8/21/2024

STAT 31653

ASSIGNMENT 02

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Background of the study

Sri Lanka has faced a challenging economic situation in recent years, marked by a series of internal problems and external shocks. The crisis began in 2019 due to several key factors. First, tax cuts were introduced that significantly reduced government revenue. At the same time, a poorly executed shift to organic farming led to lower agricultural output. The situation was made worse by events like the 2019 Easter bombings, which hurt tourism, and the global COVID-19 pandemic, which further weakened the economy.

A major issue has been Sri Lanka's heavy reliance on foreign debt, especially high-interest loans from commercial lenders. As the country moved to middle-income status, it lost access to cheaper concessional funding, leading to an increased dependence on International Sovereign Bonds (ISBs) that have shorter repayment periods. By 2019, over half (56%) of Sri Lanka's foreign debt came from commercial loans, up from just 2.5% in 2007.

The economic crisis led to severe consequences, including a sharp decline in foreign exchange reserves, which are essential for paying for imports and repaying foreign debt. In June 2022, the United Nations warned that Sri Lanka was at risk of a "full-blown humanitarian emergency" due to the worsening economic conditions. Although there are predictions that the economy might grow by 2.2% in 2024, the country still faces serious problems like high poverty rates, rising income inequality, and challenges in the job market.

Despite some recent improvements, such as lower inflation, higher government revenues, and a current account surplus driven by remittances and a recovery in tourism, poverty remains a significant issue. In 2023, nearly 26% of the population was living below the poverty line. Additionally, the labor force participation rate has dropped, particularly among women and in urban areas, partly due to the collapse of many Micro, Small, and Medium Enterprises (MSMEs).

Sri Lanka’s economic recovery has also involved restructuring its debt, especially with major lenders like India and China, to make it more manageable. This debt restructuring is crucial for Sri Lanka to stabilize its economy and reduce its vulnerability to future crises.

MSMEs, which play a crucial role in the economy, have been particularly hard hit. Many of these businesses faced significant losses and were forced to cut jobs or close. While some adapted by going digital or introducing flexible work practices, they received little support from the government or financial institutions, making recovery difficult.

Overall, Sri Lanka’s path to economic recovery is a complex challenge that requires careful management of its finances, support for key sectors like MSMEs, and strategic reforms to ensure sustainable growth in the future.

Objective of the Study

The objective of this study is to analyze the Balance of Payments (BOP) situation in Sri Lanka through the lens of relevant economic theories. The study aims to identify the underlying causes of the BOP imbalances and assess the impact of both domestic and international factors on the country's external economic position. By applying BOP theories such as the Monetary Approach, the study seeks to provide a comprehensive understanding of the challenges Sri Lanka faces in managing its BOP.

Additionally, the study will propose strategic policy recommendations to address the BOP issues, focusing on measures that can stabilize the economy, improve foreign exchange reserves, and ensure sustainable long-term growth. These recommendations will be aimed at enhancing the country's trade balance, optimizing capital flows, and reducing reliance on foreign debt, thereby contributing to overall economic stability and resilience.

Theoretical framework

What is the balance of payments?

The Balance of Payments (BOP) is a financial record that summarizes all the economic transactions between a country and the rest of the world over a specific period, usually a year. It shows how much money is coming into the country and how much is going out. The BOP is divided into three main components: the Current Account, the Capital Account, and the Financial Account.

1. **Current Account:** This part of the BOP records the flow of goods, services, income, and transfers. It includes:
   - **Trade Balance:** The difference between a country's exports (money coming in from selling goods and services abroad) and imports (money going out to buy goods and services from other countries). If exports are higher than imports, there's a surplus; if imports are higher, there's a deficit.
   - **Income:** This includes earnings from investments made abroad, such as dividends and interest, as well as payments to foreign investors in the country.
   - **Current Transfers:** Money sent or received from other countries that doesn't involve an exchange of goods or services, like remittances from workers abroad or foreign aid.
2. **Capital Account:** The Capital Account records the flow of capital transfers and the purchase and sale of non-produced, non-financial assets. This part is usually smaller compared to the other components. It includes things like debt forgiveness, transfer of assets by migrants, and the sale or purchase of rights like patents.
3. **Financial Account:** The Financial Account tracks the flow of investments between countries. It includes:
   - **Direct Investment:** Investments made to acquire a lasting interest in enterprises operating in another country, like buying a company or setting up a business abroad.
   - **Portfolio Investment:** Buying and selling financial assets such as stocks and bonds in other countries.
   - **Other Investments:** This includes loans, bank deposits, and other forms of financial transfers that don't fall under direct or portfolio investment.
   - **Reserve Assets:** The changes in a country's foreign exchange reserves held by its central bank, which are used to manage the country's currency value and settle international debts.

