

Macro Roundup: August 2021

Inflationary concerns heighten; currency records correction

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Key dates - September 2021

- 15th - 2Q 2021 GDP
- 21st - NCPI
- 30th - CCPI
- 2nd week - FX reserves - August
- 3rd week - Ext. sector - July

Amid tighter travel restrictions economic activity recorded a marginal drop in August, albeit not to the extent seen in previous cycles. However, both the PMI and Business Confidence Index showed encouraging signals for 3Q 2021 growth momentum, with the PMI continuing its upward momentum, picking up to 57.8 points. Meanwhile, fresh concerns on the inflationary impact stemming from the food basket re-emerged as initial signals of the impact from lower availability of chemical fertilizer during the Maha season emerged. This, combined with rising global commodity prices are key concerns on the inflationary front in the coming months. Meanwhile the bank conversion rates saw a sharp correction owing to low Dollar liquidity in the market. While the spot rate remained largely unchanged for most of the month, the USD/LKR corrected to 210.00 by month end as a result of low Dollar liquidity. Against this backdrop, S&P revised Sri Lanka's outlook to Negative, while maintaining a CCC+ rating. Concerns of the govt's near term repayment ability remained a concern, with the short end of the ISB curve shifting up during the month. We forecast the USD/LKR at ~215.00 - 220.00 in 2021, while we expect overall growth to reach ~4.4% - 4.8% YoY, with economic activity picking up following the roll-out of the vaccine.

Near-term boost for reserves recorded in August; spot rate records a sharp dep'n
 Following approval for the disbursement of USD 650bn in SDR to member countries of the IMF, Sri Lanka received ~USD 800mn during the month. The first tranche of USD 50mn from the USD 250mn Bangladesh swap was also realized during the month. With reserves at USD 2.8bn following the USD 1.0bn Sovereign bond payment in July, this is a key positive. The government also inked a RMB 2.0bn (~USD 300mn) term facility with China Development Bank during the month. Our discussions indicate that this will primarily be used to meet import obligations to China, and not necessarily be added into reserves. Against this backdrop, the USD/LKR bank rates saw a sharp correction during the month, reaching ~USD/LKR 220.00 while the spot rate reached USD/LKR 210.00 during the month.

Central Bank tightens rates slightly ahead of our expectations

The Central Bank raised its key policy rates by 50bps, slightly ahead of our expectation of tightening policy measures in 4Q 2021. The CB also raised the SRR up 2.0pp to 4.0% effective 01 September 2021. With tighter policies the inter-bank rate is expected to reach 9.00%. With the SRR raise we expect ~LKR165bn - LKR170bn of liquidity to be removed from the Licensed Commercial Banks. SDFR currently stands at 5.00%, and SLFR at 6.00%. Rates were raised to address the higher credit led import demand and expected inflationary pressure in 2022. While rates remain lower than pre-COVID levels, the signal of an end to the loose monetary policy stance in our view will impact growth momentum to some extent.

S&P rating agency revises SL outlook to Negative, CCC+ rating remains unchanged

Amid declining reserves following the July ISB repayments and lower demand for Sri Lanka Development bonds (SLDBs), S&P rating agency downgraded its outlook to Negative, from Stable. This follows the Moody's rating agency placing SL's credit rating under review last month. S&P's rating of CCC+ remained unchanged. S&P states that Sri Lanka looks to face an increasingly challenging financing environment over the next 12-months, negatively impacting the country's external position.

Key indicators	Month in review	Previous month	Previous year	YoY (%)	MoM (%)	CY21E
Headline inflation (%) - July	5.7	5.2	4.2	+1.5pp	+0.5pp	6.0
USD/LKR spot rate- end August	210.00	199.90	186.16	+12.8	+5.1	215 - 220
12M avg government bond yield (%) - August	5.63	5.25	4.64	+98.8bps	+26bps	7.50
Budget deficit (% of GDP) - 2Q 2021	2.5	2.2	2.3	+0.2bps	-0.3bps	11.3
Trade deficit (USD mn) - June	652	716	161	+305.0	-8.9	6,788
FX reserves (months of imports) - July	2.0	2.9	4.8	-58.3	-31.0	3.0

Source: CBSL, MoF, DoCS, Asia Securities

Roundup Summary

- Government received USD 800mn from IMF SDR, USD 50mn in B'desh swap
- S&P maintains Sri Lanka's CCC+ rating, downgrades outlook to Negative
- Essential food commodities show sharp increase in prices; chemical fertilizer shortage a near-term concern
- Mobility slows down amidst travel restrictions; unlikely to reach past restrictions lows
- Key policy rates tightened; real rates to remain negative in the short term
- Bank rates record sharp correction during the month; spot rate follows Reserves at USD 2.8bn in July; SDR and B'desh swap positives in August
- Government bond market remains flat despite higher yield post policy tightening
- Short end yields continue to increase amidst repayment concerns
- Headline inflation picks up amidst rising food prices; trend to continue
- Fiscal deficit reached ~4.7% of GDP in 1H 2021
- Exports up for second consecutive month; fuel imports decline
- Remittances continue to dip MoM; tourism revenue remains muted

Government received USD 800mn from IMF SDR, USD 50mn in B'desh swap

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The government also inked a RMB 2.0bn (~USD 300mn) term facility with China Development Bank during the month. Our discussions indicate that this will primarily be used to meet import obligations to China, and not necessarily be added into reserves.

S&P maintains Sri Lanka's CCC+ rating, downgrades outlook to Negative

Amid declining reserves following the July ISB repayments and lower demand for Sri Lanka Development bonds (SLDBs), S&P rating agency downgraded its outlook to Negative, from Stable. The long term rating of CCC+ remained unchanged. S&P states that Sri Lanka looks to face an increasingly challenging financing environment over the next 12-months, negatively impacting the country's external position.

S&P stated that the rating could be revised downwards if the government falls short of its plans to boost reserves through the issuance of SLDBs and sale of assets. The current outlook and rating could be revised upwards if the country's external buffers are significantly boosted, or if the economic recovery takes place at a faster than anticipated pace.

Essential food commodities show sharp increase in prices; chemical fertilizer shortage a near-term concern

The impact of high global commodity prices is evident in food prices, with essential food items continuing to increase in the recent past. Our discussions indicate that in addition to this, import controls have resulted in lower buffer supplies of essential food items like rice, sugar and lentils. While the government has recently taken steps to rectify the shortage through imports, retail prices continue to rise. For example, the price of sugar reached an all-time high of LKR 220/kg in the retail market amidst import restrictions last year.

Looking ahead, our conversations indicate that the Maha season is likely to produce a lower harvest than seen in the past owing to 1) lower availability of chemical fertilizer and pesticides, 2) shortage of labor owing to COVID-19 disruptions and 3) current stocks of fertilizer being sold at higher prices. While the government is currently looking to import organic fertilizer to mitigate the impact, we expect a material shortage of essential food items from the Maha season in the absence of imports.

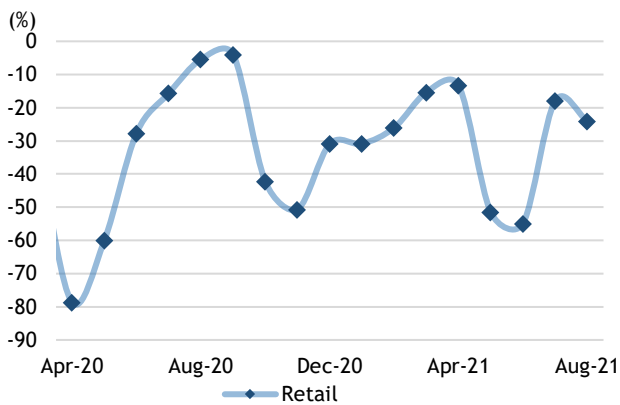
This combined with higher global commodity prices will lead to a prolonged period of higher prices in the coming months. We maintain our view that a phased out approach towards the move to organic fertilizer is the most appropriate approach.

