Sri Lanka Special Report -
What have twin surpluses looked like in other countries

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Frontier Research

After recovering from its crisis, Sri Lanka is at a unique macroeconomic point. For most of the country's modern history, Sri Lanka was a 'twin deficit' country – a primary fiscal deficit where the government spent more than it received and a current account deficit where the country spent more dollars than it earned. However, the last few years have been unusual. Sri Lanka's government revenue has been greater than its non-interest expenditure for the third year running. Despite a very strong recovery in imports, resilient exports, strong tourism, remittances and services have kept the inflow of foreign currency higher than the outflow.

We have spoken at length before about how we see this as a situation where the fundamental macroeconomics of Sri Lanka having shifted – the country is now a "twin surplus" economy, and we hold a medium term view that there is a decent chance that this continues. This is a never-before-seen scenario for Sri Lanka but also a relatively unique situation for most countries – the shift from twin deficits to twin surpluses is quite rare. Given that Sri Lanka does not have similar past experiences, in this report, we're taking a look at what other countries who have moved from twin deficits to twin surpluses can say for Sri Lanka's medium-term future.

Twin surpluses themselves are quite rare outside of commodity-based economies

When looking for suitable countries, what we found is that there aren't too many countries that have maintained consistent twin surpluses – with most countries who DO achieve this, doing so based on FX and fiscal revenues coming from commodity exports. Countries that have therefore, moved from twin deficits to twin surpluses have been quite rare. We ended up look at three countries that we felt had enough similarities to the Sri Lankan story - The Philippines, Chile and Thailand all having experienced a move into 'twin surpluses' over the last twenty years.

Of course, while every country has their own unique characteristics, we felt these three middle-sized developing economies were fair enough to look at in comparison to Sri Lanka. The Philippines is similarly dependent on remittances, and started off their twin surpluses alongside a high public debt burden. Chile had a strict fiscal rule to maintain a budget similar to Sri Lanka's statutory primary expenditure ceiling. Thailand had a failure of their twin surpluses due to infrastructure spending, and we're looking at this example in particular on whether it gives a "negative" example on how a twin surplus can work.

Given how these three economies are not those that primarily saw commodity-based twin surpluses, that also showcases examples how if Sri Lanka's twin surpluses continue, what it could be like. The Philippines saw what was largely a private sector economic activity led twin surplus, whereas strong fiscal controls were more at play in Chile. Thailand saw a combination of the two that went with its ability to plug into global value chains alongside the growth of China as a major global producer.

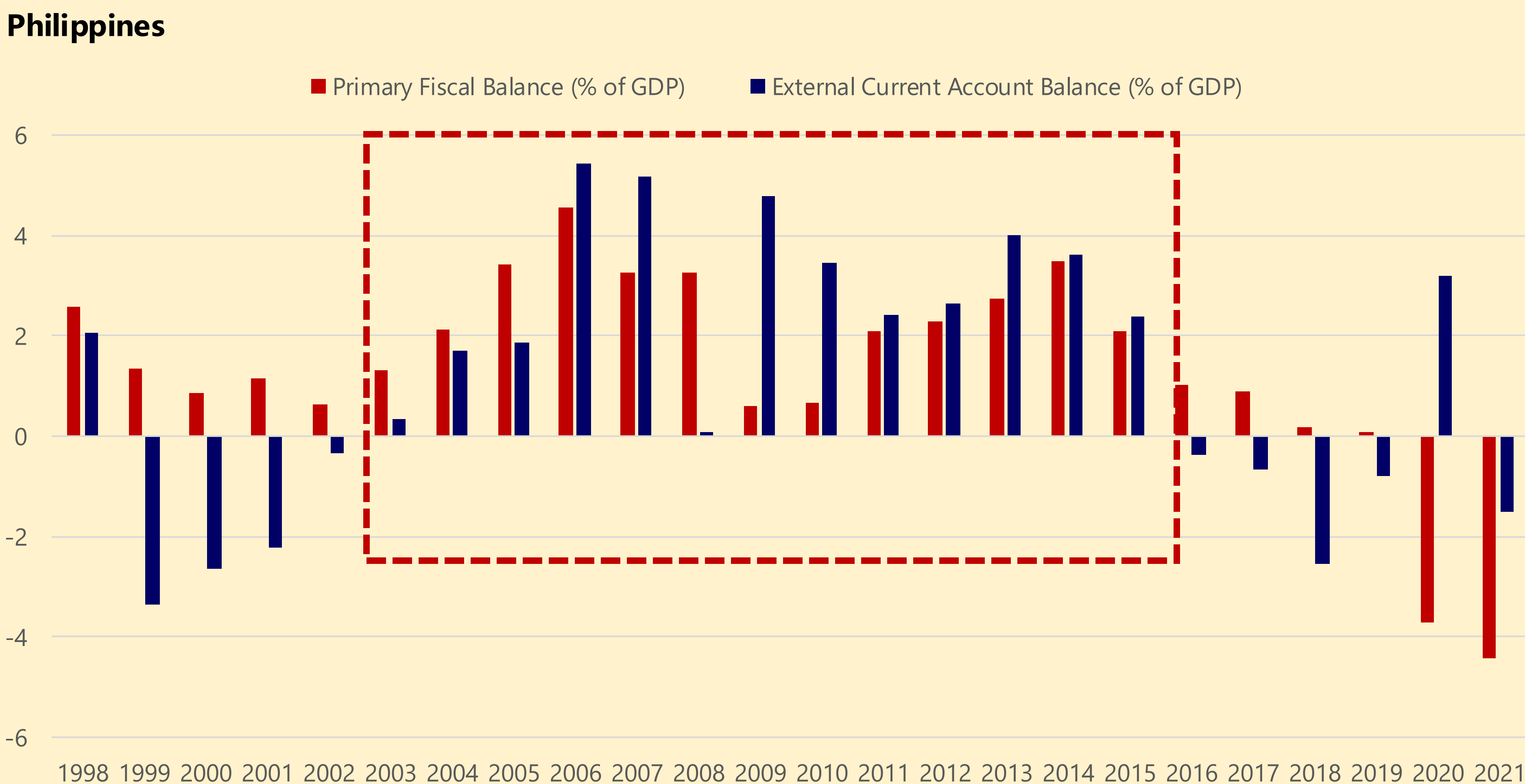
Other examples suggest that twin surpluses can stick around until specific changes come through

When looking at these countries, what we see is that once twin surpluses continue for a few years, the same drivers usually keep them going for some more years as well. Even in cases where the twin surpluses are caused by varied factors, there is usually some amount of momentum that keeps the situation stable. One particular driver here is how twin surpluses generally mean low inflation, which then support longer term decisions in the economy that generally tend to maintain the current economic balance.

However, all three countries we looked at saw how twin surpluses can move away. In all these examples, they were due to a specific factor that strongly changed and that pushed one of the two surpluses into deficit territory. In the Philippines and Thailand, it was fiscal expenditure rising to support particular growth objectives. In Chile, it was a dramatic fall in the price of copper that reduced export revenues. Outside of these changes, however, we didn't see a big change that comes from within the economy itself.

