



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



Mika Nieminen *

Jyväskylä University School of Business and Economics, P.O. Box 35, FI-40014, University of Jyväskylä, Finland

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ABSTRACT

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 had 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). The Netherlands and Belgium–Luxembourg act as financial intermediaries since there is a net capital flow from the rest of the world to these countries and a net capital flow from these countries to the other EMU countries. One aim of this paper is to understand these patterns.

Our analyzing framework provides interesting insights. In particular, we can detect whether the determinants are different between intra and extra balances. This might help us to understand why some countries have positive intra balances but yet negative extra balances, or vice versa. Using data on the EU-15 countries from 1984 to 2011, we

are able to see whether the relative importance of some variables changed for the euro area member countries after they adopted the euro.

Schmitz and von Hagen (2011, 1676) found that “with the introduction of the common currency the elasticity with respect to per-capita incomes of net capital flows within the euro area has increased for the members of the euro zone.” 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 has 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

* Tel.: +358 504016350.

E-mail address: mika.p.nieminen@ju.fi.

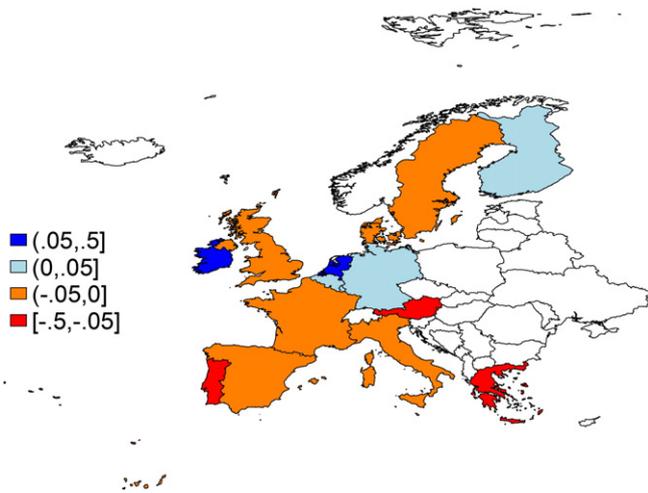


Fig. 1. Intra balances for the EU-15 countries (ratio to GDP) during the period of 1999–2011.

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

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.

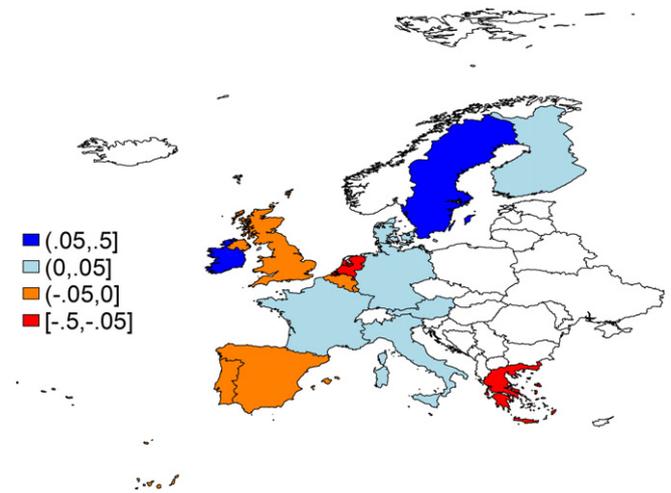


Fig. 2. Extra balances for the EU-15 countries (ratio to GDP) during the period of 1999–2011.

per capita was much stronger during the 1994–2000 period than during the 1985–1993 period (Blanchard and Giavazzi, 2002).

Schmitz and von Hagen (2011) empirically test whether, among the EU-15 countries, the net capital flows follow differences in per capita incomes. They distinguish between trade balances against euro area and the rest of the world. Their main finding is that the net capital flows follow differences in per capita incomes and that, as a result of introduction of the euro, this elasticity increased but only concerning the net capital flows, which are proxied by the trade flows, inside the euro area. They interpret this as evidence of deepened financial market integration in the euro area and conclude that the widening of current account balances within the euro area should be considered a sign “of the proper functioning of the euro area rather than a sign of improper macroeconomic adjustment” (Schmitz and von Hagen, 2011).

Giavazzi and Spaventa (2010) note that in contrast to Blanchard and Giavazzi's (2002) model, foreign borrowing is not necessarily devoted to the production of tradable goods. If a country is borrowing to finance the production of nontradables, it might be unsuccessful in generating the required trade surpluses in the future (Giavazzi and Spaventa, 2010). Arghyrou and Chortareas (2008) explore the role of real exchange rates in current account determination for the euro member countries. They observe that the real exchange rate enters the cointegrating vector with a nonzero coefficient for most of the countries (Arghyrou and Chortareas, 2008). By using data for the 11 euro countries from 1982 to 2011 and applying the pooled mean group estimator, Belke and Dreger (2013) attempt to examine the relative importance of catching up and competitiveness for the current accounts. Both of these components are statistically significant with correct signs, but a one percent decrease in competitiveness relative to the euro area average has a larger deteriorating effect on the current account balance than a one percent increase in real per capita income relative to the average (Belke and Dreger, 2013).

Schnabl and Freitag (2012) remind us that a large number of developing countries have pegged their currencies more or less to the US dollar. By contrast, a large number of European countries have pegged their currencies to the euro. Schnabl and Freitag use the concepts of a dollar bloc and euro bloc, which they define in the following way: In the dollar bloc, the U.S. serves as the center country, and East Asia, the Middle East, Latin America, and the Commonwealth of the Independent States are considered the periphery. In the euro bloc, Germany is the center country, and the emerging Europe and industrialized Europe are considered the periphery. They detect an interesting distinction between the two blocs. In the euro bloc, capital flows from the rich center country, Germany, to the poorer periphery. This difference might be explained by the fact that the dollar periphery

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