Mobility slows down amidst travel restrictions; unlikely to reach past restriction lows

Mobility tapered down in August as travel restrictions were reimposed during the month. Notably footfall into retail and grocery/pharmacy stores declined at a slower pace compared with previous cycles of restrictions, indicating the “new norm” of a smoother move towards online purchasing. Our discussions with online retailers indicated that as previous lockdowns, demand picked up 2x-3x during the month.

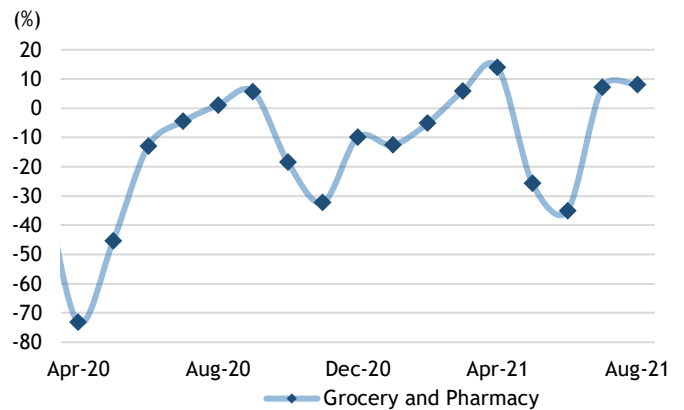
Against this backdrop, the PMI data improved for the second consecutive month in July following a downward movement seen during the previous two months. As such, the PMI was up 7.4 index points MoM to reach 57.8 points during the month. This was owing to a strong recovery seen in new orders and Production sub-indices. Meanwhile the Business Confidence remained unchanged in July, at 89 points (above the 12-month low of 83 points) compared with the 12-month average of 108 points.

Retail movement declined in August owing to travel restrictions



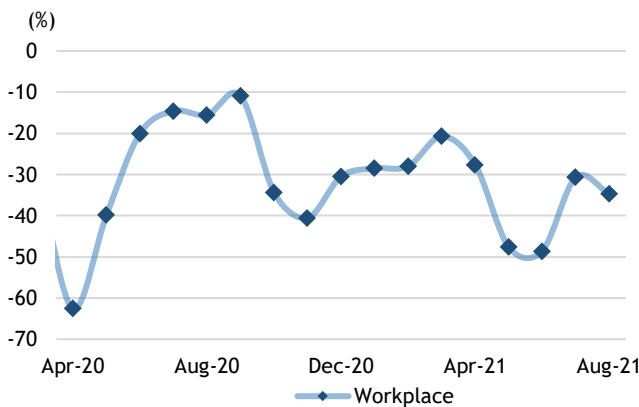
Source: Google, Asia Securities

...this trend followed for Grocery and Pharmacy footfall



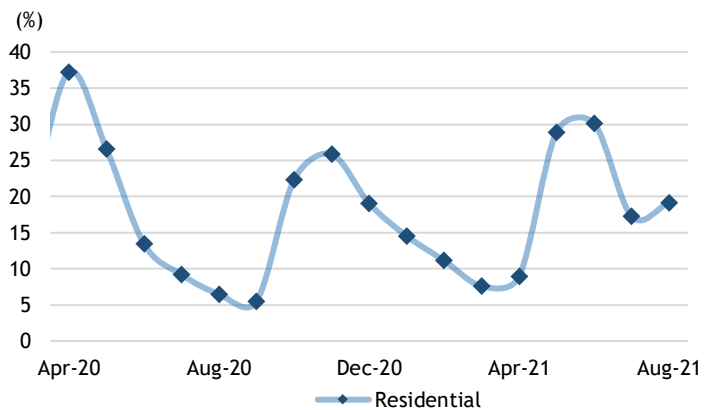
Source: Google, Asia Securities

Mobility into work places also declined



Source: Google, Asia Securities

While Residential has increased indicating less outings



Source: Google, Asia Securities

Looking ahead, we expect mobility to resume an upward trend with the easing of restrictions. However, we expect a more cautious approach to travel taken by the public given the rising Delta variant positive cases found during recent weeks. We perceive the current vaccination drive a key positive to minimies the death count due to the virus, especially in the Western province.

Rates were raised as a pre-emptive measure to curb expected inflationary pressure in 2022

Key policy rates tightened; real rates to remain negative in the short term
 The Central Bank raised its key policy rates by 50bps, ahead of our expectation of tightening policy measures in 4Q 2021. The CB also raised the SRR up 2.0pp to 4.0% effective 01 September 2021. With tighter policies the inter-bank rate is expected to reach 9.00%. With the SRR raise we expect -LKR 165bn - LKR 170bn of liquidity to be removed from the Licensed Commercial Banks. SDFR currently stands at 5.00%, and SLFR at 6.00%. Rates were raised to address the higher credit led import demand and expected inflationary pressure in 2022. While rates remain lower than pre-COVID levels, the signal of an end to the loose monetary policy stance in our view will impact growth momentum to some extent.

Following the monetary policy meeting, the CB also imposed a 5.0% cap on Dollar deposit accounts, thereby narrowing the gap between the LKR and USD deposit rates. SDA is excluded, which could continue to receive higher rates.

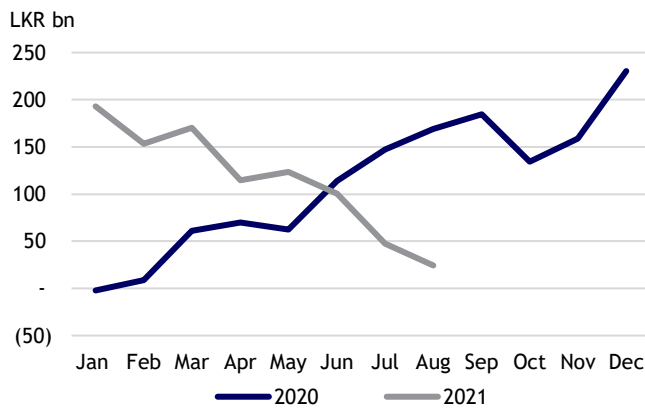
While the pre-emptive stance taken by the CB to curb inflationary pressure in 2022 is a positive, overall inflation is mainly driven by food inflation (+11.0% YoY in July) owing to supply side factors. With the impact of COVID-19, the current backdrop highlights the need for continued support on both monetary and fiscal fronts in the coming months.

The loose monetary policy stance taken by the CB so far, combined with liquidity injections have resulted in weekly average AWPLR declining by ~440bps since January 2020, while the AWPLR has increased ~0.57pp In August so far (currently at ~5.71%).

Meanwhile, 1-year bond yields have steadily increased, currently at 5.97% in the primary market, from 5.25% in July. Overnight excess liquidity averaged LKR 21bn in August, down -62.2% since end July. Notably by end August, the CB recorded a shortage of excess liquidity.

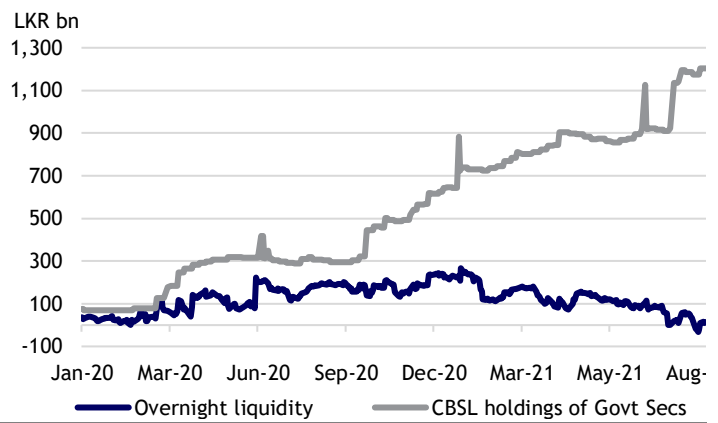
Looking ahead the CB expects AWPLR to decline further. We expect this to be at a slower rate in the near term, and we continue to expect excess liquidity to remain at elevated levels. In our view, AWPLR is near-bottom levels currently, indicating upward pressure on credit demand.

