BOX 7

Making Sri Lanka's External Current Account Outcomes More Sustainable

Sri Lanka recorded a surplus in the current account of the Balance of Payments (BOP) in 2023. This surplus can mainly be attributed to the notable reduction in merchandise imports, significant increase in earnings from tourism and healthy growth in workers' remittances. Over the years, Sri Lanka has been experiencing persistent external current account deficits mainly driven by large deficits in the merchandise trade account. Although the trade in services account and secondary income account recorded surpluses, such surpluses were not sufficient to cushion the impact of merchandise trade and primary income account deficits on the current account (Figure B 7.1).

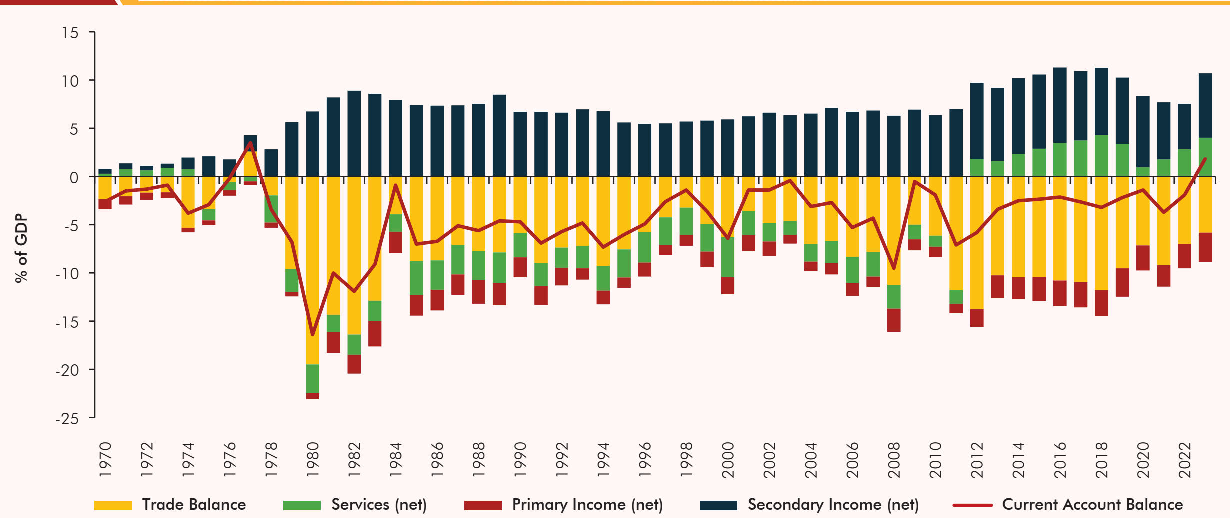
Historically, global experiences show that after a significant economic shock, such as a BOP crisis leading to a debt default, the subsequent adjustment in the exchange rate and corrective policy measures result in an immediate current account surplus. In this context, historical experiences show that some countries were able to sustain a surplus in the current account in the medium to long term following a period of economic distress. At the same time, there were countries that reverted to their historical trend of recording deficits (Figure B 7.2). Generally, countries that have been able to sustain such surpluses in the long run were able to stabilise the exchange rate at an elevated level compared to that of pre-crisis level, supporting export competitiveness, while managing inflation at lower levels. Sustaining these surpluses was supported by policies aimed at gradually accelerating real GDP growth and improving fiscal performance (i.e., improved primary balance and lower budget deficit). In this context, it is important to explore the factors influencing the sustainability of current account surpluses post-economic shocks and economic implications of maintaining persistent current account surpluses or deficits.

The current account balance mirrors the savings-investment gap in the country. A current account surplus reflects a positive savings-investment gap whereas a deficit reflects a negative savings-investment gap. In Sri Lanka, along with the current account surplus, the national savings-investment gap took an upturn to record a positive value in 2023. This surplus can be attributed to the combined effect of reduced domestic investment and a notable increase in net current transfers from the rest of the world, leading to an increase in national savings.