Together, these components show whether a country is borrowing from or lending to the rest of the world, and whether it's accumulating or depleting its foreign reserves. The BOP must always balance, meaning the sum of the current, capital, and financial accounts should theoretically be zero, but in practice, there might be discrepancies due to statistical errors or omissions

Theories

1. Monetary Approach to the Balance of Payments

The Monetary Approach views the BOP as a reflection of monetary factors, emphasizing the role of money supply and demand. According to this approach, BOP imbalances arise from discrepancies between the supply and demand for money. A surplus or deficit in the BOP indicates either an excess or shortage of money in the economy, respectively.

2. Elasticity Approach

The Elasticity Approach focuses on the responsiveness of import and export volumes to changes in exchange rates. It suggests that the effectiveness of currency depreciation in correcting a BOP deficit depends on the price elasticity of demand for exports and imports. The approach is particularly relevant in analyzing trade balances.

3. Absorption Approach

The Absorption Approach links BOP imbalances to the difference between national income (output) and national expenditure (absorption). According to this theory, a BOP deficit occurs when a country's total spending exceeds its income, leading to higher imports than exports. The approach suggests that reducing domestic expenditure or increasing production can correct BOP imbalances.

4. IS-LM Model and BOP

The IS-LM model integrates the goods market (IS curve) and the money market (LM curve) to analyze the relationship between interest rates and output. When applied to open economies, the IS-LM framework helps in understanding how monetary and fiscal policies affect the BOP. The model also illustrates the interaction between exchange rates, capital flows, and domestic economic conditions.

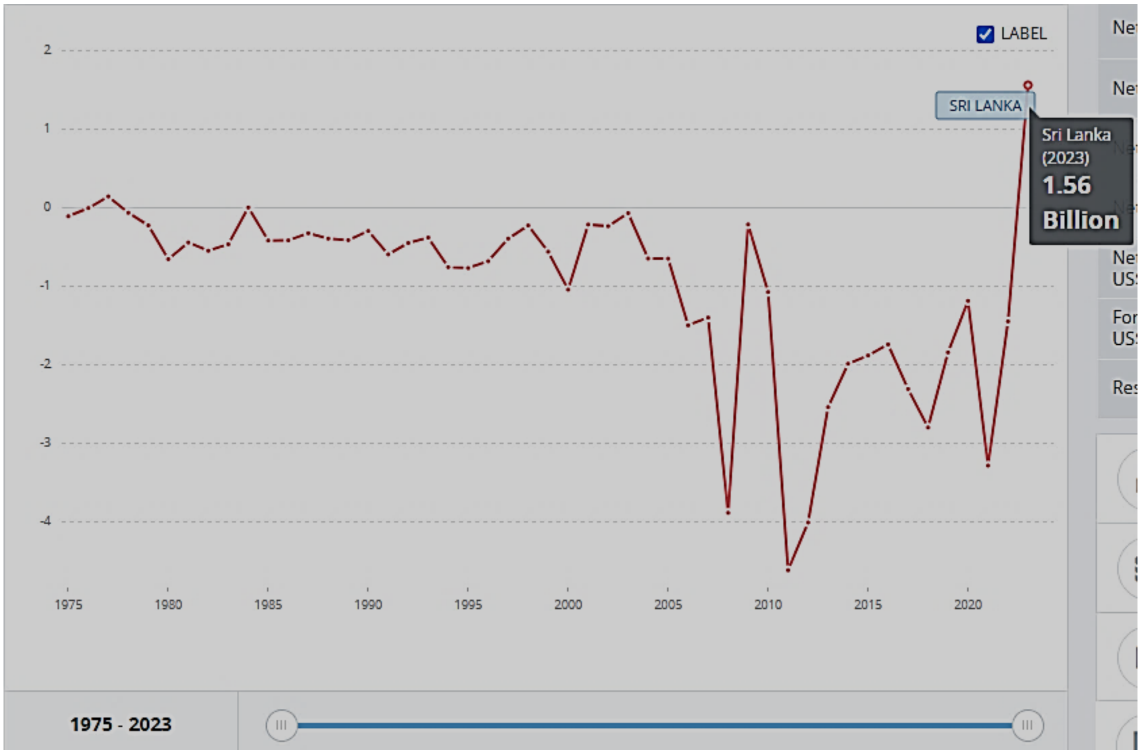
5. Balance of Payments Theory of Exchange Rates

This theory posits that exchange rates are determined by the balance between the demand and supply of foreign exchange, which is directly linked to the BOP. According to this theory, a BOP deficit leads to currency depreciation, while a surplus strengthens the exchange rate.