Avg total market liquidity continued to decline in August



Source: CBSL, Asia Securities

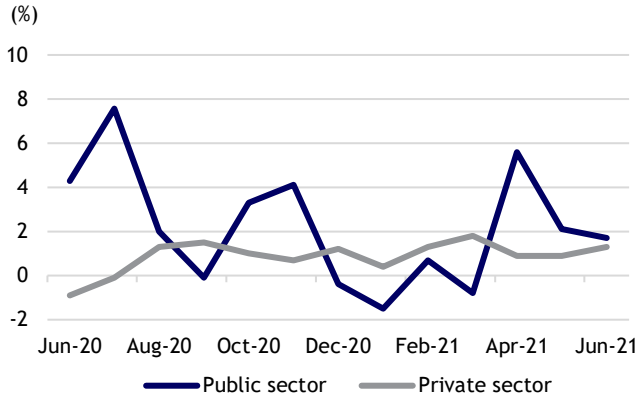
While overnight liquidity turned negative during the month



Source: CBSL, Asia Securities

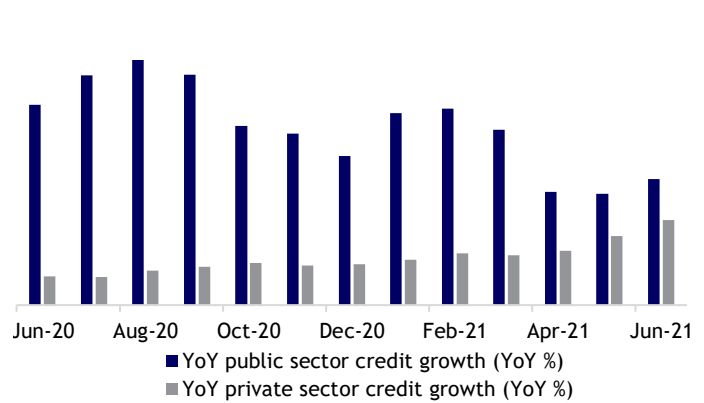
Meanwhile, Private sector credit continued to grow in June, with MoM credit growing 1.3% (+12.9% YoY). SoE credit growth remained high, at 19.0% YoY (+1.7% MoM) indicating increased financing needs of the government. The CB expects higher lending towards the Micro, Small and Medium scale enterprise sectors to continue.

MoM private sector credit gradually increased in June...



Source: CBSL, Asia Securities

...as public sector lending remained high



Source: CBSL, Asia Securities

Looking ahead, with higher policy rates, we expect bank lending rates to pickup in the coming months, leading to a slowdown in credit momentum. We also expect the current third wave impact to dampen credit demand, which we expect to be a short term barrier.

We expect credit growth to reach 10.0% - 12.0% (lower than the CB's forecast of 14.0%) in 2021.

In our view, 1) lower than pre-COVID-19 rates, 2) higher economic activity towards 4Q and 3) the credit guarantee scheme in place will lead to a pick up in loan demand steadily amidst slow economic growth.

The next policy meeting is scheduled in October where we expect rates to remain unchanged.

To access our August monetary policy review titled "*Key policy rates tightened; real rates to remain negative in the short term*", [Click here to access report](#).

Bank rates record sharp correction during the month; spot rate follows

The monthly average USD/LKR spot rate recorded a correction towards month end, with the USD/LKR reaching 210.00 by the 31st of August, while it remained largely unchanged for most of the month. As such, the currency depreciated -5.1% MoM (0.005% depreciation MoM in July) amidst low USD liquidity. The currency ended the month at an average USD/LKR 200.49.

This came following a sharp correction seen in the bank rates during the month, where the conversion rate neared USD/LKR 220.00 owing to low Dollar liquidity. Importers confirm that rates are largely in this range, mainly owing to the banks having to match the Dollar requirement to open LCs with availability through exporter conversions.

Notably the conversion rate in the kerb market was at a significantly higher USD/LKR 230.00 - 235.00 during the month on higher speculation and demand by importers. While the Central Bank released USD 200mn to the state banks this week to ease pressure on the Dollar shortage, we do not expect this to mitigate the current shortfall in the market.

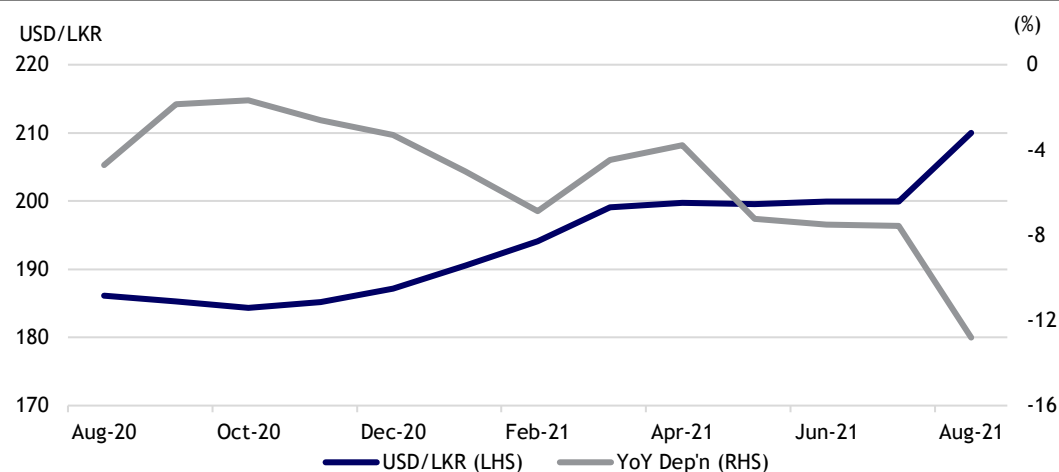
Looking ahead, the CB expects ~USD 2.3bn of inflows (of which ~USD 850mn has come in during the month) to materialise during the remainder of the year. Despite controls, imports continue to remain high, which we expect to continue owing to rising global oil and other key commodity prices. Weak forex inflows, specially FDIs so far this year (USD 198mn for 1H 2021) has resulted in added pressure on the currency. The average monthly USD/LKR has depreciated -6.8 YTD (while the spot rate depreciated ~12.2% as at end August) and looks to continue this trend amidst low inflows.

The USD/LKR reached 210.00 by month end owing to the Dollar shortage

At this point, we revise our currency forecast to USD/LKR 215.00 - 220.00 following the breach of the moral suasion rate of USD/LKR 203.00. We continue to perceive low Dollar liquidity a near term concern, which will lead to the faster than anticipated depreciation of the currency.

Looking ahead into 2022, we forecast the USD/LKR at 227.00 - 235.00 (5.9% - 7.7% dep'n) given 1) the repayment schedule of -USD 4.5bn/year until 2025, 2) lower credit rating and 3) pressure on Dollar liquidity. A faster than anticipated tourism rebound (we currently expect this to materialise in 2023) will be a key positive to supporting Dollar inflows.