However, one critical difference is that all three economies weren't primarily consumption economies in the way Sri Lanka is. Debt levels are also higher in Sri Lanka, and the population dynamics are also different. What we cannot say for certain is that for a country like Sri Lanka, whether the same factors directly apply. One issue in having a relatively limited sample size of countries is this. However, all three examples do show that at least for a medium term period, twin surpluses can support low rates, low inflation, stable currency – and at least some amount of decent growth.

Post-crisis Philippines held twin surpluses from the early 2000s to the mid 2010s



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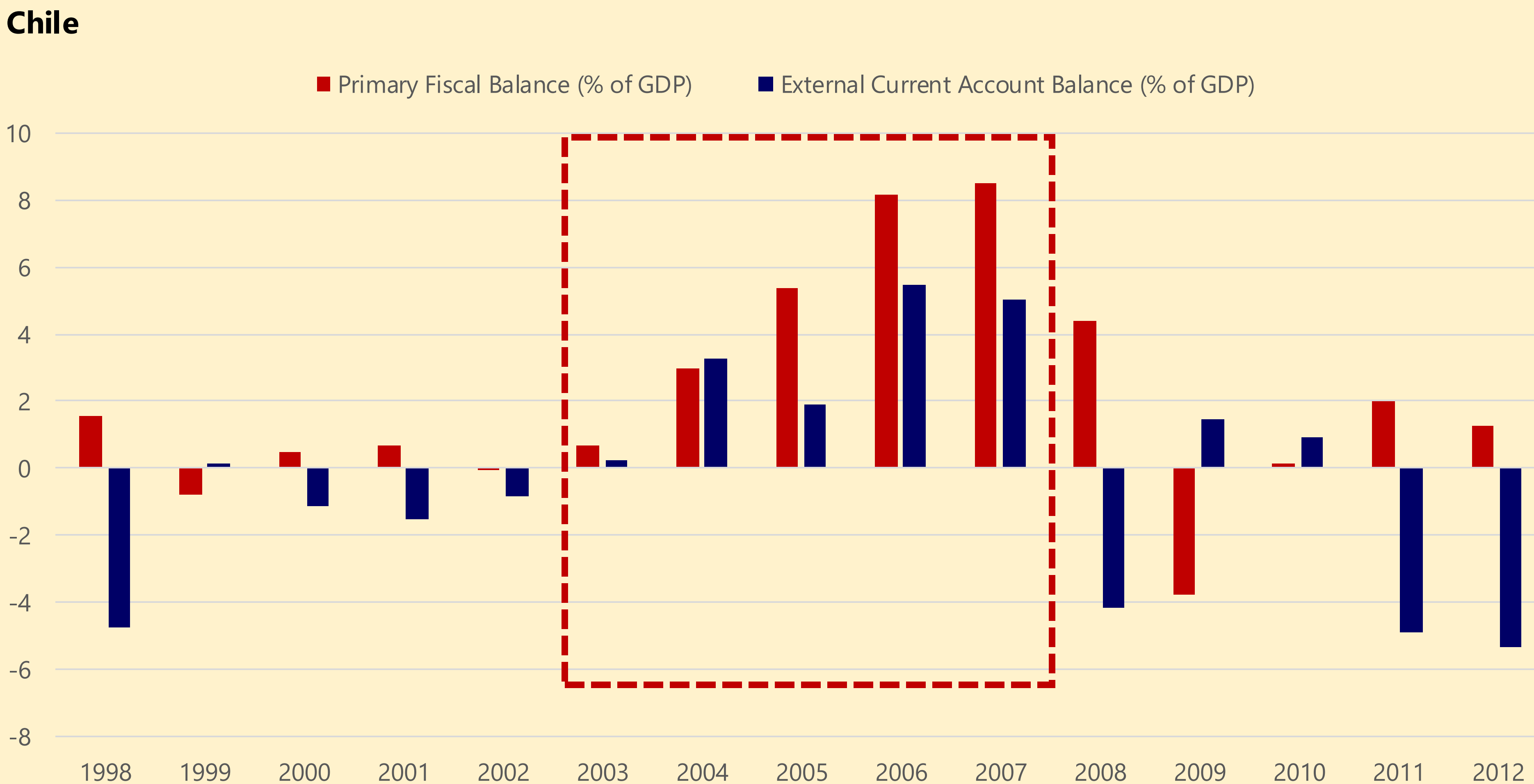
Source: IMF, World Bank

Fiscal rules kept Chile's copper boom driven twin surpluses active in the mid 2000s



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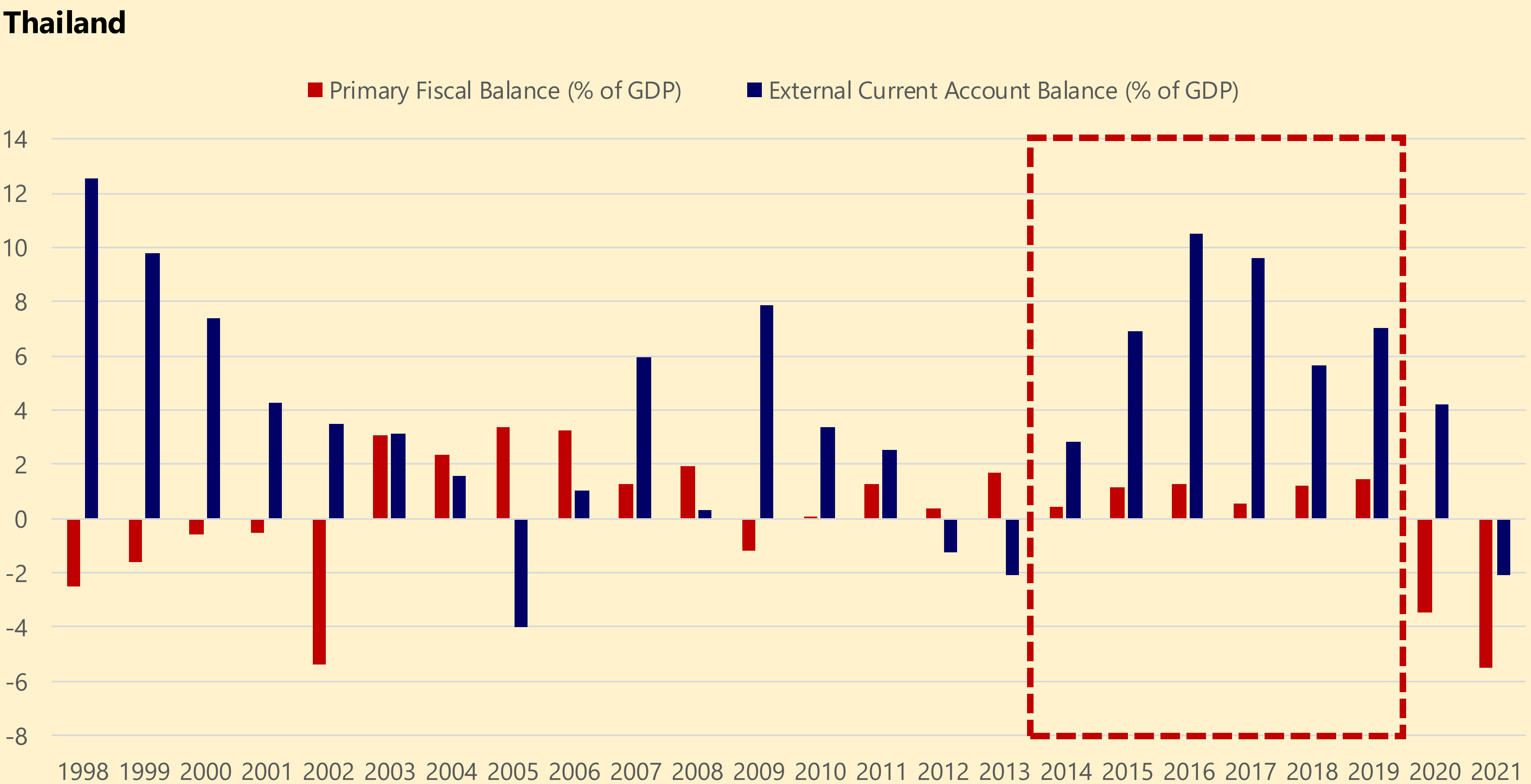
Source: IMF, World Bank