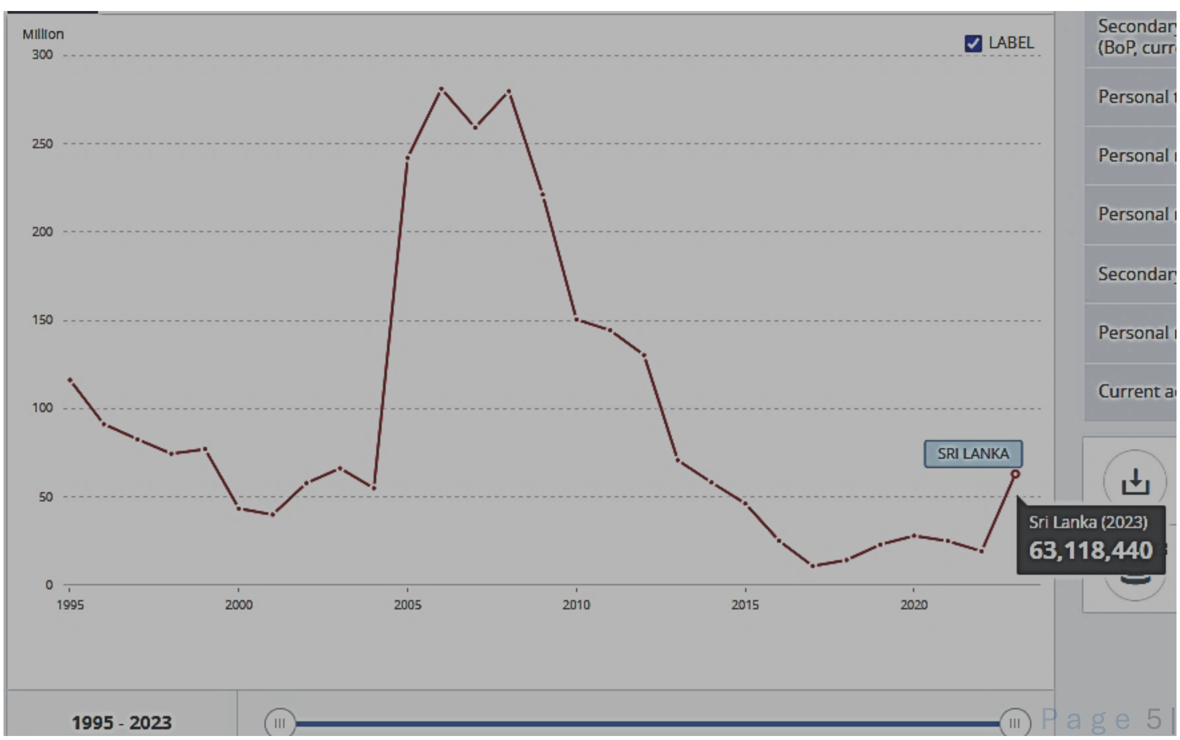
[Analysis of Sri Lanka's BOP situation]()

Historical overview

Current account balance (BOP, US$)



NET CAPITAL ACCOUNT BALANCE (BOP, US$)



Analysis of Current BOP status

Trade balance

Composition of Exports

Value in US$ million

Category	2019	2020	2021	2022	2023 (a)		Change (%) 2022/2023
					Value	Share (%)	
Agricultural Exports	**2,461.9**	**2,336.2**	**2,729.5**	**2,568.0**	**2,566.5**	**21.5**	**-0.1**
Tea	1,346.4	1,240.9	1,324.4	1,258.8	1,309.9	11.0	4.1
Spices	312.5	333.5	454.8	368.7	392.9	3.3	6.5
Coconut	329.5	345.2	425.2	400.3	336.8	2.8	-15.9
Seafood	262.5	189.8	274.1	269.0	262.2	2.2	-2.5
Minor Agricultural Products	120.0	134.7	148.8	178.8	180.9	1.5	1.2
Unmanufactured Tobacco	34.7	25.5	31.6	24.4	28.1	0.2	15.3
Rubber	24.2	30.1	42.2	41.4	28.0	0.2	-32.2
Vegetables	32.0	36.6	28.5	26.7	27.7	0.2	3.8
Industrial Exports	**9,426.3**	**7,672.0**	**9,702.0**	**10,465.3**	**9,277.7**	**77.9**	**-11.3**
Textiles and Garments	5,596.5	4,423.1	5,435.1	5,952.0	4,878.9	41.0	-18.0
Rubber Products	866.1	786.1	1,050.4	977.0	902.2	7.6	-7.7
Machinery and Mechanical Appliances	400.0	337.5	500.9	580.9	598.2	5.0	3.0
Petroleum Products	521.1	373.6	506.4	568.0	539.4	4.5	-5.0
Food, Beverages and Tobacco	447.0	464.0	586.9	519.5	539.3	4.5	3.8
Gems, Diamonds and Jewellery	305.7	181.5	276.7	450.6	500.0	4.2	11.0
Chemical Products	176.3	172.7	223.2	223.5	193.5	1.6	-13.4
Base Metals and Articles	176.5	110.9	156.4	176.7	178.3	1.5	0.9
Transport Equipment	145.9	71.4	148.2	129.3	149.3	1.3	15.4
Animal Fodder	129.0	102.9	149.4	170.5	145.6	1.2	-14.6
Wood and Paper Products	129.4	99.3	129.9	136.9	114.0	1.0	-16.7
Leather, Travel Goods and Footwear	102.9	53.9	58.4	85.8	71.2	0.6	-17.0
Plastics and Articles Thereof	73.5	176.3	78.6	60.9	56.3	0.5	-7.6
Printing Industry Products	48.3	47.9	50.0	53.1	55.1	0.5	3.9
Ceramic Products	30.1	24.0	37.4	38.1	34.0	0.3	-10.7
Other Industrial Exports	278.1	247.0	314.1	342.4	322.5	2.7	-5.8
Mineral Exports	**33.9**	**25.1**	**44.5**	**50.0**	**38.5**	**0.3**	**-23.1**
Unclassified	**17.9**	**14.1**	**22.6**	**23.2**	**28.0**	**0.2**	**20.8**
Total Exports	**11,940.0**	**10,047.4**	**12,498.6**	**13,106.4**	**11,910.7**	**100.0**	**-9.1**

