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The balance-of-payments constraint on economic growth in a long-term perspective: Spain, 1850–2000

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ABSTRACT

The balance of payments can act as a constraint on the rate of growth of output, since it puts a limit on the growth in the level of demand to which supply can adapt. In this paper, we examine this issue for the case of Spain, using time series data extending over the period 1850–2000. Overall, the external deficit does not seem to have worked as a constraint on the growth of the Spanish economy over the long run, unless some shorter and specific subperiods, such as 1940–1959 and 1959–1974. The Spanish economy seems to have used external deficits to smooth her level of aggregate consumption, which would be supported by the finding of sustainability of current account deficits along the period of analysis.

1. Introduction

The Spanish economy has experienced a steady process of growth since the beginning of industrialization at the start of the 19th century. However, though following a rather similar evolution to that of the rest of Western Europe, she underwent a relative retardation as compared to those countries. In particular, the real GDP of Spain multiplied by 40 over the period 1850–2000, with an annual average rate of growth of 2.4%; in per capita terms, GDP multiplied by 15 over the same period, and the average rate of growth was 1.7% per year. But, despite the intense catching-up that took place in the last fifty years, per capita GDP of Spain at the end of the 20th century was still around three quarters of Western Europe's, roughly the same as one hundred years before (Prados de la Escosura, 2007).

On the other hand, the foreign sector has played a critical role in the development of the Spanish economy, in a country in which the endowments of natural resources were rather poor, and traditionally characterized by a relative backwardness in relation to their neighboring countries. In addition, the loss of most of the colonial empire in the first decades of the 19th century reinforced that crucial role of the foreign sector. The disappearance of the monopoly of trade with the American colonies meant that exports to the colonies and re-exporting colonial products to Europe were both drastically reduced, which translated into a reorientation of Spanish exports to the European markets and a large trade deficit. The assessment of the role played by the foreign sector in the economic progress of Spain has been controversial, though; see, e.g., Nadal (1975) or Prados de la Escosura (1988). An account of the main developments of the Spanish foreign sector in the last two centuries is provided in Tortella (2000).

The important modernizing role played by the foreign sector on the evolution of the whole economy, though limited by its small relative size, has been emphasized in Prados de la Escosura (1988). In fact, the Spanish economy experienced a higher growth over those periods characterized by a greater external openness (as in, e.g., the 1960s, or the years after 1986); and, likewise, she fell behind coinciding with periods of a greater isolation against the rest of the world (such as the years 1890–1913, or

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1930–1950) (Prados de la Escosura, 2007). On the whole, the lower weight of foreign trade on GDP as compared to the "European norm" (Molinas and Prados de la Escosura, 1989) might explain the relative backwardness of the Spanish economy until the last third of the 20th century.

However, some authors have also argued that the trade deficit had been a chronic problem of the Spanish economy, given the traditional weakness of exports, and the need for essential imports such as energy, raw materials, intermediate products, and equipment goods. This, in turn, would have been translated into a subordination of growth to the evolution of the trade balance; see, e.g., Segura and García-Viñuela (1978).

The recent availability of long time series for both GDP (Prados de la Escosura, 2003) and the foreign sector (Tena, 2005, 2007; Prados de la Escosura, 2010) invites to a re-examination of the relationship between growth and foreign trade for the case of the Spanish economy. In particular, the aim of this paper will be to investigate whether or not the balance of payments would have meant an impediment to further GDP growth over the period 1850–2000. More specifically, we will analyze the two subperiods 1850–1913 and 1940–2000, on the grounds of availability of data on the current account balance (see below); leaving aside the interwar years, characterized by the disruption of the world economic order related to the first globalization. The paper is organized as follows: Section 2 offers a review of the literature on the relationship between external deficit and economic growth, together with the available evidence for the Spanish case; in Section 3 we investigate whether the external deficit was a constraint to economic growth, which is complemented with an analysis of the sustainability of current account deficits in Section 4; finally, Section 5 concludes.

2. Review of the literature

The relationship between international trade (or, more generally, external openness) and economic growth is a widely discussed topic in economics, but still a controversial one. Indeed, last years have contemplated a renewed interest on the subject, following the appearance of the literature on endogenous growth. These theories allow for a greater role of the countries' external openness in the process of generation and transmission of technology, as compared to the traditional, Solow-type, growth models. Specifically, by developing ideas previously put forward by Schumpeter (1934), the new approaches emphasize that technological innovation appears in response to economic incentives; where the institutional, legal, and economic environments, including the extent of external openness and economic integration, also affect the pace and direction of technological change. A survey of this literature is provided in Grossman and Helpman (1994) or, more extensively, in Aghion and Howitt (1998).

On the other hand, there is also a large body of empirical literature based on the idea that international trade and, in general, a more open commercial policy, means a major factor in order to explain economic growth. This line of research, indeed, has been given a renewed impulse with the development of endogenous growth theories, on giving it some more solid theoretical foundations. In particular, it has been emphasized that a more liberalized trade stance allows countries to enjoy a higher amount of intermediate inputs at a lower cost, and encourages technological progress; and all this would result in higher rates of growth. This literature, which is mostly concerned about the case of developing countries, is surveyed in Edwards (1992, 1993). The evidence in favor of this hypothesis, though, is far from being unambiguous, as shown in an influential paper by Rodríguez and Rodrik (2001). As these authors point out, the relationship between external openness and economic growth would be rather a contingent one, dependent on a host of particular characteristics, both country-specific and external; and, among them, the importance of institutions would be crucial.

Our main concern in this paper, however, will be the analysis of the relationship between external deficit and economic growth. Is the external deficit really an impediment to economic growth? Or, maybe, is the external deficit an inevitable consequence of economic growth for a relatively backward country; and even something necessary in order to catch-up and converge towards the more advanced countries?

A well-known approach to deal with this issue is due to Thirlwall (1979). According to this author, the balance of payments can act as a constraint on the rate of growth of output, since it puts a limit on the growth in the level of demand to which supply can adapt. An increase in domestic output, by increasing imports, can lead to a deficit in the balance of payments, which may require either a fall in demand or a real exchange rate depreciation (i.e., a worsening of the terms of trade) in order to ensure the sustainability of the external deficit. Accordingly, an unsustainable external deficit sooner or later requires a correction, which puts a brake on further output growth.

From here, the concept of balance of payments-constrained growth rate, i.e., the rate of growth of exports divided by the income elasticity of the demand for imports, follows; see Thirlwall (1979) and Thirlwall and Hussain (1982). By comparing such a growth rate with that prevailing in a particular country, it would be possible to assess whether the balance of payments works as a constraint on economic growth in the country analyzed. This concept, on the other hand, is equivalent to a result derived by Krugman (1989), who found that countries growing faster face a higher income elasticity for their exports than for their imports. The rationale behind this approach is that no country can grow faster than its balance of payments-constrained growth rate for a very long time, since its ratio of external debt to GDP will reach unsustainable levels leading to a collapse in international confidence and to an external debt and currency crisis. Only when the actual growth rate is lower than the balance of payments-constrained one a country would be able to experience a sustained growth. A historical background to the approach is provided in Thirlwall (2011); and a collection of papers on the subject is McCombie and Thirlwall (2004).

An alternative view on the significance of the external deficit follows the so-called intertemporal approach to the current account, which has become in last years the orthodox account for explaining the countries' external imbalances. The starting point of this approach is that, from the perspective of the national accounts, the current account equals the difference between savings and investment. From here, and because savings and investment decisions are based on intertemporal factors (such as life-cycle