Thailand's weak imports allowed it to run a much stronger external surplus than fiscal surplus



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Source: IMF, World Bank

In Detail

Philippines

The Philippines saw fiscal reform driving the primary surplus but remittances being the major driver of the external surplus

The Philippines's economy is a useful comparison to Sri Lanka. Both countries are middle-sized developing countries and remittances are their largest source of foreign currency. The Philippines had an uninterrupted twin surplus from 2003 to 2015. During these 12 years, the Philippines could be described as a stable period measured by the exchange rate, inflation and a falling debt burden.

Following high debt levels and a period of primary fiscal deficits, the Philippines started brining in more cautious fiscal policies in the early 2000s. The Government also introduced new forms of revenue such as expanded VAT and other taxes that improved its fiscal health. The external surplus also reduced pressure to borrow and the conservative fiscal policy meant a consistent primary budget surplus. This would result in a consistent fiscal surplus over time and reduced debt burden. One aspect of these were that there was also an after-effect of the Asian Financial crisis where reforms pushed it toward a balanced budget and to lower its debt burden.

On the external side, The Philippines had a consistently negative balance of trade meaning that the country imported more in terms of value than it exported. Though the Philippines attempted multiple polices to boost exports, these policies didn't really result in any significant growth in merchandise exports. Instead, the growth in foreign inflows that led to its current account surplus was mainly due to Remittances. From comprising 2.9% of GDP in 1990, remittances was approximately 10% of GDP for most of the twin surplus years and the absolute value of remittances increased every year on average. As a result, there was a proportionally large net inflow of foreign currency increasing reserves and for external debt servicing payments. As result, during this time, foreign reserves in the Central Bank steadily increased.

What happened as a result of these twin surpluses?

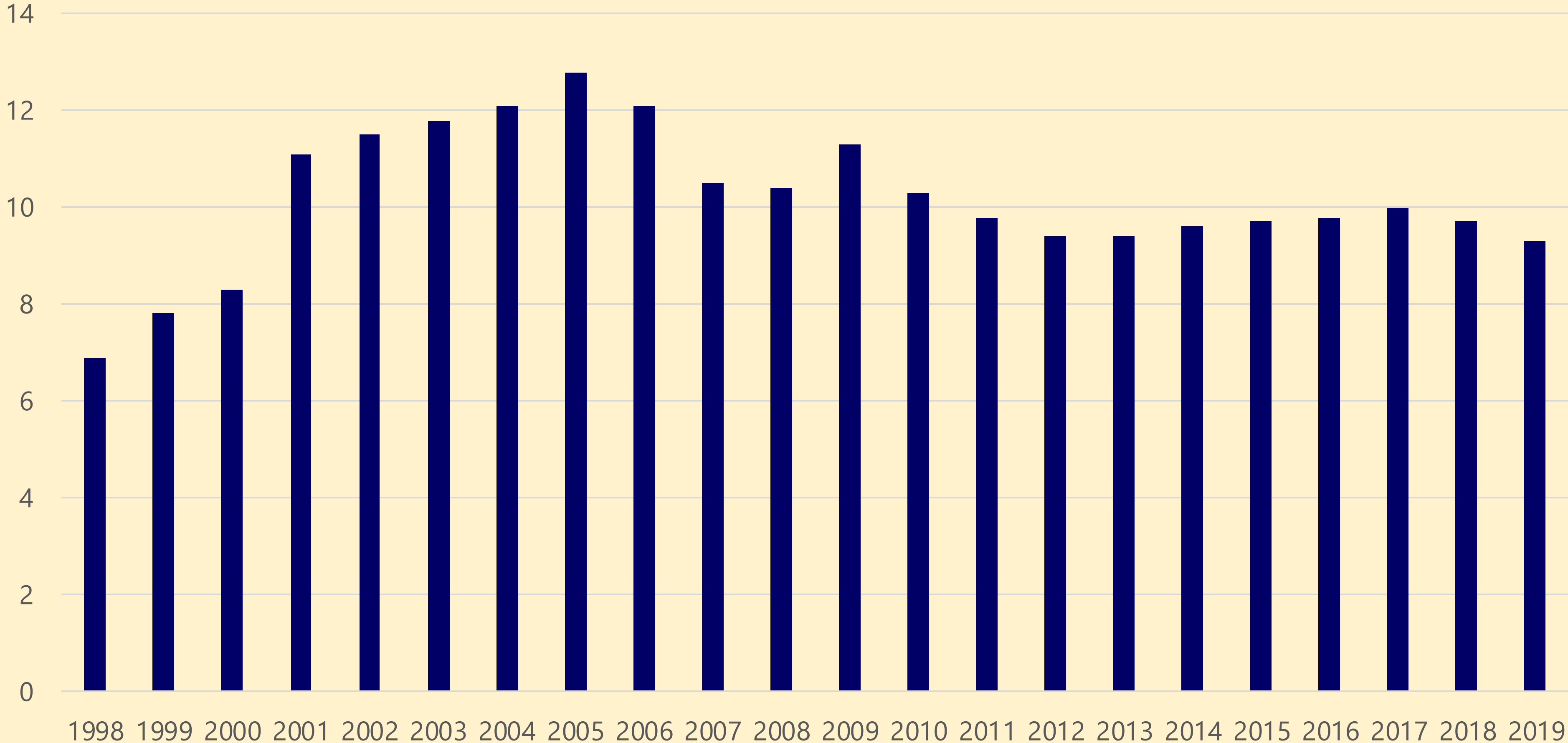
During this period, The Philippines had stable economic indicators as measured by the debt burden, inflation and the currency exchange rate for the twin surplus years of 2003-2015. That there were 12 continuous years of a twin surplus suggests that remittances were a source of consistent foreign currency that persisted throughout the 2008 financial crisis and afterward.

The Philippine's debt burden falling is probably the most critical relevance we see. The Philippines' debt-to-GDP ratio decreased from 71% in 2003 to 43% in 2013. The accumulation of foreign reserves and less pressure to borrow led to the Philippines currency gradually strengthening over time. Inflation stayed stable as the government faced less pressure to borrow and less import-price variation.

However, these twin surpluses didn't last beyond 2015. The newly elected Philippine administration of Duterte ended the conservative fiscal policy that had caused a fiscal surplus for the last decade. Duterte's 'Build, Build, Build' program focused on infrastructure building resulting in expanded government expenditure. However, the end of a twin surplus shows that an ambitious administration wanting to increase economic growth, employment and capacity will end a fiscal surplus.