Country Experiences

During the East Asian Financial Crisis of 1997-1998, countries such as Thailand, South Korea, Indonesia, Philippines and Malaysia experienced BOP distress that led to a multitude of macroeconomic shocks, including sharp depreciation of local currencies. In response, these countries implemented structural reforms, including

Figure B 7.1 **Composition of the Current Account: 1970 - 2023**

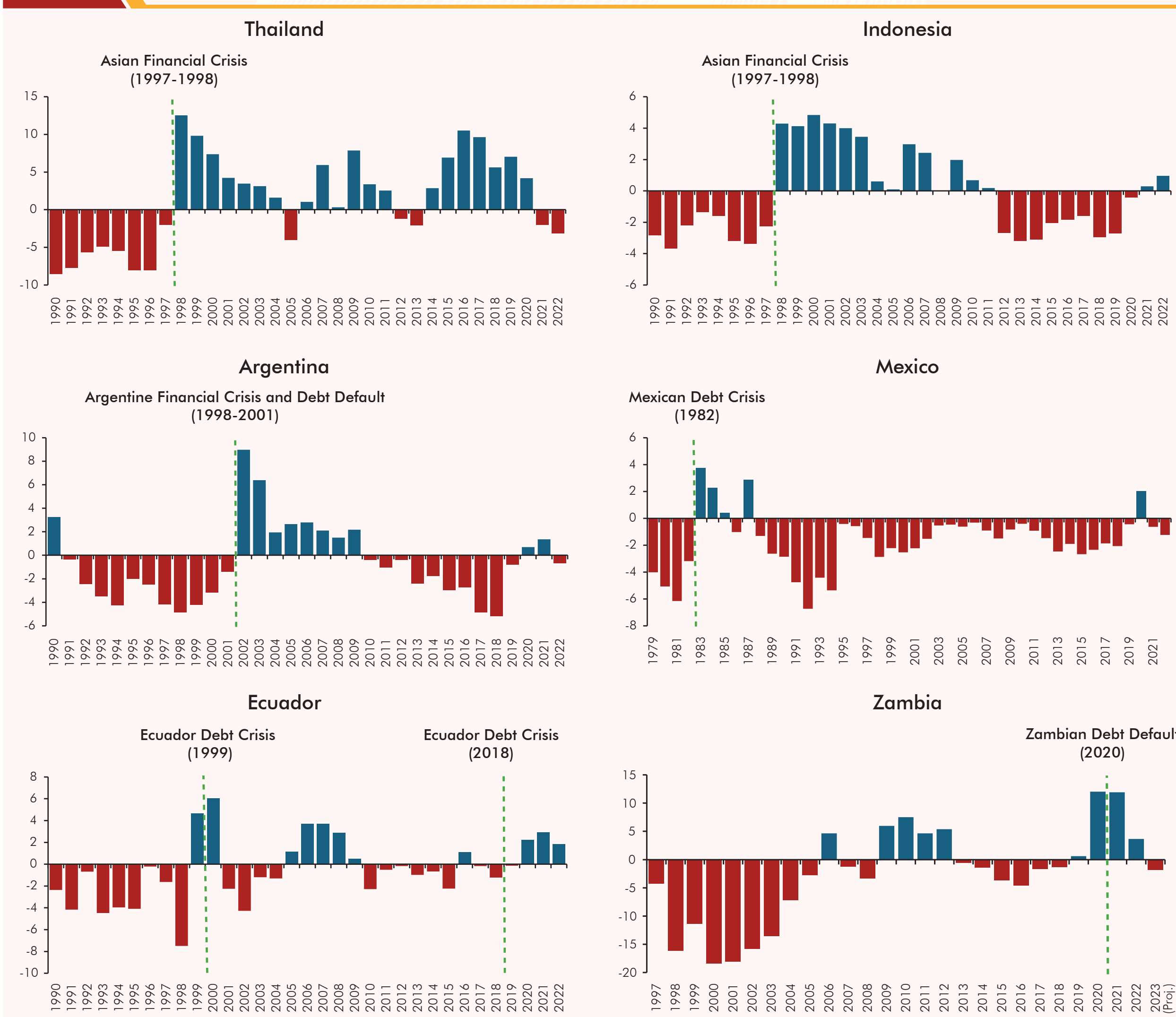


Source: Central Bank of Sri Lanka

fiscal consolidation, strengthening the regulatory framework for the financial sector, adoption of inflation targeting frameworks, implementation of export promotion policies, and reinforcing external buffers by transitioning to flexible exchange rate regimes (Wellisz 2022). As a result, these economies were able to witness V-shaped recoveries characterised by large current account surpluses. However, only some countries were able to sustain these surpluses over the medium to long term. The persistent current account surpluses achieved by these countries could be attributable to export led growth strategies, diversification of export markets, and prudent macroeconomic management executed by these economies. For example, South Korea's export oriented growth policies and diversification of export markets enabled it to maintain current account surpluses, contributing to its economic resilience post-crisis. Thailand transitioned from a fixed exchange rate regime to an independently floating exchange rate regime post-crisis by allowing its currency to float which facilitated an adjustment in its external balances (Sharma 2003). After achieving a current account surplus in the aftermath of the crisis, Thailand was able to maintain a current account surplus for decades by adopting appropriate policy measures including the promotion of services exports, particularly tourism.