(a) Provisional

Sources: Ceylon Petroleum Corporation and Other Exporters of Petroleum
National Gem and Jewellery Authority
Sri Lanka Customs
Central Bank of Sri Lanka

- **Agricultural Exports**: These remained fairly consistent over the years. The overall change in 2023 was a minor decrease of -0.1%. Tea showed a significant increase in value by 11.0%, whereas Seafood saw a notable decrease of -15.9%.
- **Industrial Exports**: The largest category, contributing the majority of export value. The total value decreased by 11.3% in 2023 compared to 2022. Textiles and Garments, the largest contributor, saw an 18.0% decline.
- **Mineral Exports**: A relatively small part of the total exports, showing a decrease of -2.3% from 2022 to 2023.
- **Total Exports**: The total export value declined from $13,106.4 million in 2022 to $11,910.7 million in 2023, reflecting a -9.1% decrease.

- The data reflects a general downturn in exports from 2022 to 2023, driven primarily by declines in key industrial sectors, particularly Textiles and Garments.
- Agricultural exports remained relatively stable, with some categories experiencing growth while others declined.
- The significant changes in the industrial sector highlight shifts in global demand, possibly influenced by economic conditions or trade policies.

IMPORTS

- **Consumer Goods**:
    - A slight decrease in total import value is observed from 2022 to 2023 (-7.9%). Food and Beverages saw a significant drop of -13.5%.
    - The overall decrease in imports of durable consumer goods (like vehicles and electrical items) could indicate a slowdown in consumer spending or tighter import regulations.
- **Intermediate Goods**:
    - The largest category, contributing the majority of import value. The total value decreased by -16.1% in 2023 compared to 2022.
    - Petroleum products showed a notable decrease of -24.8%, likely due to fluctuations in global oil prices or reduced demand.
    - Fertilizers and Chemical Products also saw reductions, indicating potential shifts in agricultural or industrial activity.
- **Investment Goods**:
    - Imports in this category dropped by -20.7%, reflecting reduced investments in building materials, machinery, and equipment. This could be tied to economic uncertainty or reduced capital expenditures.
- **Unclassified Imports**:
    - A very small and variable category, showing a -67.5% decrease in 2023. The reasons behind such a sharp decline would need further context or investigation.
- **Total Imports**:
    - The total value of imports fell from $18,121.8 million in 2022 to $15,293.6 million in 2023, a -15.6% decline. This substantial reduction across nearly all categories reflects broader economic challenges or policy changes affecting import activities.