Remittances were a major driver that pushed the Philippines' current account surplus

Remittances (% of GDP) – Philippines



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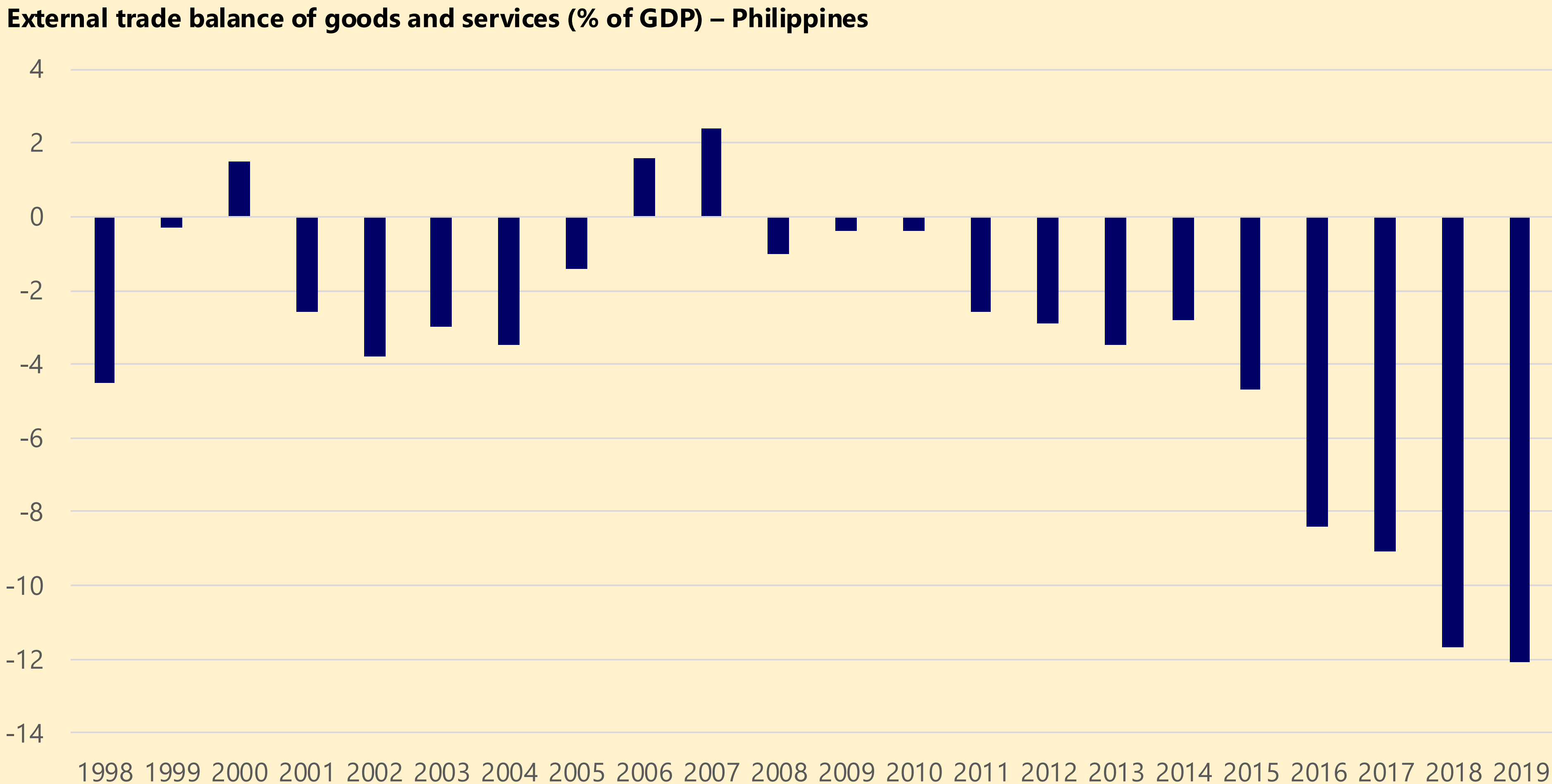
Source: IMF, World Bank

This meant an overall goods and services trade deficit was countered



Source: IMF, World Bank

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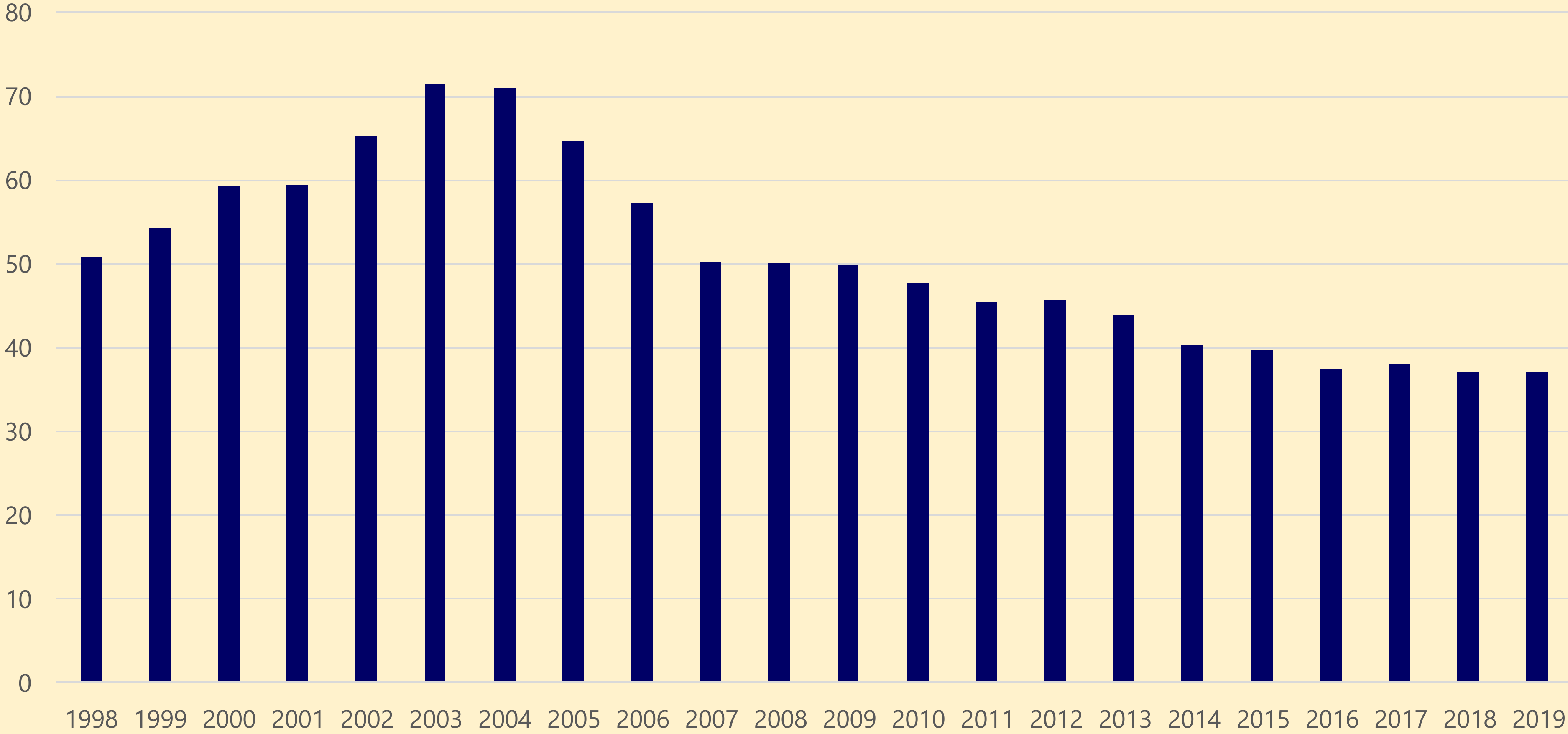
Philippines was able to use its twin surplus economy to reduce its outstanding debt

