionally, prices are expected to stay elevated towards the rest of the year as stagflation is expected to remain.

Overall base metal prices showed a strong decline following rising fuel and energy prices causing industrial activity in Europe to take a dip. However industrial activity has picked up in China which has led to a record increase in aluminum production. Other metals such as copper, nickel and tin dove as investors expect high inflationary expectations and tightening monetary conditions to curb demand.

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 for manufacturing recorded a contraction in July 2022, compared to the previous month mainly due to subdued demand conditions prevalent in the food and beverage sectors. Other PMI indicators such as new orders and production numbers also saw a decline. The PMI for services also declined for the fourth consecutive month as a resulting of declining indicators such as new businesses, business activity and Employment. Furthermore, a decline consumer spending on discretionary items was observed resulting from rising inflation & interest rates.

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

Outlook for August-September

In August, the Central Bank opted to maintain the base rates at their current levels, as they believed that existing measures are sufficient to anchor rising inflation figures, while maintaining market rates at a level that would not deter credit expansion in the private sector.

Following IMF discussions, it was stated that critical reforms such as the Central Bank independence, strong anti-corruption measures and promotion of the rule of law were necessary in order to ensure a successful debt restructuring program. Treasury bill rates which skyrocketed past in the past month, have now settled just under the 30% mark.

According to the Central Bank Governor, upward pressure on the exchange rate have eased to a certain extent which has resulted in a positive trade balance as exporters are likely to bring down their proceeds through official channels. Furthermore, imports of non-essentials have been curtailed to considerable levels.

Global oil prices have descended from their peak prices and settled below USD 100 a barrel following recessionary fears, which bodes well for struggling emerging economies such as Sri Lanka. However, prices are expected to persist at higher levels for the remainder of the year.

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
Orient Finance PLC	Issuer Rating	Notice of Withdrawal	[SL]BB (Stable)	[SL]BB (Stable)
Bank of Ceylon	Issuer Rating	Revised	[SL]AAA (Negative)	[SL]AA (Negative)
Bank of Ceylon	Issue Rating (Basel III Compliant Additional Tier 1 Capital Bond Program 2020) LKR 10 Bn	Revised	[SL]AA (hyb) (On Watch)	[SL]A+ (hyb) (Negative)
Bank of Ceylon	Issuer Rating (Basel III Compliant Additional Tier 1 Capital Bond Program 2021) LKR 3.35 Bn	Revised	[SL]AA (hyb) (On Watch)	[SL]A+ (hyb) (Negative)
Bank of Ceylon	Issue Rating (Basel III Compliant, Tier II Subordinated Debenture Program) LKR 5.4 Bn	Revised	[SL]AA+ (Negative)	[SL}AA- (Negative)
People's Bank	Issuer Rating	Revised	[SL]AAA (On Watch)	[SL]AA (Negative)
People's Bank	Issue Rating (Basel III Compliant Additional Tier 1 Capital Bond Program)	Revised	[SL]AA (hyb) (On Watch)	[SL}A+ (hyb) (Negative)

Abbreviations

ASPI	All Share Price Index
bps	Basis points
pps	Percentage points
CBSL	Central Bank of Sri Lanka
CDA	Coconut Development Authorit
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

To subscribe to ICRA economic updates, contact
Shevinda Thilakaratne
Analyst
Call: +94 77 406 6764
Email: research@icralanka.com

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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

Viruba Nagulan
Acting CEO
+94-774780366
viruba@icralanka.com

Rasanga Weliwatte
Head of Ratings
+94-773553564
rasanga@icralanka.com

Shevinda Thilakaratne
Analyst
+94-774066764
shevinda@icralanka.com

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