



Long-run determinants of current accounts in OECD countries: Lessons for intra-European imbalances



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ABSTRACT

In this paper we study the long-run determinants of current account balances in 21 OECD countries. We define long-run targets to determine whether actual current account balances are in line with their equilibrium values and find that, following the crisis, the United States, Japan and Spain returned towards their targets but that much remains to be done in Austria, Greece and Germany. Using linear and asymmetric panel VECM models, we find that the speed of convergence of external imbalances is much faster in deficit countries than in surplus ones. These results suggest that the adjustment of intra-European imbalances has to take place in both surplus and deficit countries and should be particularly substantial in the former. This revived the old debate of how to get the surplus countries to adjust.

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1. Introduction

Current account imbalances and the cost of external adjustment have been a major source of concern for economists. In the 2000s the debate mostly focalised on global imbalances, in particular those of the United States and Asia. The economic literature sought to determine whether these imbalances resulted from either an informal agreement (Dooley et al., 2003, 2004) or a saving glut in Asia (Bernanke, 2005). Caballero et al. (2008) and Gruber and Kamin (2009) underlined the role of the differences in financial development by explaining why the saving glut was heading to the United States. However, since 2008 a part of the literature studied the relationship between the financial crisis and the global imbalances. Obstfeld and Rogoff (2009) consider that they are the product of common causes, while Borio and Disyatat (2011) highlight the negligible role played by global imbalances and net flows relative to gross financial flows, which fuelled the development of the United States' shadow banking system.

In Europe, even if at the aggregate level the current account is balanced, there is a debate regarding intra-European external imbalances, which have been widening since the introduction of the euro. Indeed these imbalances imply permanent transfers from northern to southern Europe with no price-adjustment mechanisms. The optimistic

argument relies on the fact that these imbalances are sustainable and may be explained by the deeper capital market integration resulting from the creation of the European Monetary Union (EMU), leading to deficits in countries with higher growth prospects (Blanchard and Giavazzi, 2002). However, according to Blanchard and Milesi-Ferretti (2010) and Jaumotte and Sodriwiboon (2010), the rise of external imbalances in some EMU countries is not sustainable and may be explained by bubble-driven booms caused by overly optimistic growth prospects and excessive private and public borrowing.¹ Arghyrou and Chortareas (2008) explain the widening in the current account within the euro area by the decrease in real exchange rate flexibility with the creation of the EMU. Some other authors even point out that the European sovereign crisis could be explained by the possibilities of a balance-of-payment crisis in Europe (Fahrholz and Freytag, 2012; Mayer, 2011).

The underlying issue behind these fields of study is whether current account imbalances are 'excessive' and whether and how they should be adjusted (Lane and Milesi-Ferretti, 2011). The issue of persistent imbalances is an old phenomenon. Before the First World War, the United Kingdom already ran current account surpluses for more than a century,

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¹ Schoder et al. (2012) have tested for the sustainability of current account imbalances in European countries using parametric and non-parametric tests. They find that external imbalances are unsustainable within the euro area and that the introduction of the euro is associated with a regime shift from sustainability to unsustainability.

while French and German current accounts were in surplus for more than forty years.² More recently, Japan and the United States have been in a situation of persistent imbalance since the early 1980s. It seems therefore particularly interesting to identify the factors that explain such persistence in order to define long-run targets of current account balances. In this paper we propose a new measure of external imbalances by studying the long-run determinants of the current account. With this new long-run measure, we determine whether current levels of global and intra-European imbalances are in line with their structural levels. We establish the long-run determinants of the current account in 21 OECD countries with panel cointegration techniques. Then we estimate short-run dynamics with panel VECM models – both linear and asymmetric – in order to determine the speed of adjustment towards the long-run target.

Our contribution is linked to previous empirical studies of long-run determinants of the current account, applying both time series (Argyrou and Chortareas, 2008; Batdelger and Kandil, 2012) and panel data (Chinn and Ito, 2008; Chinn and Prasad, 2003; Gruber and Kamin, 2009; Legg et al., 2007). Regarding these former empirical studies, two major limitations may be proposed. First, it is well known that small sample size implies that unit root and cointegration tests have low power. The use of cointegration panel analysis increases the size of the sample, which should improve the power of statistical tests. Second, the earlier panel data studies do not take into account unit roots and the existence of a potential long-run relationship between variables, so they may be subject to the ‘spurious regression’ phenomenon (Kao, 1999; Phillips and Moon, 1999). Afonso and Rault (2008) produced the first paper to estimate the intensity of the long-run relation between the current account, the fiscal balance and the real effective exchange rate in several groups of EU and OECD countries with panel cointegration techniques.³ Recently, Belke and Dreger (2013) also applied panel cointegration techniques in order to explain the euro area current accounts. We extend their approach in three different ways. First, we introduce more macroeconomic determinants into the specification. Second, we calculate excess current account imbalances by comparing the actual current account to its ‘equilibrium’ value, as in Lane and Milesi-Ferretti (2011), using a recent methodology advocated by Elbadawi et al. (2011). Panel DOLS estimates provide a robust framework to calculate the long-run ‘equilibrium’ current account, and enable us to measure the external imbalances by subtracting the structural current account from the original series. Third, we estimate the speed of convergence towards the long-run targets by applying both linear and non-linear panel VECM. Asymmetric adjustment is modelled with the panel threshold framework developed by Hansen (1999).⁴

