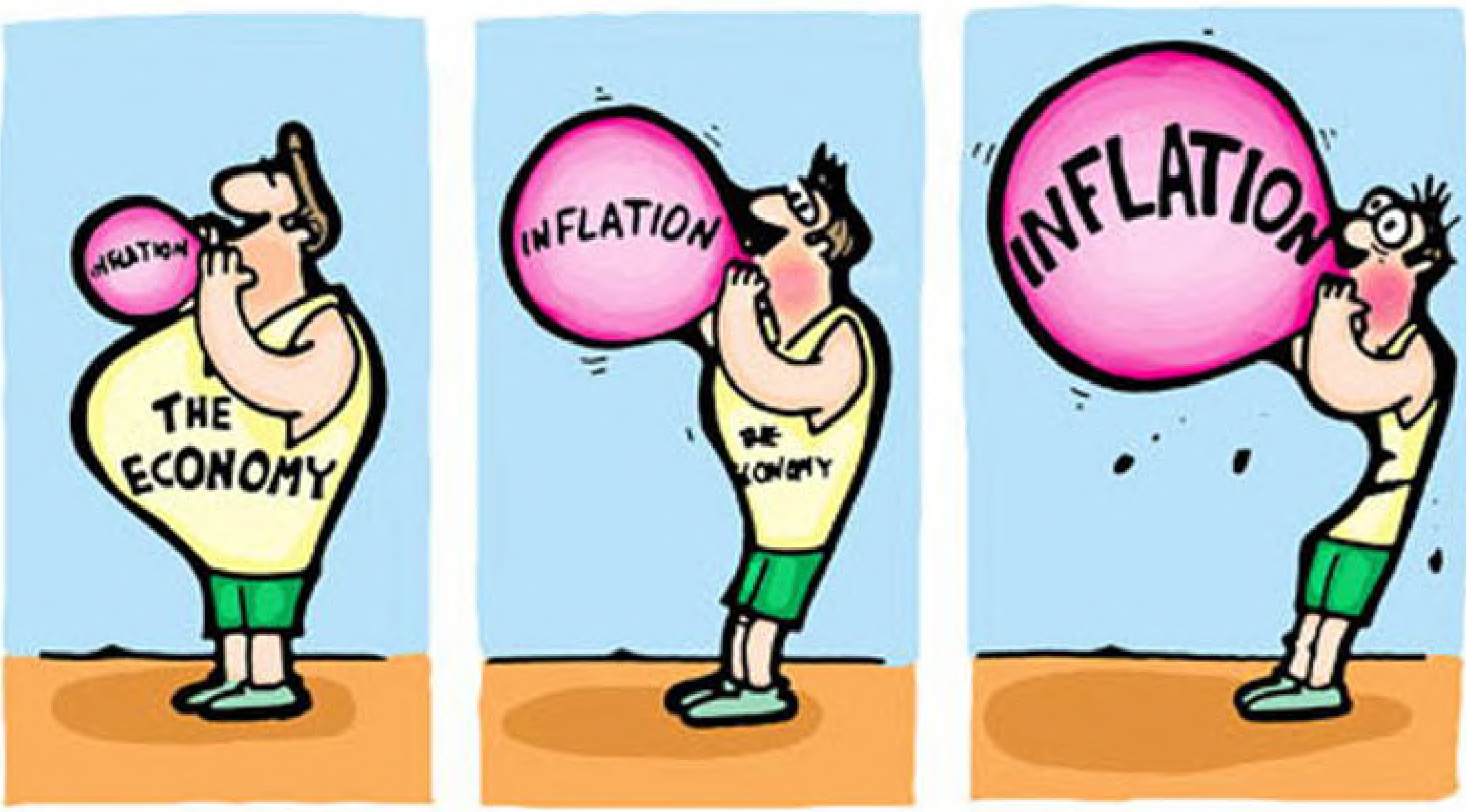
The Sri Lankan Economic Crisis

Sri Lanka's foreign reserves decreased to USD 2.8 billion at the end of July 2021 from USD 7.5 billion when the administration took office in November 2019, according to the Central Bank of Sri Lanka. The rupee has lost more than 20% of its value versus the US dollar in that period. On 1st September 2021, Sri Lankan President Gotabaya Rajapaksa proclaimed an "economic emergency" due to high inflation and dwindling currency and foreign exchange reserves. But what triggered the island nation's unexpected economic downturn?