Composition of Imports

Value in US$ million

Category	2019	2020	2021	2022	2023 (a)		Change (%) 2022/2023
					Value	Share (%)	
Consumer Goods	**3,956.5**	**3,401.7**	**3,848.7**	**2,813.0**	**3,043.9**	**18.1**	**8.2**
Food and Beverages	**1,426.9**	**1,554.4**	**1,666.5**	**1,607.9**	**1,693.0**	**10.1**	**5.3**
Sugar and Confectionery	201.2	277.1	288.8	257.8	435.5	2.6	68.9
Vegetables (b)	310.0	352.9	384.3	318.4	358.6	2.1	12.6
Dairy Products	311.9	333.8	317.7	225.3	273.7	1.6	21.5
Oils and Fats	29.4	106.9	184.1	43.9	133.9	0.8	205.2
Spices	115.4	126.9	127.2	136.6	133.4	0.8	-2.4
Cereals and Milling Industry Products	36.1	33.6	97.4	430.5	116.9	0.7	-72.8
Seafood	214.6	188.6	122.3	66.4	79.4	0.5	19.6
Other Food and Beverages	208.4	134.7	144.7	128.9	161.6	1.0	25.3
Other Consumer Goods	**2,529.6**	**1,847.3**	**2,182.2**	**1,205.1**	**1,350.9**	**8.0**	**12.1**
Medical and Pharmaceuticals	552.6	595.5	882.5	533.4	667.0	4.0	25.0
Clothing and Accessories	275.1	200.7	221.3	215.6	170.0	1.0	-21.1
Household and Furniture Items	171.9	146.9	161.2	116.3	122.1	0.7	5.0
Telecommunication Devices	247.2	268.4	382.9	69.0	98.8	0.6	43.3
Home Appliances	206.6	174.2	257.1	85.5	72.4	0.4	-15.4
Personal Vehicles	815.7	282.9	12.8	11.7	27.7	0.2	136.9
Other Non-Food Consumables	260.5	178.7	264.4	173.7	192.9	1.1	11.1
Intermediate goods	**11,369.6**	**9,076.5**	**12,308.9**	**12,438.8**	**11,006.6**	**65.5**	**-11.5**
Fuel	3,891.6	2,542.6	3,742.9	4,896.8	4,702.6	28.0	-4.0
Crude Oil	970.7	583.0	625.1	483.8	1,137.5	6.8	135.1
Refined Petroleum	2,706.4	1,742.2	2,840.0	4,048.2	3,095.4	18.4	-23.5
Coal	214.6	217.3	277.8	364.8	469.8	2.8	28.8
Textile and Textile Articles	2,909.4	2,335.1	3,066.9	3,065.2	2,371.2	14.1	-22.6
Chemical Products	831.5	831.5	1,074.4	966.2	814.7	4.8	-15.7
Plastic and Articles Thereof	612.9	540.2	765.7	650.8	474.6	2.8	-27.1
Paper and Paperboard and Articles Thereof	457.3	383.1	468.9	465.9	412.4	2.5	-11.5
Wheat and Maize	346.4	384.4	418.3	303.1	338.2	2.0	11.6
Base Metals	562.8	460.3	866.4	323.2	313.8	1.9	-2.9
Diamonds and Precious or Semi stones	201.4	117.2	143.6	203.8	268.4	1.6	31.7
Fertiliser	221.4	258.9	158.2	275.9	235.0	1.4	-14.8
Agricultural Inputs	187.9	200.8	264.2	214.5	233.8	1.4	9.0
Vehicle and Machinery Parts	270.1	239.4	349.4	254.9	232.5	1.4	- 8.8
Rubber and Articles Thereof	238.9	218.7	400.7	334.7	200.2	1.2	-40.2
Food Preparations	227.7	235.1	269.9	189.7	171.3	1.0	-9.7
Mineral Products	243.3	168.9	158.9	123.7	80.9	0.5	-34.6
Other Intermediate Goods	167.0	160.3	160.4	170.4	156.9	0.9	-7.9
Investment Goods	**4,602.6**	**3,563.2**	**4,462.7**	**3,030.5**	**2,744.6**	**16.3**	**-9.4**
Machinery and Equipment	2,489.7	2,176.1	2,809.5	1,969.0	1,867.6	11.1	-5.1
Building Materials	1,508.7	1,035.6	1,248.9	926.3	775.1	4.6	-16.3
Transport Equipment	596.6	348.3	398.5	132.1	98.5	0.6	-25.4
Other Investment Goods	7.6	3.2	5.8	3.0	3.3	...	9.2
Unclassified Imports	**8.3**	**14.0**	**17.1**	**8.8**	**16.0**	**0.1**	**82.9**
Total Imports	**19,937.1**	**16,055.4**	**20,637.4**	**18,291.0**	**16,811.1**	**100.0**	**-8.1**
Non Oil Imports	**16,045.4**	**13,512.8**	**16,894.6**	**13,394.2**	**12,108.5**	**72.0**	**-9.6**

(a) Provisional
(b) Includes lentils, onions, potatoes, leguminous and other vegetables

Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

BALANCE OF PAYMENTS – CURRENT ACCOUNT

Balance of Payments - Current Account

US$ million

Item	2022 (a)			2023 (b)		
	Credit	Debit	Net	Credit	Debit	Net
Goods and services	**16,169**	**19,244**	**-3,075**	**17,327**	**18,823**	**-1,496**
Goods (c)	**13,106**	**18,291**	**-5,185**	**11,911**	**16,811**	**-4,900**
General merchandise	13,106	18,289	-5,183	11,911	16,807	-4,896
Non-monetary gold		2	-2		5	-5
Services	**3,062**	**953**	**2,110**	**5,416**	**2,012**	**3,404**
Manufacturing Services	-	-	-	17	194	-177
Maintenance and repair services	-	-	-	45	8	37
Transport	676	333	343	1,550	732	818
Sea Transport	410	137	272	813	286	528
Passenger	-	-	-	0.1	3	-3
Freight	410	137	272	432	252	180
Other	-	-	-	381	31	350
Air transport	266	195	71	736	440	296
Passenger	221	180	41	304	241	63
Freight	46	15	30	81	78	3
Other	-	-	-	351	120	230
Postal services	-	-	-	0.5	6	-6
Travel (d)	1,136	244	893	2,068	152	1,916
Construction	9	11	-2	355	111	244
Insuarance and pension services	19	36	-18	35	51	-16
Financial services	92	96	-5	64	57	7
Charges for the use of intellectual property	-	-	-	15	94	-79
Telecommunication and computer services	1,097	161	936	917	251	666
Telecommunications services	31	28	3	122	53	69
Computer services	1,066	133	933	795	198	597
Other business services	15	16	-1	310	344	-33
Personal, cultural and recreational services	-	-	-	35	11	24
Government goods and services n.i.e	18	56	-38	7	7	-1
Primary Income	**266**	**2,136**	**-1,870**	**463**	**3,027**	**-2,564**
Compensation of employees	30	69	-39	53	30	23
Investment Income	237	2,068	-1,831	410	2,997	-2,587
Direct Investment	15	549	-534	12	888	-876
Dividends	12	385	-374	6	621	-615
Re-invested earnings	3	164	-161	6	267	-261
Portfolio Investment		778	-778		866	-866
Equity		17	-17		86	-86
Interest		761	-761		780	-780
short-term		1	-1		20	-20
long-term		761	-761		760	-760
Actual ISB coupon payments		191			-	
Accrued ISB coupon payments		551			727	
Actual other sectors coupon payments		12			12	
Accrued other sectors coupon payments		6			12	
Other Investment	217	741	-523	349	1,243	-894
Government - Interest Payments		273			377	
Government - Accrued Interest		133			384	
Central Bank - Interest Payments		57			282	
Central Bank - Accrued Interest		3			15	
Commercial Bank - Interest Payments	217	129		349	74	
Other Sectors - Interest Payments		130			111	
Other Sectors - Accrued Interest		16			-	
Reserve assets	5		5	49		49
Secondary Income	**3,793**	**296**	**3,496**	**5,989**	**371**	**5,619**
General Government (e)	3		3	20		20
Personal transfers	3,789	296	3,493	5,970	371	5,599
of which, worker's remittances	3,789			5,970		
Current Account	**20,228**	**21,677**	**-1,448**	**23,780**	**22,221**	**1,559**
Capital Account	**38**	**19**	**19**	**94**	**31**	**63**
Capital Transfers	38	19	19	94	31	63
General Government (f)	6		6	36		36
Private Capital transfers	32	19	13	57	31	27
Current and Capital Account	**20,266**	**21,695**	**-1,429**	**23,873**	**22,251**	**1,622**