The USD/LKR recorded a sharp depreciation, reaching the 210.00 mark by month end



Source: CBSL, Asia Securities

To read more about the sharp depreciation seen in the bank rates and its impact on the equity market, [Click here to access report](#) titled “Dollar shortage catches up; price-regulated counters to see largest impact”

Reserves at USD 2.8bn in July; SDR and B’desh swap positives in August

Sri Lanka’s official reserves declined to USD 2.8bn in July, down 30.2% MoM (-60.1% YoY) following the July ISB payment. This comes amidst the Central Bank’s net Dollar purchases of USD 33.7mn in June. According to Central Bank data, USD 1.5bn repayments (only foreign currency loans, securities, and deposits) were due during the month.

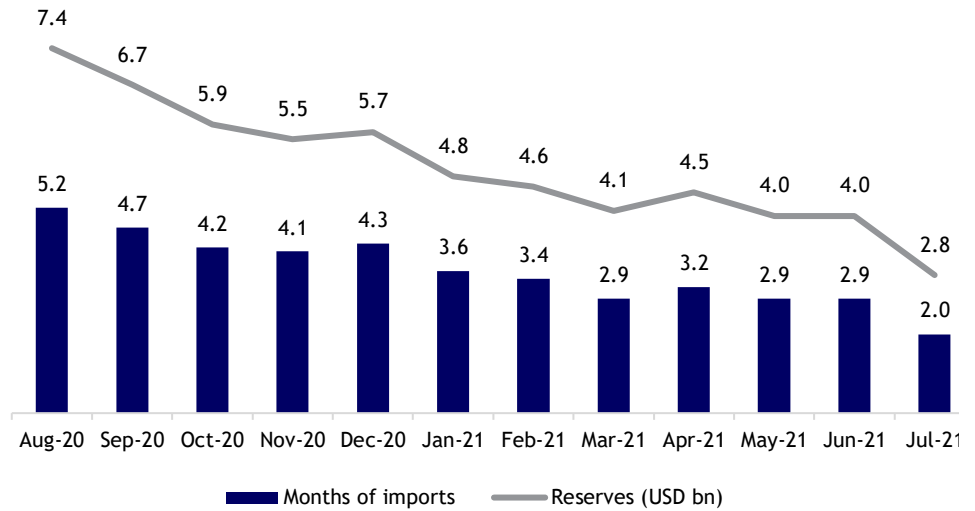
The Bangladesh swap and IMF SDR inflows are key positives to support reserves in the near term

Looking ahead, we expect the USD 800mn IMF SDR allocation and USD 50mn tranche of the Bangladesh swap to support reserves in the near-term. The CB expects ~USD 2.6bn inflows in the coming months mainly through swaps and bilateral lending options and the IMF SDR. While the government has paid off a majority of external repayments due for 2021, we expect the remaining months in 2021 to be crucial to add a further buffer to reserves going into 2022.

Meanwhile, the Central Bank’s steps taken to curb forex outflows through imposing 1) restrictions on a number of import items until year end, 2) temporary suspension of forward USD purchases by banks and a 3) temporary suspension of remittances from businesses and individuals continues.

As of end July, official reserves cover ~2.0 months of imports, down from 2.9 months in June. Meanwhile foreign currency reserves were down 30.2% MoM (-64.2% YoY). Gold reserves recorded a 2.5% MoM increase. At this point, our main concerns are on the country’s refinancing schedule for the 2022 repayments. We also factor in higher refinancing risk following the ratings downgrades last year.

By end July, reserves were at USD 2.8bn, covering ~2.0 months of imports



Source: CBSL, Asia Securities

Against the current backdrop of delays in finalising funding, we expect reserves to end the year at ~USD 4.6bn - USD 4.8bn covering ~3.0 months of imports. However, we note that if reserves decline further than our expectations in the coming months, this will be revised down.

Government bond market remains flat despite higher yield post policy tightening

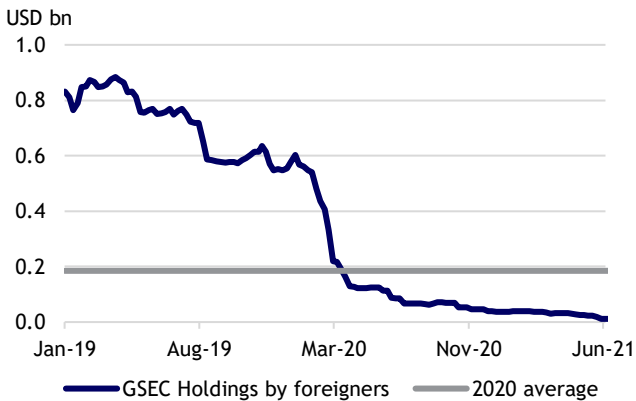
The government bond market continued to recorded outflows during the month, as foreign holdings of government bonds remain significantly low, accounting for less than ~0.1% of the total bond market. 1-yr Govt bond yields edged up to 5.97% during the month (still below the overnight rate of 6.0%) following the policy rate hike but, investor appetite for government bonds remained muted. This comes in-line with our expectations of upward pressure on yields in 2H 2021.

Foreign holdings of government bonds remain significantly low

Looking ahead, given the lack of forex inflows amidst higher domestic refinancing, we expect this trend to continue. This has been evident in the recent weeks, with the longer term government bond yields increasing during the month. Our conversations with sector experts also indicate that the bond issuances in the 3-month and 6-month maturities are significantly higher, compared to the 1-year issuances indicating the Central Bank’s preference of opting for shorter duration debt.

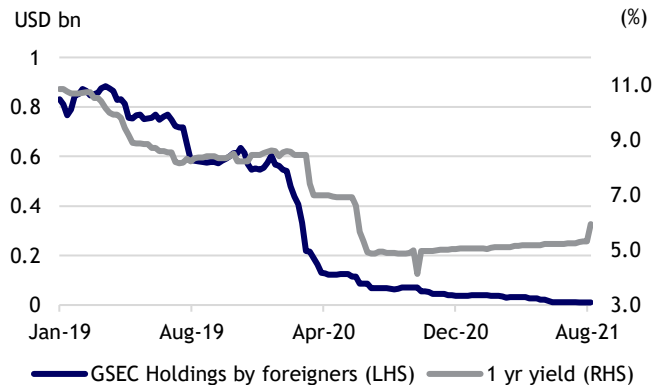
In our view, 1) fiscal pressure, 2) rating downgrades and 3) uncertainty on upcoming debt repayments exacerbated by the COVID-19 shock are some key reasons for low inflows into the bond market. While in our view this will be one of the first areas to see an inflow in 2H 2021, we expect this to be gradual. We note that the downgrade by all three rating agencies in 2020 will constrain inflows further.

Foreign bond holdings continue to decline gradually



Source: CBSL, Asia Securities

Yields picked but failed to attract inflows



Source: CBSL, Asia Securities

We expect the yield cap to be raised to at least 7.50% by end 2021 owing to low forex inflows. As such, we maintain our government yield forecast to 7.50% for 2021 to attract foreign inflows. We expect this to increase to ~10.0% in 2022 given the country's ~USD 4.5bn repayment schedule for the year.

At this point, we do not factor in material foreign inflows to the bond market in 1H 2022.