Although Indonesia was able to sustain the post-crisis current account surpluses over a decade, the country started to record current account deficits since 2012 due to the sharp fall in commodity prices adversely affecting Indonesia’s commodity exports (IMF 2016). Considering elsewhere in the world, Zambia encountered an external debt

Figure B 7.2 Current Account Balance (as a percentage of GDP): Selected Countries



Sources: World Bank, International Monetary Fund crisis in 2020 resulting in a sharp exchange rate depreciation and BOP challenges. Although Zambia was able to experience temporary current account surpluses in the aftermath of the crisis, the current account is estimated to have reverted to a deficit in 2023 due to a significant contraction in copper exports and imports returning to high levels (IMF 2023). Similar experiences can be observed in the cases of Argentina, Mexico and Ecuador where the current account deficits turned into surpluses in the aftermath of the debt crises followed by debt restructuring. However, these surpluses did not persist. Therefore, it is evident that countries have had mixed experiences with respect to sustaining post-crises current account surpluses, depending on a multitude of factors, including structural reforms, diversification strategies, prudent macroeconomic management as well as the country's ability to withstand external vulnerabilities.

Are current account surpluses always good?

A current account surplus may be considered favourable for the purpose of building up reserves. However, a persistent surplus may lead to significant appreciation of the local currency which would necessitate the Central Bank to intervene in the domestic foreign exchange market to avoid undue appreciation of the currency to ensure maintenance of trade competitiveness. However, adopting such practices for extended time periods may lead to such countries being labelled as stereotypical "currency manipulators" who maintain their currencies undervalued, akin to an export subsidy, to boost their trade surpluses. Moreover, if the current account surplus is achieved as a result of low domestic demand or compressed imports due to restrictive trade policies, it can hinder domestic consumption and investment affecting future economic growth. In order to achieve a sustainable current account balance in the aftermath of an economic crisis, adopting an appropriate policy mix is required while ensuring that there will be no disruptive adjustments. In this regard, adopting a flexible exchange rate policy, where the exchange rate is determined based on demand and supply conditions in the domestic foreign exchange market, maintaining low and stable inflation, and focusing on export promotion and diversification are essential.

Conclusion

There is no agreement among academia or policymakers on an optimal level of current account balance or whether a country should maintain a persistent current account deficit or a surplus (Ghosh and Ramakrishnan 2006; Devadas and Loayza 2018; World Economic Forum 2023). Neither a current account deficit nor a surplus alone could be interpreted as favourable or unfavourable for an economy. A current account is considered to be sustainable if external deficits do not necessitate an immediate change in monetary or fiscal policy or do not result in a BOP crisis leading to a strain on the country's international reserve level or having adverse implications on its ability to service external debt. Although recording a current account surplus is interpreted as favourable for an economy which had recorded persistent deficits historically, a persistent current account surplus may reflect an undervalued currency so that it may subsequently necessitate an appreciation of the country's local currency leading to a loss of trade competitiveness. In conclusion, if Sri Lanka could adopt and maintain an appropriate policy mix with export promotion and diversification, which would result in a stable exchange rate, lower inflation levels and gradual economic growth path, the country would be able to maintain a sustainable current account balance over the medium to long term.

References

1. Devadas S and Loayza N (2018) *When is a Current Account Deficit Bad?*, World Bank Research and Policy Briefs No. 130415, World Bank.
2. Ghosh A and Ramakrishnan U (2006) *Do Current Account Deficits Matter?*, Finance and Development, 43:4, International Monetary Fund (IMF).
3. IMF (2023) *Zambia: Second Review Under the Arrangement Under the Extended Credit Facility - Staff Report*, IMF.
4. IMF (2016) *2015 Article IV Consultation - Press Release; Staff Report; and Statement by the Executive Director for Indonesia*, IMF Country Report No. 16/81, IMF.
5. Sharma S (2003) *The Asian Financial Crisis: Crisis, Reform and Recovery*, Manchester University Press.
6. Wellisz C (2022) *From the Asian Financial Crisis to Today*, Finance and Development, IMF.
7. World Economic Forum (2023) *What is a country's current account balance, and is a deficit good or bad for its economy?*, World Economic Forum.

3