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Capital flows and income convergence in the European Union. A fresh perspective in view of the macroeconomic imbalance procedure

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Abstract

In this paperwe conduct an empirical analysis regarding the impact of current account imbalances, as counterparts to net capital flows, on the income convergence in the European Union during 1995 – 2007. Our results show that the current account deficits had an income convergence effect in the area, more specifically they contributed to a higher economic growth in the countries with lower levels of initial GDP per capita. As a consequence, compliance with the indicative thresholds established by the European Commission through the Macroeconomic Imbalance Procedure – according to which the current account balances should be maintained within the range (-4% GDP, +6% GDP) – would be equivalent to a maximum value of the convergence parameter of -1.833. However, exceeding the lower limit of the interval (of -4% GDP), through the increase in the current account deficits, would lead to gains on the income convergence side within the European Union. The implications are important for the Central and Eastern European economies. Our results suggest that a more appropriate approach of net capital flows, and thus of current account imbalances, would be their regulation in order to avoid overheating and to limit the adverse impact of volatility, rather than their direct limitation.

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*Keywords:*capital flow, current account inbalances, income convergence, European Union, Macroeocnomic Imbalnce Procedure

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1. Introduction

Here introduce the paper, and put a nomenclature if necessary, in a box with the same font size as the rest of the paper. The paragraphs continue from here and are only separated by headings, subheadings, images and formulae. The section headings are arranged by numbers, bold and 10 pt. Here follows further instructions for authors.

Both of the concepts referred in this paper, specifically “capital flows” and “income convergence” have been long studied in economic research, either separately or together. The results have been very diversified, according to the sample of countries, time period analyzed or econometric techniques. However, the economic crisis has shifted somehow the attention from the income convergence process to the worldwide macroeconomic imbalances, which are reflected in the current account positions. Furthermore, within the European Union (EU), the latter became an extensive subject for research, due to the macroeconomic problems of the Southern countries.

The EU tried to respond to the challenges brought about by the crisis, by strengthening the economic governance. Thus, the “Six-pack” legislative initiative introduced a new surveillance procedure for the macroeconomic imbalances (European Commission, 2012). The initiative comprises the Macroeconomic Imbalance Procedure (MIP) which consist of two arms. The first one is preventive, in order to identify the existence of early imbalances and the second one is corrective, in case the imbalances require action. The MIP Scoreboard consists of ten indicators, and the current account position is one of them. Methodologically speaking, the current account balances are employed as percentage of GDP and arithmetic averages over 3 years, in order to correct for short-term fluctuations (European Commission, 2012). The indicative thresholds established are within the interval (-4% GDP, +6% GDP). Even though both deficits and surpluses of the current account are taken into consideration, the emphasis remains on the negative current account balances which bring into debate the issues of external debt and financing capacity. Both the limits of the intervals are debatable, but we concentrate here on the inferior bound of -4% GDP. First of all, we would like to point out that, in order to establish this threshold, the European Commission employed the statistical distribution of the current account positions starting in the 1970s, but until the middle of the 1990s the data were not available also for the New Member States. Thus, this method is questionable, as it introduces a bias of results in favour of the Old Member States. Secondly, although there is a general recognition regarding the need to consider the special situation of the catching-up economies, there are no different thresholds for these countries.

Despite the generally negative connotation given to the current account deficits, in this paper we explore the current account as counterpart to net capital flows, due to the accounting relationships in the balance of payments. Within this context, our empirical study identifies and quantifies the impact of the current account deficits, or net capital inflows, on the income convergence within the EU during the pre-crisis period, 1995 – 2007. This perspective on the income convergence process is different from most of the previous research (see Abiad et al. (2009) for a similar approach), as most of the papers have concentrated on traditional macroeconomic indicators, such as human capital, investment or trade openness.

Furthermore, in this research we extend the findings in the empirical literature on capital flows and income convergence in the EU by placing the relationship within the context of MIP described above. As a consequence, we will be able to emphasize the gains in income convergence obtained as a result of exceeding the lower threshold of -4% GDP for the current account deficits.

The remainder of the paper is structured as follows. Section 2 provides some stylized facts regarding the capital flows within the EU. In Section 3we present the econometric evidence for the impact of the current account imbalances, or net capital flows, on the income convergence in the EU. We make some concluding remarks in Section 4.

2. Capital flows within the European Union. Stylized facts

According to the neoclassical economic theory, the net capital flows should go from rich to poor countries. However, Lucas (1990) has showed that in reality the capital flows from North to South are very small compared to this theory. This intriguing result has boosted a lot of empirical research on the direction of capital flows at an international level (Prasad et al. 2006; Alfaro et al., 2008; Kalemli-Ozcan et al., 2010; Ohanian and Wright, 2010; Gourinchas and Jeanne, 2011).