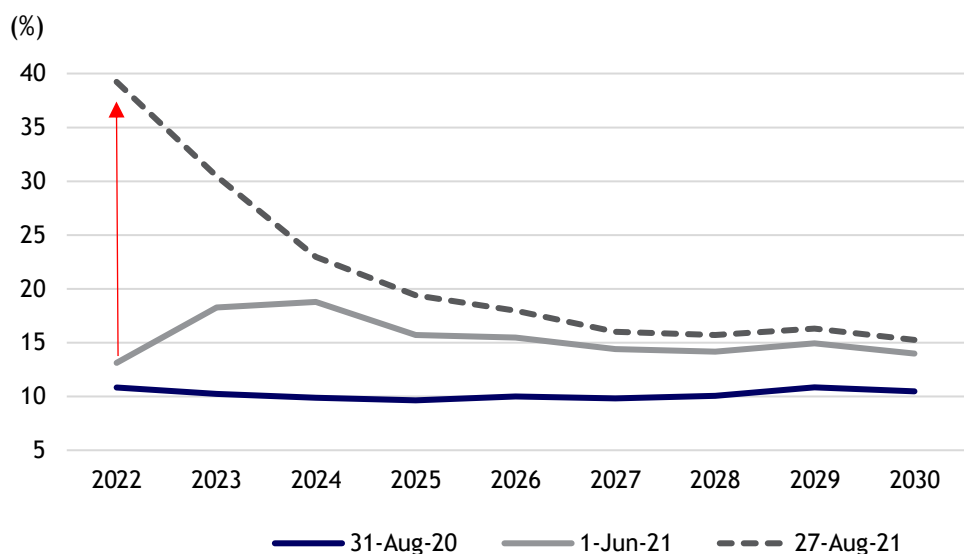
Short end yields continue to increase amidst repayment concerns

While the government successfully met its USD 1.0bn ISB maturity in June, investor worries continued on near term repayment capabilities following the S&P outlook downgrade during the month. This was reflected in the short end of the curve, with the 2022 July ISB yields reaching 39.2% (as of 27th August), up 26.1pp since the beginning of June.

While we re-iterate our view that we do not see a near term concern in terms of the January 2022 repayment at this point, we expect the uncertainty of 1) low USD inflows, 2) government's refinancing options and 3) absence of an IMF deal to impact the Sovereign curve in the coming months.

Despite the successful payment of the July ISB, investor worries continue on the country's short term repayment ability

The short end of the Sovereign curve reflected fresh repayment concerns in the near-term



Source: Bloomberg, Asia Securities

In our view, the longer-term refinancing concerns continue to be a pain point for SL Sovereign bonds, amidst no clear fiscal framework currently in place. Our main concern continues to be the government's fiscal constraint.

In-line with our expectations, food inflation picked up in July

Headline inflation picks up amidst rising food prices; trend to continue

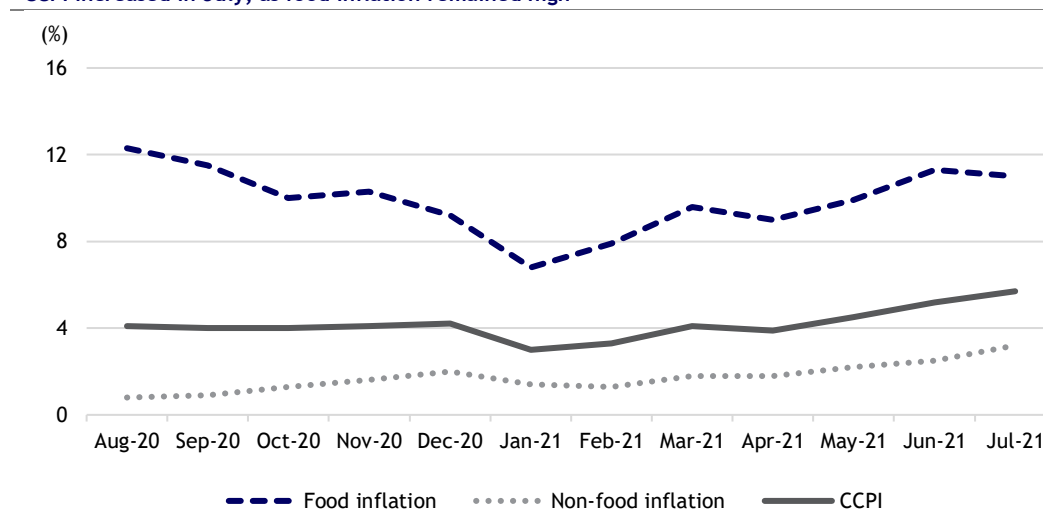
Inflation measured by the Colombo Consumer Price Index (CCPI) increased to 5.7% YoY in July, up from 5.2% YoY in June. In-line with our expectations, the increase in headline inflation was on the back of higher food inflation during the month, while non-food inflation also edged up. Core inflation which represents the underlying inflation in the economy excluding volatile items increased to 3.7% YoY (3.2% YoY in June).

Non-food inflation also gathered pace increasing 0.7pp to 3.2% YoY. On a YoY basis, non-food inflation contributed +2.22% (+1.71% in June) due to a higher contribution in the groups of Transport (+0.81% compared with 0.54% in June) and Restaurants and Hotels sub-categories (+0.48%, up from +0.27% in June).

Food inflation tapered down marginally to 11.0% YoY (+11.3% YoY in June) which in our view was mainly owing to supply side factors. On a YoY basis, food commodities were the highest contributor towards overall inflation, at 3.41% (3.49% in June), due to price increases in eggs (+19.9% MoM) and sugar (+7.3% MoM). Notably, Samba rice which was up +27.5% MoM in June declined 1.3% MoM.

Looking ahead, we expect the recent fertilizer ban and shortage of buffer stocks to negatively impact food prices in the medium term. While the recent price controls on essential food items are a positive, we factor in higher food inflation in the coming months. We also expect demand to continue picking up in the coming months as economic activity picks up. We also factor in an impact from the recent fuel price hike.

CCPI increased in July, as food inflation remained high



Source: DoCS, Asia Securities

Meanwhile, island-wide inflation as measured by the National Consumer Price Index (NCPI), also picked up to 6.8% YoY in July. This was on the back of elevated food inflation, while non-food inflation also continued to edge up during the month.

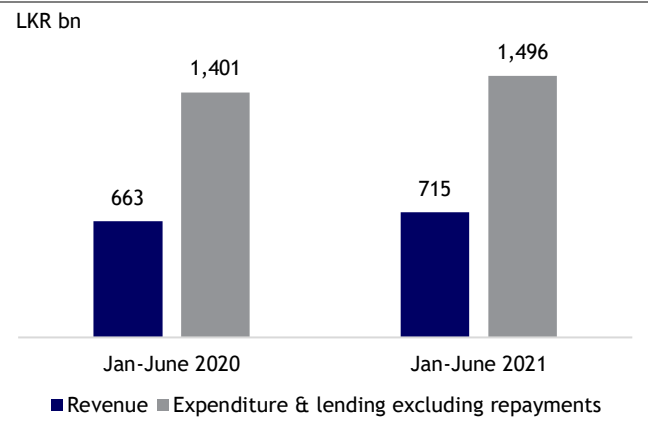
Fiscal deficit reached ~4.7% of GDP in 1H 2021

The fiscal deficit for 1H 2021 reached ~4.7% of GDP (compared with 4.8% of GDP for 1H 2020). Government revenue was ~4.3% of GDP (4.4% in 1H 2020), up 7.5% YoY for 1H 2021 (+5.5% YoY in June), amidst revenue collections facing significant pressure amidst the third wave restrictions.

Tax revenue which accounts for 89.6% of total revenue was up 10.4% YoY largely owing to the low base effect. Meanwhile, non-tax revenue recorded a 11.2% YoY decline for the period under review to reach LKR 73.3bn.

