Trade imbalances within the euro area and with respect to the rest of the world

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A B S T R A C T

Many studies have explored the determinants of current account balances in Europe. However, only in a few studies has trade balance been decomposed into intra balance, trade balance vis-à-vis the euro area, and extra balance, trade balance vis-à-vis the rest of the world. This decomposition is necessary for us to understand why some core euro area countries are acting as financial intermediaries for the periphery countries. Furthermore, the determinants of intra and extra balances might be different because nominal exchange rate cannot adjust between the EMU countries while their financial markets are highly integrated. Thus, we apply this decomposition and supplement the previous studies by including a larger set of theoretically plausible explanatory variables, which is derived from the current account literature. Our contribution is twofold: We observe that, contrary to Schmitz and von Hagen (2011), the introduction of a common currency has not increased the elasticity of net capital flows to per capita incomes within the euro area for the member countries. On the other hand, there is a great heterogeneity among the usual determinants of trade balances whether those contribute to intra balances or extra balances. These results increase our understanding of the imbalances in the euro area.

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1. Introduction

Despite the fact that the euro area as a whole has been in balance with the rest of the world, many euro area member countries have had substantial current account imbalances. These imbalances have a tendency to grow after the adoption of the common currency in 1999. However, in order to fully understand these imbalances we need to look at how these imbalances have been distributed between balances against the euro area and balances against the rest of the world (see, e.g., Eichengreen (2010)). Thus, we follow the decomposition made in Schmitz and von Hagen (2011) and decompose trade balances into intra balances and extra balances. Intra balance measures the trade balance vis-à-vis the euro area, whereas extra balance measures the trade balance vis-à-vis the rest of the world. In some cases, a country has had a positive intra balance but a negative extra balance, or vice versa (see Figs. 1–2). However, they included only government budget balances and oil prices as additional explanatory variables. Our paper provides some evidence that if we include a set of explanatory variables that have become standard in the current account literature, this result largely disappears.

Our set of explanatory variables is derived from the current account literature. Therefore, in Section 2 we summarize this literature. In Section 3, we describe our data more closely and explain the reasons we choose to use the Prais–Winsten estimation with panel corrected standard errors. We present our results in Section 4. Section 5 concludes the paper.

2. Current account imbalances in the euro area

2.1. Empirical literature on current accounts

Chinn and Prasad (2003) explored the medium-term determinants of current account balances using data on 18 industrial and 71 developing countries over the period of 1971–1995. The following set of economic fundamentals turned out to be statistically significant: government budget balances, relative income, dependency ratios, terms of trade volatility, financial deepening, and net foreign assets. Chinn and Ito (2007); Gruber...
and Kamin (2007) included institutional variables to account for heterogeneity in the domestic financial markets and the quality of government institutions because investors are more willing to invest in countries that are highly developed in these respects.

There is a strand of literature that follows Chinn and Prasad (2003) in methodology but tries to uncover the special features of the euro area with respect to current account dynamics. Slavov (2009) used data on 39 different episodes of common currency agreements between 1976 and 2005. He found that common currency participants had larger current account imbalances.\(^1\) Further, in a monetary union, the current accounts of the member countries become more sensitive to the economic fundamentals, including relative income (Slavov, 2009). According to Jaumotte and Sodsriwiboon (2010), the Southern euro area countries have had current account deficits far beyond what can be explained by the IMF’s macroeconomic balance (MB) approach or external sustainability (ES) approach (see also International Monetary Fund (2006)). Barnes et al. (2010) came very close by pointing out that the predictive power of standard models to explain the imbalances in the euro area has become weaker (see also Ca’ Zorzi et al. (2012)).

2.2. A catching-up process or diverging competitiveness?

Two alternative explanations for the widening current account imbalances in the euro area are often emphasized: the ongoing catching-up process between rich Northern Europe and poor Southern Europe or the diverging competitiveness between the two. In the first case widening imbalances are expected to be only temporary, while in the latter those might have undesirable consequences.

By using a simple intertemporal model, Blanchard and Giavazzi (2002) show that for a converging country the recommended level of current account deficit increases with the expected output growth (relative to others) and with the elasticity of substitution between domestic and foreign goods and decreases with the wedge between the domestic interest rate and foreign interest rate. The single European market, goods market integration, has increased the elasticity of substitution, and the monetary union has decreased the wedge within the euro area. In addition, as financial integration reduces the costs to finance investments, investments and the expected future output will increase. Hence, it has become optimal for the poorer countries to run larger deficits. They provide evidence that for the euro area, the relation between the current account balance and income

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\(^1\) Berger and Nitsch (2010) used bilateral trade data on 18 European countries from 1948 to 2008. They observed that, as a result of the introduction of the euro, the trade imbalances among the euro area members widened and became more persistent.
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