General Government Debt (% of GDP) – Philippines



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Source: IMF, World Bank

Chile

While a commodity boom was the trigger for external strength, fiscal rules were a big part of why Chile was able to maintain fiscal strength

We looked at Chile as a case study despite it having some commodity exports, due to its 'Structural Fiscal Rule' that aimed for a surplus of 1% in the primary balance. We felt this was similar to how Sri Lanka's Public Finance Management Act imposes a 13% of GDP ceiling on primary expenditure, creating somewhat of a mandated situation of fiscal strength. Chile had a twin surplus in the years 2003 to 2007.

During the 2000s, there was a copper boom where Chile as a major copper exporter saw large increases in its copper exports. This direct impact in increasing net exports was quite large, with the increase for exports in nominal dollar terms roughly quadrupling between 2000 and 2008. However, beyond this, Chile also saw its mineral rents (difference between world price and cost of production) increase from 4% of GDP in 2000 to 18% of GDP in 2009.

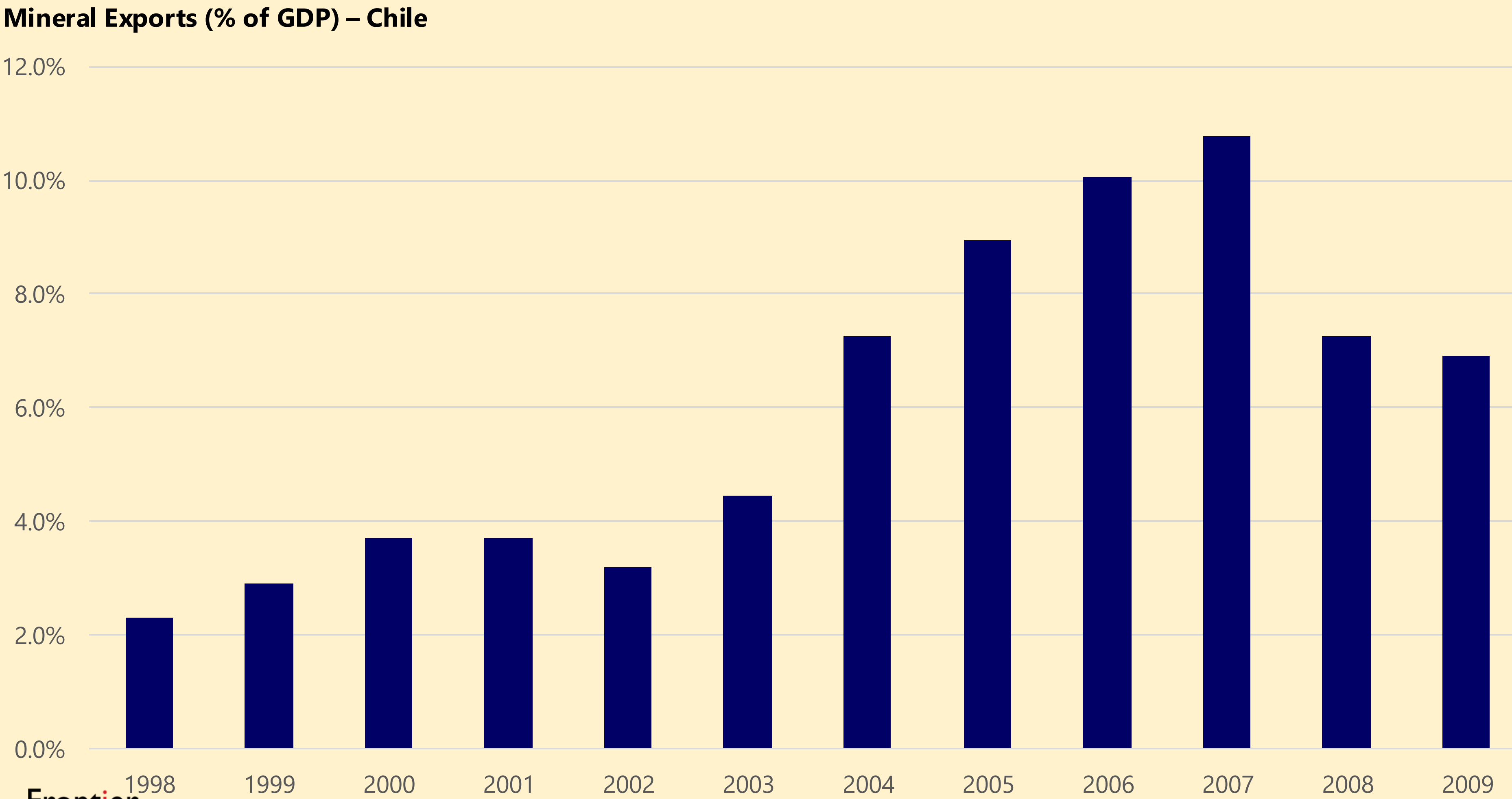
However, unlike in many other cases, the increased revenue from export taxes for global demand for copper was not spent immediately. The main reason here was the structural fiscal rules that prevented large expenditures from coming into play directly. Instead, the Chilean government had to chose to save a considerable proportion of revenue in Sovereign Wealth Funds instead. One outcome of this large savings was that interest rates fell, supporting both economic activity and a reduction in Chilean debt levels.

What happened as a result of these twin surpluses?

During the twin surplus years, Chile's debt burden reduced as measured by its share of expenses going towards debt servicing. The Chilean Government also had its reserves increase significantly and created Sovereign wealth funds from the revenue received from the commodity boom. The stable currency shows the management by the Chilean government. While economic activity after the 2008 financial crisis shows a rebound, Chile was using its savings to boost the economy. After a small burst of activity, the 2010s were characterized by sluggish inflation and economic growth compared to the 2000s.

The 2008 financial crisis ended the commodity boom and there was a slump in demand for copper. As a result, Chile would end its twin surplus due to a sharp reduction for commodities affecting its current account balance. The country also pursued a fiscal expansionary strategy for recovery following the 2008 financial crisis that ended its fiscal surplus. The continued demand from China might have softened the impact, but Chile was unable to return to years of large twin fiscal and external surpluses.