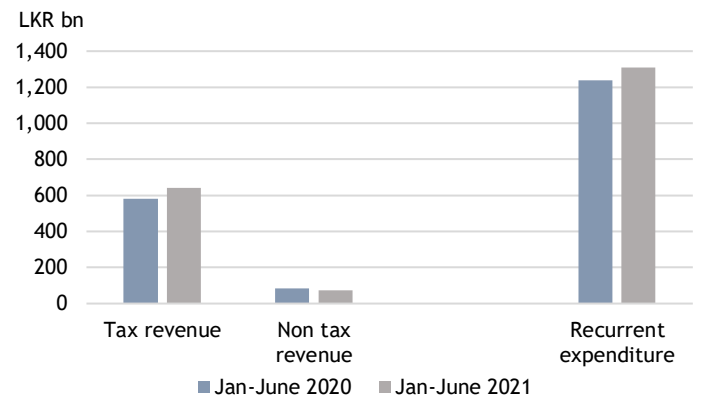
Elevated Pressure on the deficit was mainly owing to higher government expenditure in 1H 2021

Consumption-based taxes recovered in 2021



Source: CBSL, Asia Securities

...while interest expenses continued to increase



Source: CBSL, Asia Securities




Meanwhile, overall expenditure and lending minus repayments increased 6.7% YoY for 1H 2021, amounting to -9.0% of GDP (compared with 9.4% of GDP for 1H 2020). As such, government expenditure excluding repayments came in at LKR 1.5tn for 1H 2021. Recurrent Expenditure was up 5.9% YoY in 1H 2021, at LKR 1.3tn. Our discussions indicate that this is mainly owing to higher than expected expenditure towards supporting the public during COVID-19, while recurrent expenses also pressured overall expenditure.

Exports up for second consecutive month; fuel imports decline

The deficit reached USD 652mn in June, down 8.9% MoM (+350% YoY) owing to improving exports, which reached USD 1.0bn during the month. Terms of trade deteriorated by 16.7% YoY amidst lower export prices, as import prices increased.

The export volume index increased 8.9% YoY (+54.7% YoY in May) while the export value index declined 3.4% YoY, reflecting the impact of higher export volumes and prices during the month. We note that lower availability of containers is currently a main constraint for exporters.





The trade deficit was USD 652mn in June, down 8.9% MoM

	Earnings from Garment and Textiles increased 2.9% YoY in June (+11.6% MoM, +28.0% for 6M 2021). While there is a likely near-term impact on garment manufacturing, we view the current vaccination drive and lower restrictions a key positive for 2H 2021.
	Agri exports were up 0.5% YoY (+15.5% MoM, +21.2% YoY for 6M 2021). Tea exports were up 7.8% YoY, owing to higher volumes exported, while the price declined. On a MoM basis, tea exports were up 13.5%. Looking ahead, our discussions with tea buyers indicate higher prices at recent auctions, indicating an upward movement in the coming months.
	June saw export revenue from petroleum products increase 147% YoY, owing to higher global prices, while the quantity exported also saw an increase. Looking ahead, as global prices continue to remain higher compared with 2020, we expect revenue from petroleum products to improve further.

Source: CBSL, Asia Securities

Imports recorded a 57.2% YoY increase (+3.2% MoM) in June owing to the base effect and higher imports during the month. Non-food consumer goods were up 47.6% YoY, while investment goods recorded a 81.1% YoY increase. Import demand for Consumer goods increased 53.4% YoY, while intermediate goods recorded a 48.5% YoY increase. The volume index of imports (+26.7% YoY) and unit value index (+24.1% YoY) indicate that higher imports recorded was driven by higher volumes and prices compared with June 2020.

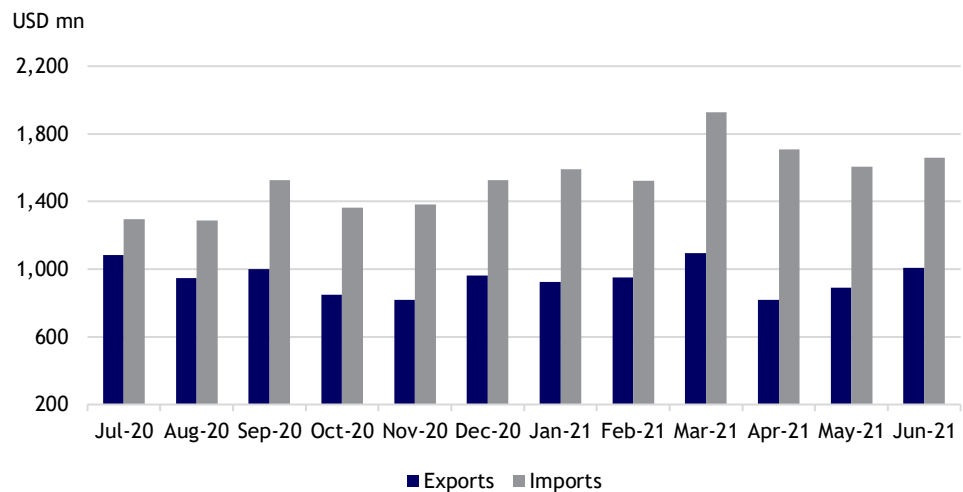
The total fuel import bill declined 62% YoY in June amidst lower volumes imported

	<p>F&B goods increased 61.9% YoY, driven by higher Dairy products (+118% YoY) and Cereal and milling products including rice (+255% YoY). Notably vegetable imports increased 49.7% YoY, while other food and beverages increased 237% YoY.</p>
	<p>The fuel import bill declined 40.0% YoY, as no crude oil was imported during the month given sufficient stocks. On a MoM basis, fuel imports were down 80.0% which was a key positive to the import bill.</p>
	<p>Meanwhile vehicle imports declined 95.9% YoY amidst the import restrictions. Medical and pharma imports including vaccines increased 55.9% YoY. We factor in motor vehicle import restrictions into 2022 to curb forex outflows.</p>
	<p>Expenditure on Investment goods increased for the fourth consecutive month, recording a 81.1% YoY increase. Machinery and equipment imports were up 84.6% YoY while transport equipment imports increased 187% YoY.</p>

Source: CBSL, Asia Securities

We factor in continued import controls on non-consumer goods like vehicles until the end of 2021. We expect exports to continue its momentum in 3Q 2021, amidst a recovery in global demand.

Exports remained steady in June



Source: CBSL, Asia Securities

Figures in USD mn	Jun-20	May-21	Jun-21	YoY (%)	MoM (%)	1H CY20	1H CY21	YoY (%)
Total exports	894	892	1007	+12.6	+12.9	4,413	5,699	+29.1
Industrial exports	661	687	771	+16.6	+12.3	3,357	4,408	+31.3
Tex. and garments	404	372	416	+2.9	+11.6	1,944	2,487	+28.0
Rubber products	66	89	93	+40.8	+4.5	336	500	+48.9
FB&T*	42	39	42	+0.0	+7.2	198	248	+25.4
Gems, D&J**	11	16	21	+89.3	+32.5	73	132	+81.7
Agri exports	229	199	230	+0.5	+15.6	1,039	1,259	+21.2
Tea	115	109	124	+7.8	+13.5	572	651	+13.8
Coconut	34	34	39	+12.9	+13.5	147	196	+33.7
Spices	32	25	36	+12.7	+40.9	114	197	+72.9
Seafood	24	15	16	-35.0	+5.3	99	106	+7.4
Rubber	3	2	3	-10.3	+13.0	14	20	+50.4
Total imports	1,056	1,607	1,659	+57.2	+3.2	7,675	10,015	+30.5
Consumer goods	249	254	382	+53.4	+50.7	1,782	1,912	+7.3
F&B	102	121	165	+61.9	+36.4	787	915	+16.2
NF cons. goods^	147	133	217	+47.7	+63.8	995	997	+0.3
Vehicles	9	1	0	-95.7	-20.0	273	4	-98.4
Clothing & acc.	18	15	15	-14.3	-2.6	111	105	-5.1
Intermediate goods	565	1,045	839	+48.5	-19.7	4,167	5,950	+42.8
Fuel	110	331	66	-39.9	-79.9	1,243	1,787	+43.7
Crude oil	27	93	-	-100.0	-100.0	251	317	+26.1
Refined petroleum	84	238	66	-20.8	-72.1	866	1,344	+55.2
Textiles	176	236	277	+57.5	+17.4	1,066	1,451	+36.2
Fertiliser	22	13	2	-90.1	-83.1	107	98	-8.9
Base metals	14	103	58	+322.8	-44.1	171	355	+107.1
Investment goods	241	308	436	+81.1	+41.6	1,715	2,147	+25.2
Machin. and equip	146	183	270	+84.6	+47.5	990	1,367	+38.0
Building material	78	101	119	+52.4	+17.4	495	602	+21.5
Transport equip	16	23	47	+187.7	+100.0	229	178	-22.3
Trade balance	(161)	(716)	(652)	+305.0	-8.9	(3,262)	(4,316)	+32.3
Tourism earnings	-	2	2	nm	-	682	23	-96.6
Worker remittances	572	460	478	-16.4	+3.9	2,980	3,324	+11.5
Inflows to the CSE	(46)	(12)	(6)	-87.0	-50.0	(111)	(125)	+12.6
Inflows to the govt.	121	7	175	+44.6	nm	1,213	1,174	-3.2
T bills and bonds	3	7	0	-96.7	-98.6	90	14	-84.4
Int'l sov. bond	-	-	-	nm	Nm	-	-	nm
LT loans	118	-	175	+48.3	nm	1,124	1,160	+3.2
FDI	-	-	-	nm	nm	188	198	+5.3