(a) Revised
(b) Provisional
(c) Exports and imports are recorded on f.o.b. and c.i.f. valuation basis, respectively.
(d) Passenger services provided for non-residents are included in transport services.
(e) Includes outright grants received in the form of programme, food and commodity aid, cash and technical assistance.
(f) Includes outright grants received in the form of project aid.

Source: Central Bank of Sri Lanka

The image depicts a detailed table showing the balance of payments for a country's current account. It includes various components such as goods, services, primary income, and secondary income. Each component is further broken down into specific items, such as goods (exports, imports, general merchandise), services (transport, travel, financial services), primary income (investment income, compensation of employees), and secondary income (current transfers). The table covers multiple years, providing comparative data for 2020, 2021, 2022, and part of 2023 (up to the first quarter). Each category shows credits (inflows) and debits (outflows), resulting in a net figure. The data appears to be sourced from a country's central bank and gives insights into the economic interactions of the country with the rest of the world, highlighting trends in trade, income, and transfers.

Balance of Payments - Financial Account

US$ million

Item	2022 (a)		2023 (b)	
	Net Acquisition of Financial Assets	Net Incurrence of Liabilities	Net Acquisition of Financial Assets	Net Incurrence of Liabilities
Financial Account	84	1,652	3,474	2,171
Direct Investment	15	884	34	712
Equity and Investment Fund Shares	11	275	29	496
Equity other than Reinvestment of Earnings	7	111	22	228
Reinvestment of Earnings	3	164	7	267
Debt Instruments	5	610	5	216
Portfolio Investment	-	370	173	931
Equity and Investment Fund Shares	-	151	-	8
Debt Securities	-	218	173	923
Deposit taking corporations	-	-	173	-
Long-term	-	-	173	-
General Government		212		910
Short Term (Treasury Bills)		30		132
Long Term		183		778
Treasury Bonds		21		78
Sri Lanka Development Bonds		2		-27
Sovereign Bonds		159		727
Maturities		-391		-
Accrued Interest		551		727
Other Sectors		6		12
long-term		6		12
Accrued Interest		6		12
Financial Derivatives	-	-	-	-
Other Investment	1,302	398	1,022	528
Currency and Deposits	514	-583	114	-143
Central Bank		402		-350
Short Term		-1		0.1
Long Term		403		-341
International Swaps		400		-350
Accrued Interest on International Swaps		3		9
Deposit-taking Corporations	514	-985	114	207
Short Term	605	-985	-472	207
Long Term	-91	-	586	-
Loans		385		1,056
Central Bank		-140		-172
Credit and Loans with the IMF		-140		-172
Extended Fund Facility		-140		-172
Deposit-taking Corporations		-1,163		-644
Short Term		-826		-397
Long Term		-337		-248
General Government		1,679		1,845
Long Term		1,679		1,845
Credit and loans with the IMF		-		681
Disbursements		2,391		1,822
Accrued Interest		133		384
Repayments		-845		-1,041
Other Sectors (c)		9		27
Long Term		9		27
Disbursements		332		331
Accrued Interest		16		-
Repayments		-339		-304
Trade Credit and Advances	282	-895	186	-555
Deposit-taking Corporations	-27	-	-4	-
Short Term	-27	-	-4	-
Other Sectors (d)	310	-895	190	-555
Short Term	310	-895	190	-555

(a) Revised
(b) Provisional
(c) Includes State Owned Business Enterprises (SOBEs) and private sector companies.
(d) Includes trade credits received by the Ceylon Petroleum Corporation (CPC) and other private companies

Source: Central Bank of Sri Lanka

The table displays the financial account data for 2022 and 2023, showing net acquisitions of financial assets and net incurrence of liabilities across various financial instruments. In 2022, there was a net acquisition of financial assets amounting to $864 million, while net liabilities stood at $1,662 million. For 2023, the net acquisition of assets was $1,022 million, and net liabilities were higher at $2,175 million.

