How relevant are balance-of-payments disequilibria in the industrialised countries? The case of the euro area and the United States

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1. INTRODUCTION

The balance of payments, insofar as it is a record of a country's trade and financial transactions with other countries, is an important source of information for evaluating the economic situation. However, analysing these data is by no means simple, since they can be interpreted in different ways. In a world in which most trade and financial flows are channelled through private agents, a current-account deficit is only a cause for concern insofar as it casts doubt on the sustainability of the exchange-rate regime (or presages large movements in the exchange rate), or is indicative of serious competitiveness problems. Either way, it is difficult to make a diagnosis solely on the basis of the information provided by the balance of payments and other variables need to be taken into account for a better grounded assessment. It is therefore complicated to specify under what conditions the financial markets perceive that the situation of the external sector is not sustainable and a sudden exchange rate correction may take place. A large and persistent current-account deficit may be symptomatic of the fact that national output lacks competitiveness, but it may also arise from strong growth in national investment, financed partly by external savings, that will in the medium term improve competitiveness and restore equilibrium to the external accounts. Moreover, it is difficult to assess to what extent it is current-account transactions that give rise to a financial position that has to be covered with net inflows of capital or, by contrast, it is cross-border financial flows that drive current-account developments.

Section 2 of this article analyses which variables help to characterise the treatment merited by the analysis of the balance of payments. The case of a developed economy with a flexible exchange-rate regime, such as the United States and the euro area, is examined in Section 3, while Section 4 considers the case of countries linked by a common currency, such as those that have joined the euro area. In the euro-area countries, while the single currency eliminates the risk of the external deficit giving rise to a sharp correction in the exchange rate, the competitiveness problems that may build up are, potentially, more serious, since there is no possibility of correcting them through a currency devaluation. The conclusions are set out in Section 5.

2. BALANCE-OF-PAYMENTS DISEQUILIBRIUM AS AN INDICATOR OF INSTABILITY

The world has seen a number of economic crises in recent years (Mexico in 1994, Russia and South-East Asia in 1998, Argentina in 2001). Among the factors that have set these crises off have been balance-of-payments disequilibria. Although the existence of a large current-account deficit was not the heart of the problem in every case, these crises were triggered by sudden changes in cross-border financial flows; countries that normally received net investment from the rest of the world began to experience massive flights of capital, which led to sharp exchange rate depreciations. A common feature of these countries is that they were emerging economies (or, at least, not full members of the group of industrialised countries), they were dependent on external financing and they had exchange rate regimes that linked the local currency more or less tightly to some other foreign currency (normally the US dollar). The industrialised economies, meanwhile, have not experienced similar balance-of-payments crises in recent years. In Europe, the last episode with somewhat similar characteristics was during the period 1992-1994, when a number of factors led to the crisis of the Exchange Rate Mechanism of the European Monetary System and various countries abandoned this mechanism or devalued their currencies.

Various factors can be mentioned whose presence generally makes a balance-of-payments disequilibrium worrying (1). The crucial element is probably the exchange-rate regime chosen, since this determines the extent to which changes in the relative demand for financial assets denominated in domestic and foreign currency can correct themselves through exchange-rate movements. Under fixed and semi-fixed exchange-rate regimes, in which the authorities are committed to maintaining a greater or lesser degree of exchange-rate stability, the central bank must respond to changes in net capital flows by intervening (whether automatically, as in the case of a currency board, or discretionally) in the money or foreign exchange markets, in order to keep the exchange rate at the desired level. The chances of this strategy succeeding are limited, since central bank interventions are restricted by the availability of reserves or by the difficulty of maintaining severe monetary squeezes indefinitely. In fact, experience shows that if, as a consequence of balance-of-payments disequilibria, there is strong downward pressure on the exchange rate, then usually it will eventually be devalued.

The degree of stability of the capital inflows is also fundamental in any assessment of the importance of an external disequilibrium (2). This element is bound up with the credibility enjoyed by the national authorities, the country's tradition of macroeconomic and political stability, the position of the national economy in the world, its specialisation, etc. Obviously, the more volatile these capital inflows and the more they are linked to high returns on investments with a speculative content, the greater the risk that they will be reversed and so generate a balance-of-payments crisis. In this sense, current-account deficits may contain an element of vulnerability if external financing is considered to be more unstable than domestic financing. This tends to be the case when capital inflows are strongly influenced by the level of the exchange rate or by expectations of its future course.