What's going on in Sri Lanka?

Sri Lanka, which is known for its beautiful coastline and mountains, is primarily reliant on its tourism. The tourist industry is estimated to account for 10% of the country's total Gross Domestic Product (GDP). However, The COVID-19 pandemic has had a significant impact on tourism all around the world, including Sri Lanka. Its tourism sector has been adversely affected, one of the country's key sources of foreign cash.

As a result, foreign exchange reserves dropped drastically. The amount of money that Sri Lankans have to spend to purchase the foreign exchange needed to import products has increased as the supply of foreign exchange has dried up. As a result, the Sri Lankan rupee has lost about 8% of its value so far this



year. It should be highlighted that the country's basic food supply is mainly reliant on imports. High import costs and the depreciating value of the rupee has caused a steep hike in food prices.

The government's restriction on chemical fertilisers in agriculture has exacerbated the issue by reducing agricultural output. Mr Rajapaksa announced his aim earlier this year to make Sri Lanka the first country in the world to have a 100 percent organic agriculture sector. The government outlawed the use of pesticides and fertilisers in agriculture, which has had a significant impact on crop yields. Sri Lanka, which is one of the world's top tea and spice growers, is expecting a significant decline in yield in the coming days.

What measures has the government taken to address the crisis?

The Sri Lankan government has blamed speculators for the surge in food prices, blaming them for stockpiling crucial supplies and declaring an economic emergency under the Public Security Ordinance. Meanwhile, it has also named a retired army general as commissioner of critical services, with the authority to seize and regulate food inventories held by dealers and retailers. The army can seize food supplies from traders and distribute them to customers at reasonable prices. It has also been granted the authority to guarantee that foreign reserves are only utilised to buy necessities. The government has refused to back down from its strong campaign for 100% organic farming, declaring that the short-term costs will be offset by the long-term benefits. It has also committed to provide organic fertilisers to farmers as an alternative. Furthermore, earlier this year, Sri Lanka's financial institution banned dealers from exchanging over 200 Sri Lankan rupees for an American dollar and from moving into forward currency contracts.

Is the government's approach going to be beneficial to the economy?

Mr Rajapaksa's push to make Sri Lankan agriculture completely organic is expected to result in a considerable reduction in local food output and a rise in costs. Food price caps might result in severe shortages if demand exceeds supply at the government-set price. The purchase of basic necessities became more cumbersome due to its shortage. The authority to seize and regulate food inventories held by dealers and retailers might sometimes have unexpected consequences. When traders' supplies are taken, they have less inducement to bring in new supply to the market. This could result in a severe shortage of supplies and even higher costs for basic necessities. It's also worth noting that speculative traders contribute to price stability by sensibly allocating scarce supplies over time. Army's intervention in food speculation can further worsen the situation as food prices can become more versatile.

The Sri Lankan central bank's decision to ban forward contracts and spot trading of rupees at over 200 rupees to the US dollar may have an effect on crucial supplies. A food supply dealer, for example, who wishes to spend more than 200 rupees for an American dollar in order to import rice may no longer be able to do so. In fact, since the central bank's decree, currency trading in the spot market has ceased. Furthermore, without forwarding contracts, which allow dealers to shift currency volatility risk to professional speculators, many traders may be hesitant to acquire critical supplies.

The impact of the COVID-19 epidemic, along with a deepening financial crisis, has put Sri Lanka's development in jeopardy. The rupee's depreciation is projected to increase the cost of repayments. Despite taking steps to address the situation, imports of tea, rubber, seafood, and textiles are surpassing exports due to increased costs and insufficient revenue. Sri Lanka can lift the ban on fertilisers since the country isn't ready for organic agriculture. This could help to down food prices and ease the increasing inflation. Secondly, the government could seek assistance from the IMF to maintain its foreign exchange reserves, as well as collaborate with international economic experts to develop a plan to address the economic crisis that has arisen as a result of the pandemic, as the neighbouring Indian state of Tamil Nadu has done. Nonetheless, Sri Lanka's terrible financial situation demonstrates that reform is essential to make progress. To achieve this though, steps like these must begin now. Otherwise, Sri Lanka's position could deteriorate further.

-Viraj Shroff