A copper boom helped Chile's mineral exports sharply rise in the early 2000s



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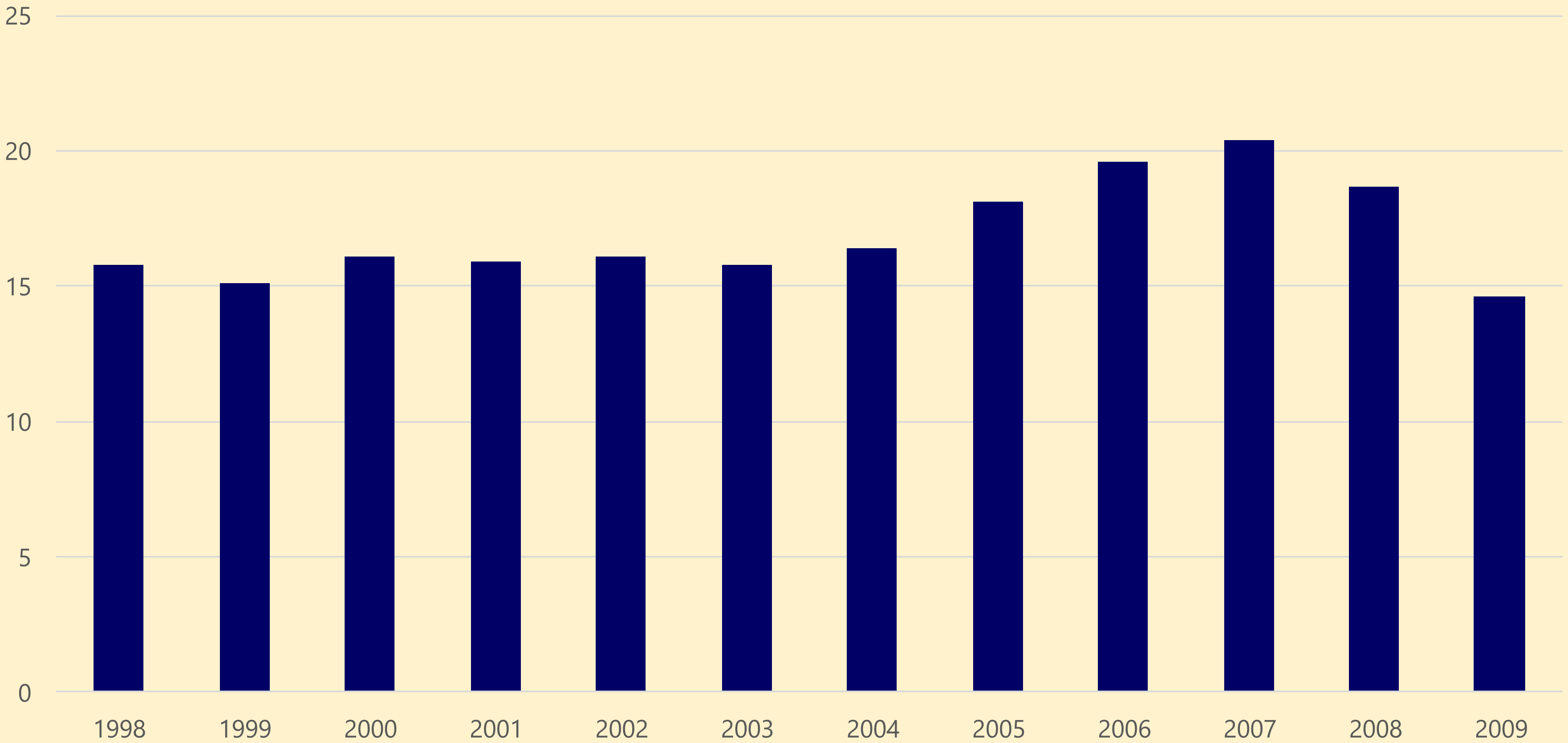
Source: IMF, World Bank

Tax revenues rose during this period as export based commodity rents picked up

Tax revenue (% of GDP) – Chile



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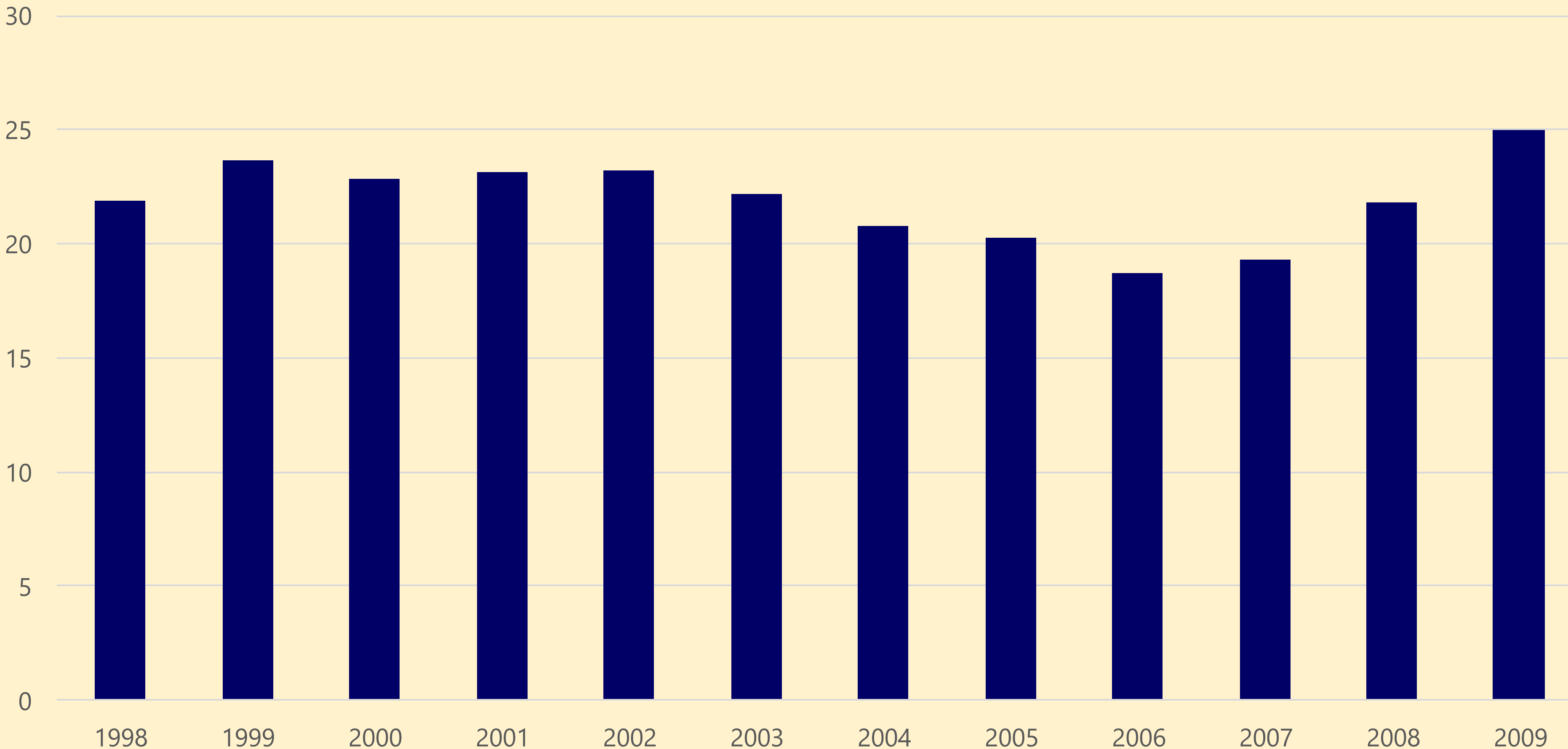
Source: IMF, World Bank

However, the presence of fiscal rules kept government expenditure contained

Government expenditure (% of GDP) – Chile



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Source: IMF, World Bank

Thailand

Thailand was able to benefit from global trade patterns but its fiscal strength didn't go alongside much domestic consumption

Thailand was is an example of a twin surplus where underlying structural change and integration into global trade stories supported their twin surplus. Outside of these overall structural changes, we don't see Thailand having had a single main factor that caused the twin surplus – but rather a combination of factors working together. In fact, a weak consumer recovery following the Asian Financial crisis helped create stagnant private investment and relatively high savings. This contributed to the current account surplus alongside the export competitiveness for certain goods and its growth as a popular tourist destination.