Direct investment saw moderate changes, with the net acquisition of financial assets at $15 million in 2022 and $34 million in 2023, whereas liabilities were $826 million and $717 million, respectively. Portfolio investment remained relatively unchanged, showing minor activity in debt securities, with both acquisitions and liabilities mainly concentrated in government bonds and treasury bills. Currency and deposits had a notable impact, with net assets changing from $514 million in 2022 to $114 million in 2023, and liabilities reflecting shifts due to changes in central bank and corporate sector activities.

Loans were a significant part of the financial account, with net acquisitions decreasing over time. In 2022, loans saw a net outflow of $1,486 million, primarily driven by central bank activities, while in 2023, this figure was reduced to $1,025 million. Trade credit and advances indicated a negative net flow, with $282 million in 2022 and $186 million in 2023. Other investments, including financial derivatives, showed significant activity, with net incurrences of liabilities at $398 million in 2022 and $122 million in 2023.

The table presents data on the financial account, focusing on net acquisition of financial assets and net incurrence of liabilities in 2022 and 2023. It includes categories such as other investments, reserve assets, and memorandum items. In 2022, the net acquisition of financial assets under other investments was $506 million, while the net incurrence of liabilities was $1,492 million. For 2023, these figures were $721 million and $171 million, respectively. Reserve assets showed a significant shift from a net reduction of $1,234 million in 2022 to a net increase of $2,245 million in 2023, primarily influenced by changes in monetary gold and other reserve assets.

The memorandum items cover foreign direct investment (FDI) details, including equity, reinvestment of earnings, and intercompany loans. In 2022, total FDI amounted to $884 million, with an additional $282 million including loans to Board of Investment (BOI) companies, totaling $1,167 million. In 2023, total FDI stood at $712 million, with loans to BOI companies contributing $46 million, resulting in a total of $758 million. Net foreign investments in rupee-denominated government securities showed a net increase, reflecting foreign purchases of $69 million and foreign sales of $18 million in 2022, compared to $274 million in purchases and $214 million in sales in 2023. The table offers a comprehensive view of financial transactions, with data sourced from the Central Bank of Sri Lanka.

Balance of Payments - Financial Account

US$ million

Item	2022 (a)		2023 (b)	
	Net Acquisition of Financial Assets	Net Incurrence of Liabilities	Net Acquisition of Financial Assets	Net Incurrence of Liabilities
Other Investment				
Other Accounts Receivable/Payable	**506**	**1,492**	**721**	**171**
Central Bank	-	1,492	-	171
Short Term (e)	-	1,492	-	171
Deposit-taking Corporations	506		721	
Short Term	506		721	
Special Drawing Rights				
Reserve Assets	**-1,234**		**2,245**	
Monetary Gold	-152		-	
Special Drawing Rights	-118		33	
Reserve Position in the IMF	-58		-	
Other Reserve Assets	-906		2,212	
Currency and Deposits	-895		1,802	
Claims on Monetary Authorities	-526		-383	
Claims on Other Entities	-369		2,185	
Securities	-11		422	
Debt Securities	-11		422	
Long Term	-11		422	
Other Claims	-0.3		-11	
Financial Account (net)	**-1,569**		**1,304**	
Errors and omissions	-139		-318	
Memorandum Items				
Foreign Direct Investment (FDI)				
Equity		**111**		**228**
BOI companies		72		146
CSE companies (not registered with BOI)		31		10
Other Companies		8		72
Reinvestment of Earnings		**164**		**267**
BOI companies		153		179
CSE companies (not registered with BOI)		-39		38
Other Companies		50		50
Intercompany Loans		**610**		**216**
BOI Shareholder Advances		204		285
BOI Intercompany Loans		365		79
Other Companies		41		-148
Debt Repayments		**-0.1**		-
Total FDI (1)		**884**		**712**
Loans to BOI Companies (2)		282		46
Total FDI, Including Loans to BOI Companies (1 + 2) (f)		**1,167**		**758**
Total Net Inflows to the CSE		**182**		**18**
Direct Investment		31		10
Portfolio Investment		151		8
Net Foreign Investments in Rupee Denominated Government Securities (Treasury Bills and Bonds)		**51**		**210**
Foreign Purchases		69		824
Foreign Sales		18		614

(e) Net transactions of Asian Clearing Union (ACU) liabilities
(f) Any difference with the BOI estimates is due to differences in coverage and compilation methodologies.

