

F-23: Determinants of current account balance of Sri Lanka in the period from 1970 to 1996 (an empirical analysis)

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In theory, factors affecting the current account balance are broadly categorised into external and internal. Although, a number of empirical studies focusing on factors affecting current account balance have been conducted in Less Developed Countries (LDCs), there still remains considerable controversy over the relative importance of external and internal factors. For example, Dell (1980) argued that most of the deterioration in current account balances of LDCs in 1970s can be attributed to external factors. This has been disputed by, among others, Killick (1981) and Khan & Knight (1982).

The purpose of this study is to examine empirically the influences of external and internal factors on the determination of the current account of Sri Lanka during the period 1970-1996. For this purpose, a simple model was developed and tested by using the technique of regression analysis. The data used for this analysis was collected from the Annual Reports of Central Bank of Sri Lanka and World Economic outlook reports.

The result showed that Sri Lanka's current account balance has been determined by both external and internal factors. Among external factors, terms of trade effect and world recession were most important. The study also found that the increase of the import price of intermediate goods and decline of the export price of agricultural goods were the main sources of adverse terms of trade effect of the country. In the domestic side, both import substituting industries

and export industries in Sri Lanka have heavily depended on imported inputs. the expansion of production of these industries (or country's economic growth) was invariably accompanied with increase of imports and correspondingly wide current account deficit. In this context, Sri Lanka has 2 policy options to neutralize the adverse terms of trade effect and world recession effect on current account deficit, First, export diversification can be given priority in economic policy making. Secondly, the investment expenditure can be diverted to export industries which use more domestic inputs. This conclusion suggests that the policy makers need to pay attention to research and development aimed at promoting export diversification through domestic industrialization process.