Thailand had a larger current account surplus and a smaller fiscal surplus. One part of this was that Thailand didn't have substantial public debt overhangs. As a result, it only showed relatively mild primary surpluses, which meant that it was able to borrow relatively cheaply and increasingly from domestic sources. Since it still kept a budget deficit despite a primary surplus, it then kept having a period where their overall debt burden gradually increased during this time period.

A big part of this was also relatively weak growth rates in Thailand. This ties into the relatively slow recovery of its consumer following the Asian Financial Crisis. However, this did add into one reason behind Thailand's external surplus – where it was able to support a trade surplus. This then allowed Thailand to benefit from its geographic location, comparative advantage in multiple manufacturing fields and large labor pool. Outside of this, Thailand was also a popular net tourism country. We see both of these drivers of the external surplus also having been tied pretty closely to China's rise as a production hub, and the rotation of capital out of China to support the development of supply chains as well.

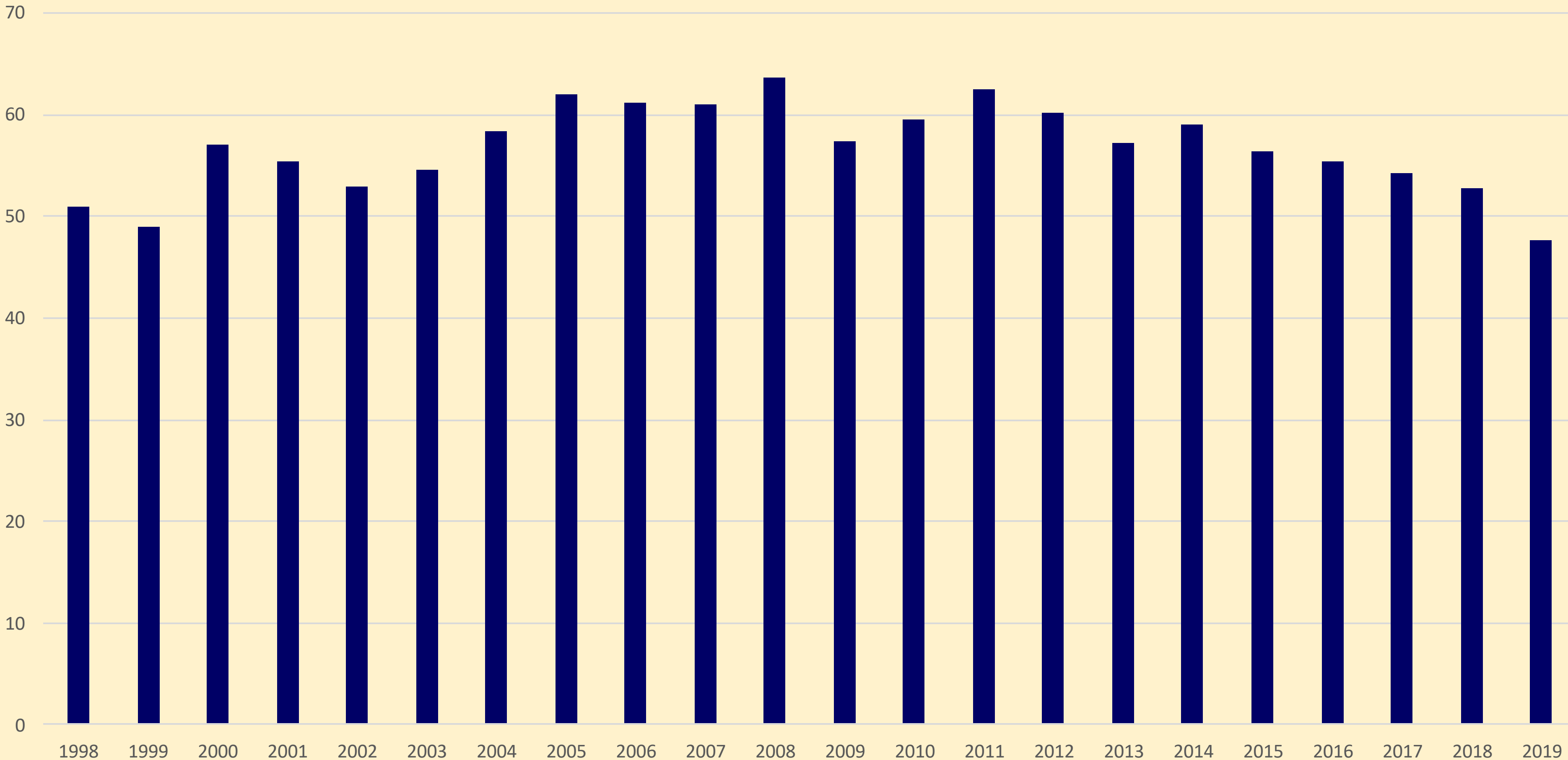
What happened as a result of these twin surpluses?

In the case of Thailand, there was no systematic factor causing a twin surplus. Thailand had advantages in maintaining a current account surplus due to its competitive export and tourism sector. Thailand would not run a current account surplus for only 5 years during the years 2000 to 2024 but ran minor budget deficits more often. In Thailand's case, import demand and investment demand never increased to potential levels explaining the sluggish growth during the time period despite its strong net export performance.

One additional factor then came into play as a result of Thailand's weak growth. The political economy of the country moved towards supporting policies that could support some growth, which then meant that there was a period where infrastructure spending was prioritized, alongside additional spending as a response to Covid-19. Alongside political pressures, all this meant that the there was no longer a fiscal surplus despite maintaining an external surplus.