The rest of the paper is organised as follows. Section 2 presents the determinants of the current account balance in the literature. Section 3 presents the panel econometric methodology. In Section 4, we discuss the main empirical results regarding the short-run and long-run determinants of the current account in OECD countries. Section 5 is devoted to the issue of divergence of current account

balances across the euro area countries. In Section 6, we implement a threshold panel VECM model in order to address the issue of an asymmetric adjustment of external imbalances. Finally, Section 7 offers some conclusions.

2. Determinants of current account imbalances

According to Belke and Schnabl (2013), since the early 1980s there have been four different generations of global imbalance. The first generation of current account imbalances emerged between the USA and Japan in the early 1980s. The second appeared in the aftermath of the Asian crisis with a deficit in the USA matched by a surplus in East Asian countries and China. From 2003 the third grew with the rise in commodity prices and the accumulation of current account surpluses in oil-exporting countries. Finally, the fourth generation of current account imbalances arose in Europe after the launch of the European Monetary Union (EMU) with the widening of the current account balance between northern and southern euro area countries.

This section aims to review the main theoretical and empirical determinants of these current account imbalances.⁵ The main determinants are the following: fiscal policy (the ‘twin deficits’ issue), relative prices (the competitiveness effect), productivity surge in the United States, demographic factors, the saving glut and differences in the level of development of financial markets.

The term ‘twin deficits’ was coined by Martin Feldstein (1985, 1987) to describe the link between US fiscal and current account balances during the 1980s. Salvatore (2006) developed a theoretical approach of the ‘twin deficit hypothesis’ in terms of demand and supply of loanable funds in order to highlight the link between fiscal policy and current account. According to this model, the expected effects of a fiscal deficit are: (i) an increase in the real interest rate; (ii) an appreciation of the domestic exchange rate; and (iii) a decrease in the current account balance. Therefore, we should observe a positive relationship between the government fiscal balance and the current account.

By contrast, in inter-temporal current account models with Ricardian agents it is assumed that an increase in the deficit will be offset by an increase in private saving so that the current account will not amend (Glick and Rogoff, 1995; Obstfeld and Rogoff, 1995). Recently, some inter-temporal models have assumed that there are two kinds of agent: ‘spender’ households, which spend their disposable income at each period; and ‘saver’ households, which consume according to their permanent income and smooth their resources inter-temporally (Bussière et al., 2010). Within this new framework, the impact of the fiscal deficit on the current account is positive and will depend on the share of non-Ricardian households in the economy. Abbas et al. (2010), using a large panel of 140 countries, have obtained that in terms of advanced countries, large current account improvements were associated with changes in the fiscal balance, not in the short run (one or three years), but in the medium run (seven years). By contrast, large current account deteriorations were associated with changes in the private sector saving–investment balance rather than the public one.

The competitiveness effect could be measured using two different indicators: real effective exchange rates and terms of trade. The HLM effect – from the names of the three economists who highlighted it (Harberger, 1950; Laursen and Metzler, 1950) – implies that an improvement in the terms of trade generates an increase in the current account balance. This effect is explained by the following mechanism: improvement in the terms of trade of a small open economy increases its real income and if one assumes that the propensity to consume is less than one, consumption increases less than income – which means that it has a positive impact on the current account balance by boosting private savings. The inter-temporal approach to the current

² For data relative to current account balances of the United Kingdom, France and Germany, see Imlah (1958) and Jones and Obstfeld (1997).

³ Smith (2011) applied a panel ARDL model to estimate a long-run relationship between the current account and a large vector of determinants. However, she did not test for panel cointegration in the data. We extend her study by applying the panel cointegration test developed by Westerlund (2007). Chiu et al. (2010) also applied a heterogeneous panel cointegration framework to examine the long-run relationship between the real exchange rate and bilateral trade balance of the United States and her 97 trading partners.

⁴ In the literature one may find many explanations that might justify the presence of threshold effects. For example, in the model advocated by Nickel and Vansteenkiste (2008), the relationship between the fiscal balance and the current account depends on the level of debt to GDP ratio. If the debt to GDP ratio is above a threshold value, then private agents might perceive the current fiscal situation as unsustainable. In this case, a decrease in the fiscal deficit could lead to higher private consumption and lower savings, which would improve the current account balance (for further analysis, see Holmes, 2011).

⁵ See Chinn et al. (2011) for a recent review of the empirical literature on the current account determinants, and Gourinchas and Rey (2013) for a review of the theoretical literature.

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