Source: Central Bank of Sri Lanka

To strategically address these issues, the following remedies could be considered:

1. Enhancing Export Competitiveness

- **Diversify Export Products and Markets**: The country could diversify its export base to reduce reliance on a limited number of commodities or markets. Investing in sectors with high demand in global markets, such as information technology, apparel, and agricultural products, could boost exports.
- **Improve Quality and Value Addition**: Encouraging industries to add more value to raw materials before exporting can increase export revenues. Providing support for quality improvement and certification can make products more competitive internationally.
- **Trade Agreements and Partnerships**: Pursuing new trade agreements and strengthening existing ones could open up new markets for exports, making it easier to access international markets.

2. Controlling Imports

- **Promote Import Substitution**: Encouraging the domestic production of goods that are currently imported can help reduce the import bill. This could involve providing incentives for local industries to produce goods that are otherwise imported.
- **Implement Tariffs and Non-Tariff Barriers**: Selective tariffs on non-essential goods can reduce unnecessary imports, while non-tariff measures like quotas and quality standards can control the quantity and quality of imports.

3. Attracting Foreign Direct Investment (FDI)

- **Improve Business Environment**: Creating a more investor-friendly environment by simplifying regulations, ensuring legal protections, and offering tax incentives can attract more FDI. The increase in FDI from $111 million in 2022 to $228 million in 2023 shows potential that can be further harnessed.
- **Focus on Strategic Sectors**: Encouraging FDI in sectors that have potential for export growth, such as technology, manufacturing, and tourism, can increase foreign exchange earnings and create jobs.

4. Managing External Debt and Loans

- **Debt Restructuring and Refinancing**: Given the significant outflows due to loan repayments, the country could negotiate better terms for existing debt or seek to refinance loans to extend the repayment period and reduce immediate outflows.
- **Limit New Borrowings**: New loans should be carefully scrutinized, focusing on those that finance projects with high returns or are essential for economic stability. Emphasizing concessional loans over commercial borrowing can reduce interest costs.

5. Boosting Remittances

- **Engage the Diaspora**: Encouraging the overseas diaspora to invest in the home country and remit more funds could be achieved through targeted marketing campaigns and the introduction of attractive savings schemes.
- **Skill Development for Overseas Employment**: Investing in training programs that align with the demand in international job markets can increase the number of skilled workers abroad, thereby boosting remittance inflows.

6. Strengthening Reserve Management

- **Increase Foreign Exchange Reserves**: Enhancing reserve assets, which showed a significant net increase in 2023, can help stabilize the currency and provide a buffer against external shocks. This could involve more prudent management of gold reserves and other financial assets.
- **Sovereign Wealth Fund (SWF)**: Establishing an SWF could help manage surplus revenues from exports or other sources, ensuring that reserves are available for economic stability and strategic investments.

7. Improving Financial Account Balances

- **Capital Market Development**: Strengthening local capital markets can attract more portfolio investment. This includes improving regulatory frameworks, ensuring market transparency, and offering more investment products.
- **Promote Long-term Investment over Short-term Capital Flows**: Focusing on stable, long-term investment rather than volatile short-term flows can provide a more stable source of financing.

8. Tourism Sector Revitalization

- **Promote Tourism**: The tourism industry can be a significant source of foreign exchange earnings. Developing tourism infrastructure, ensuring safety, and marketing campaigns in key source countries can boost tourist arrivals and expenditure.

Conclusion

Sri Lanka is experiencing a Balance of Payments (BoP) deficit. This is evident from the negative net financial flows, significant outflows due to loan repayments, and a higher net incurrence of liabilities compared to the net acquisition of financial assets. The current account shows deficits driven by high import costs and lower-than-expected export revenues, which further exacerbate the BoP situation. The increase in external debt and liabilities, alongside lower foreign direct investment inflows relative to liabilities, indicates that Sri Lanka is facing challenges in maintaining a sustainable balance in its international transactions, resulting in an overall BoP deficit.

Analyzing Sri Lanka's Balance of Payments (BoP) data highlights critical imbalances and areas of concern that need addressing to stabilize the country's external economic position. The data reveals deficits in the current account due to high import bills and insufficient export growth, significant outflows in loans, and an overall increase in liabilities. To address these issues, it is crucial to utilize relevant BoP theories such as the Elasticity Approach, Absorption Approach, and Monetary Approach, which emphasize the importance of improving export competitiveness, controlling imports, managing external debt, and attracting stable foreign investment.

Strategic remedies proposed include diversifying and enhancing export sectors, promoting import substitution, attracting foreign direct investment, and managing external debt through restructuring and refinancing. Additionally, improving reserve management and revitalizing key sectors such as tourism can provide a more sustainable inflow of foreign exchange. These measures, when implemented effectively, will not only address immediate BoP imbalances but also pave the way for long-term economic stability and growth.

The successful application of these strategies requires a coordinated effort involving government policy, private sector participation, and international collaboration. By adopting a comprehensive approach that aligns with BoP theories and strategic remedies, Sri Lanka can enhance its economic resilience, reduce its vulnerability to external shocks, and achieve a more balanced and sustainable economic future.

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