Source: CB, Asia Securities | Note - *Food, beverages & tobacco, **Gems, diamonds & jewelry, ^Non-food consumer goods

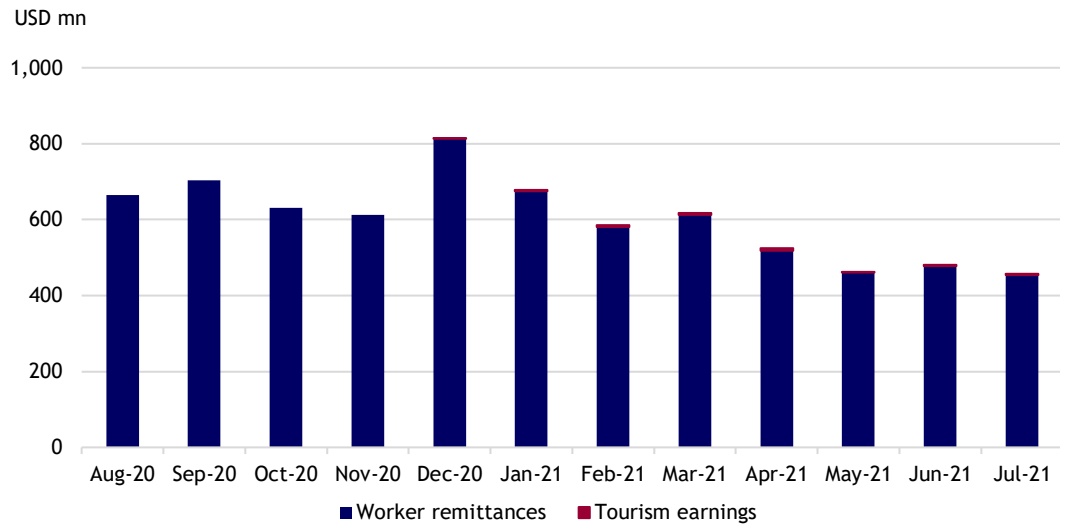
We expect tourism to record a gradual recovery in 2022

Remittances continue to dip MoM; tourism revenue remains muted

June recorded 1,614 tourist arrivals (16,908 arrivals for 1H 2021), with tourism earnings of USD 2.0mn. Amidst the impact of the third wave and a number of travel advisory warnings by key in-bound countries, we expect tourist arrivals to remain slow despite lower restrictions on foreign travel movements.

Meanwhile remittances recorded a 5.2% MoM decline in July, down 35.4% YoY in-line with our expectations of declining remittance inflows following higher travel movements. We expect remittances to continue a gradual decline as domestic economic activity picks up, resulting in less assistance required for family members of migrant workers. The higher rates in the kerb and Hawla markets (USD/LKR 225-230 compared with ~USD/LKR 215 in the banking system) will also deter remittance flows through the banking system, in our view.

Remittances declined MoM in July, while tourism earnings remained negligible



Source: CBSL, Asia Securities

For 2021, we factor in 1) a gradual increase in imports as consumer demand picks up, 2) increase in demand amidst slow global growth and 3) higher global oil prices to impact the import bill. We expect apparel exports to pickup as the COVID-19 impact in US and Europe improve. However, amidst the current third wave, we expect overall momentum to be dampened in the near term. We perceive the higher than forecasted remittance inflows in 1Q 2021 and continued export momentum as positive.

In our view, an expansion of export products is a key medium term solution for Sri Lanka’s trade balance. We forecast the trade deficit to reach 7.9% of GDP in 2021.

Outlook

1) We forecast GDP to reach ~4.4% YoY in 2021- With the third wave of COVID-19 resulting in fresh restrictions, we expect the recovery momentum seen in 1Q 2021 to be negatively impacted. We expect the Services sector to recover the fastest, while we expect a prolonged impact on the Industrial and Agricultural sector owing to a shortage in labor. We also perceive the country's tight refinancing conditions to dampen growth momentum in the near term. With the low base in 2020, higher consumer demand and the low-rate environment, we forecast the economy to grow by 4.4% - 4.8% YoY in 2021.

2) Credit growth to reach ~10.0% - 12.0% in 2021 - With the Central Bank's proposals to cap mortgage-backed housing loans at 7.00% combined with the expected lending targets, we expect private sector credit growth to increase, as economic activity gradually increased in 2H 2021. As such, we forecast overall credit growth at ~10.0% - 12.0% YoY in 2021.

3) Fiscal deficit to widen in 2021 - As economic activity increases, we expect revenue collections to improve. However, with the current restrictions, we expect collections to be dampened in the near term. Amidst the government's domestically driven growth agenda, we factor in higher government expenditure in 2021. As such, we forecast the fiscal deficit at ~10.8% of GDP in 2021.

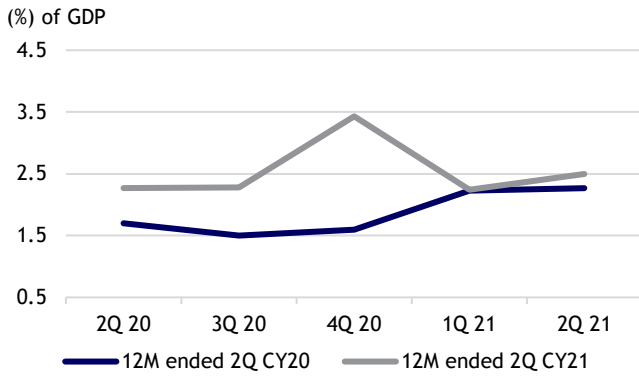
4) Currency to face pressure in 2021 - With low USD liquidity, we expect the USD/LKR to face pressure towards 2H 2021. As such, we forecast the currency to end 2021 at ~USD/LKR 215.00 - 220.00. Any Dollar inflows above than our forecasted flows will be a key positive to improving the currency.