A strong export sector continued to be a feature of Thailand, driving external strength

Exports of Goods and Services excluding tourism receipts (% of GDP) – Thailand



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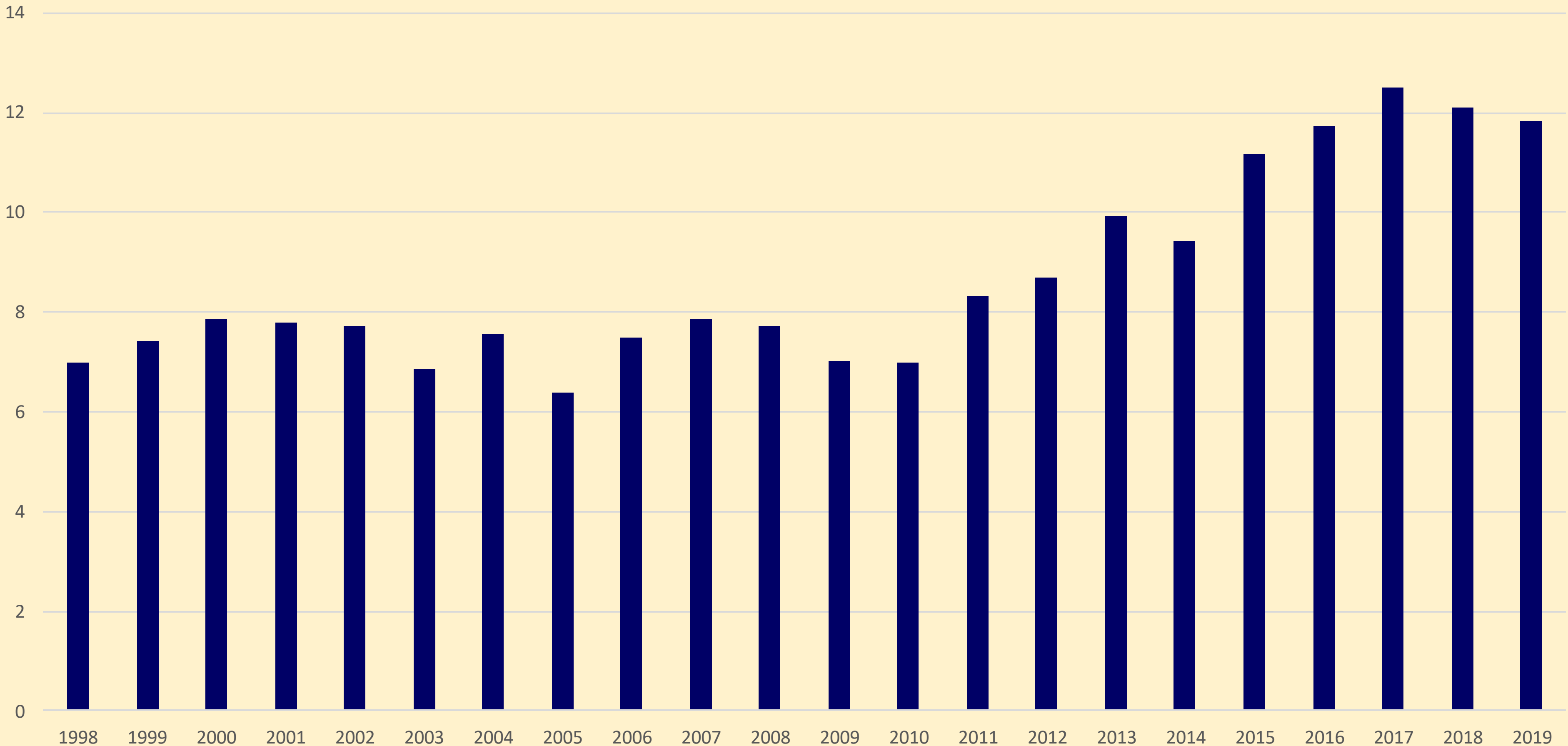
Source: IMF, World Bank

Tourism strength, especially in the late 2010s, supported this as well

Tourism receipts (% of GDP) – Thailand



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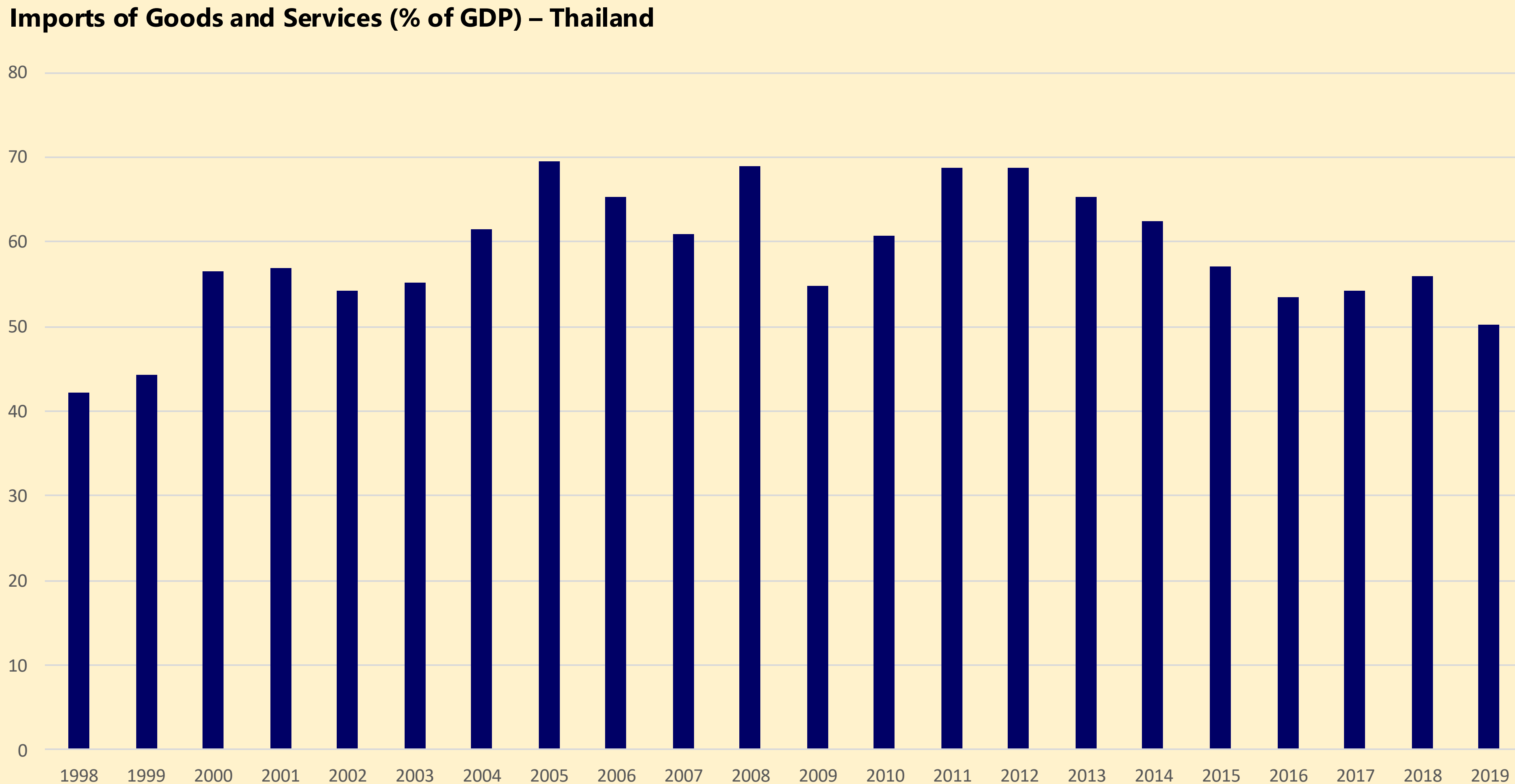
Source: IMF, World Bank

However, outside of a few exceptions, imports didn’t keep up with exports



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Source: IMF, World Bank

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