Summary of Key Economic Indicators

Key indicators	2016	2017	2018	2019	2020	2021E	2022E	2023E
Real GDP growth (%)	4.5	3.6	3.3	2.3	(3.6)	4.4	5.1	5.3
Headline inflation (%)	4.0	7.1	2.8	4.8	4.2	6.0	6.0	6.1
<i>12M moving average (%)</i>	4.0	6.6	4.3	4.3	4.6	6.2	6.2	6.0
Core inflation (%)	4.4	4.3	3.1	4.8	3.5	5.6	5.5	5.1
LKR/USD	149.80	152.85	182.75	181.63	186.41	215-220	227-235	240.00
Depreciation (%)	4.0	2.0	19.6	(0.6)	2.6	15.3 - 18.0	5.6 - 9.3	2.1 - 5.7
Unemployment (%)	4.4	4.2	4.4	4.8	7.5	6.0	5.7	5.0
12M government bond yield (%)	10.20	8.90	11.20	8.45	5.00	7.50	10.00	11.50
<i>12M moving average (%)</i>	9.93	10.05	9.75	9.22	4.20	7.00	8.50	9.20
Fiscal balance (% of GDP)	(5.4)	(5.5)	(5.3)	(6.8)	(11.1)	(11.3)	(10.5)	(9.2)
Trade balance (% of GDP)	(10.9)	(10.9)	(11.6)	(9.5)	(7.6)	(7.9)	(8.2)	(8.9)
Current balance (% of GDP)	(2.1)	(2.6)	(3.2)	(2.2)	(1.3)	(2.5)	(2.9)	(3.0)
FX reserves (months of imports)	3.7	4.0	3.7	4.6	4.3	2.5	4.0	4.4
Debt/GDP (%)	78.2	77.4	83.4	86.8	101.0	99.0	95.0	90.0
Foreign debt (% of total debt)	33.7	35.5	41.2	42.6	40.4	41.3	43.8	43.0

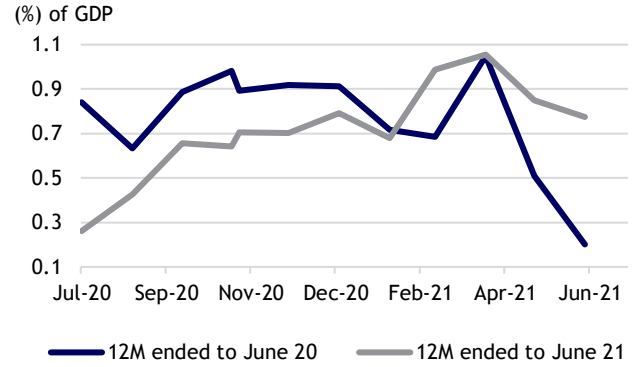
Source: CBSL, DoCS, MoF, Asia Securities | E: baseline estimate

Fiscal deficit



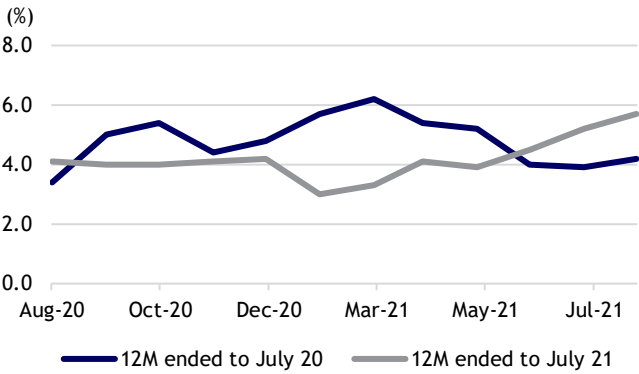
Source: MoF, Asia Securities

Trade deficit



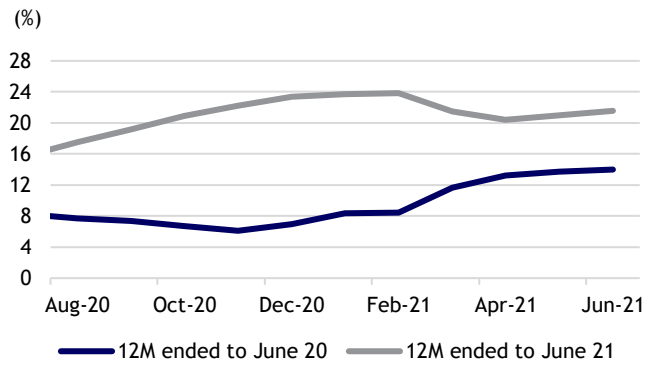
Source: CBSL, Asia Securities

Headline inflation



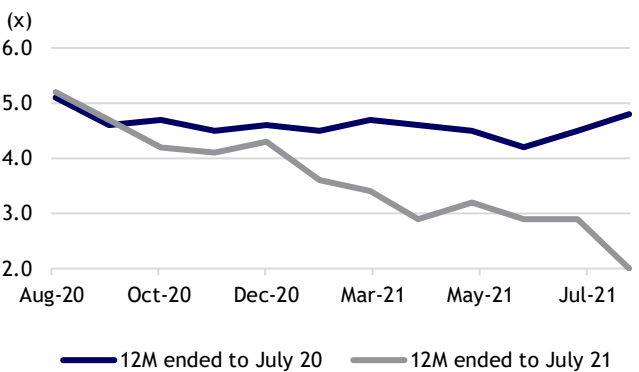
Source: DoCS, Asia Securities

Broad money growth



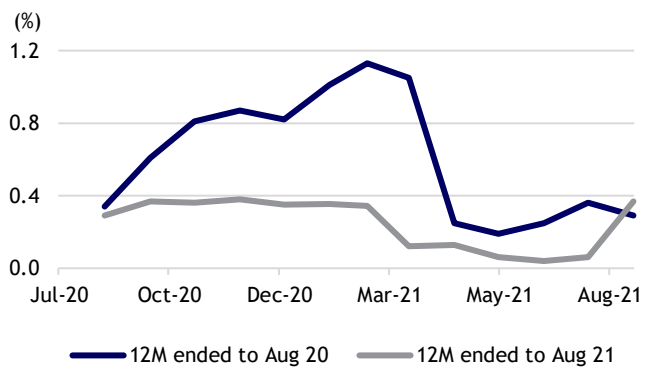
Source: CBSL, Asia Securities

Forex reserves (Months of imports)



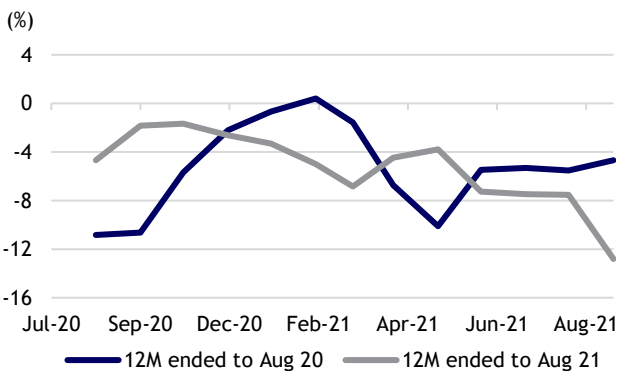
Source: CBSL, Asia Securities

Yield spread (3M vs. 1Yr)



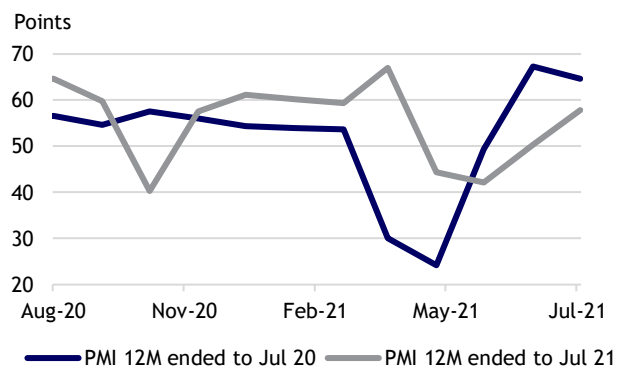
Source: CBSL, Asia Securities

Currency depreciation



Source: CBSL, Asia Securities

Purchasing Manager Index



Source: CBSL, Asia Securities

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