In the industrialised countries these factors are generally of little significance. First, in the case of the three large economic areas, the exchange rates between their currencies (the euro, the dollar and the yen) are flexible, so that the central banks of these zones do not have exchange rate targets to defend and capital inflows and outflows lead to changes in exchange rates that can, if necessary, correct any external disequilibrium by themselves. Second, the high living standards, price stability and high degree of economic policy credibility in these countries are conducive to the stable financing of any external deficit. Short-term capital inflows with a more speculative content do exist, but their importance is smaller, so that it is less likely that there will be a sudden change in market sentiment prompting substantial changes to investment patterns in these zones. Obviously this does not mean that a persistent external deficit will not, on occasions, require an adjustment in these countries, but such adjustments will usually be less traumatic than in emerging economies. This article focuses on two cases of particular interest among this group of industrialised countries: the United States and the euro area.

(1) The current-account deficit is the indicator usually used to assess the external disequilibrium or vulnerability of an economy to changes in financial markets' sentiment, although even without a current-account deficit a country can still be affected by sudden changes in the direction of financial flows.

(2) In fact, an indicator that is also frequently used to measure external equilibrium is the *basic balance*. This is obtained by summing the balance on current account and the net flows of investment that are judged to be more permanent, such as direct and portfolio investment.

3. EXTERNAL DISEQUILIBRIUM UNDER A REGIME OF MACROECONOMIC STABILITY AND FLEXIBLE EXCHANGE RATES: THE CASE OF THE UNITED STATES AND THE EURO AREA

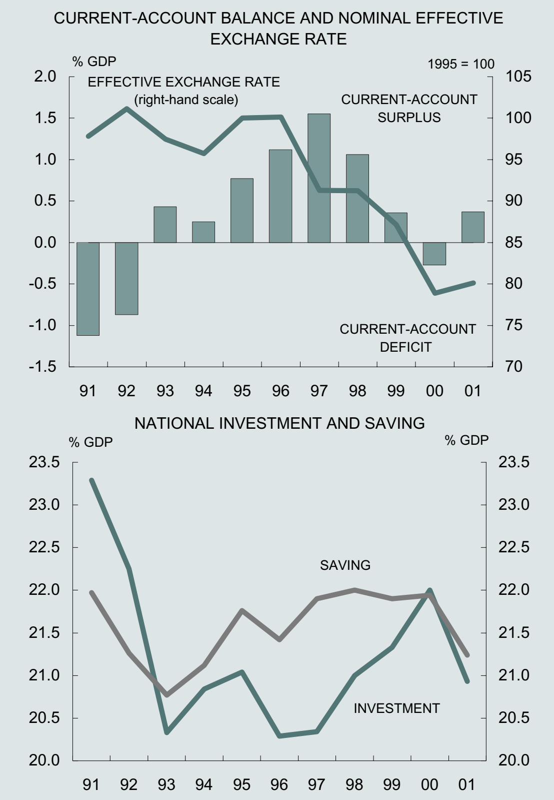
The euro area has run a current-account surplus in every year since 1993, with the sole exception of 2000 (see lower panel of Chart 1). As mentioned above, the fact that it does not need to resort to the savings of the rest of the world to finance its domestic investment does not necessarily mean that the euro area is sheltered from the effects of changes in the direction of international financial flows on the exchange rate and the economic situation (3). Moreover, it is very important to know to what extent the introduction of the euro has changed the ability of the member countries to run balance-of-payments deficits, something that will be analysed in the following section.

The United States, meanwhile, has been running a very large deficit on current account, for more than two decades now (see Chart 2). This deficit has, on occasions, been interpreted as being a consequence of the dollar's central role in the international financial system and of the dynamism of the US economy. This makes dollar assets highly attractive, so that capital flows into the United States, leading to appreciation of its currency and, in short, a deficit emerges. In the case of the United States, this chronic balance-of-payments disequilibrium on current account has not only not led to dollar weakness, but the dollar has instead proven itself relatively strong over prolonged periods.

In recent years, the large and widening external deficit in the United Sates has been a cause for concern for international economic authorities. The fear is that patterns of investment in the US economy might change significantly, giving rise to a sudden movement in the exchange rate, which could upset world economic growth. In fact, analysis of the external sector of the industrialised economies in recent decades shows that adjustment typically takes place when the current-account deficit reaches around 5% of GDP, which is the level the US deficit has been at in the last few years [see Freund (2000)]. Moreover, while the large current-account deficit that existed almost throughout the 1990s involved recourse to external saving given the insufficiency of domestic saving to finance increasing investment, the recent decline in investment has not been accompanied by any moderation in the deficit. The sharp deterioration in the US international investment position is also a sign of the difficulty of maintaining the current situation, although the income that has to be paid on the liabilities with the rest of the world is similar to that accruing on US financial assets with the rest of the world (see Chart 3).

CHART 1

The current-account balance, saving and investment in the euro area



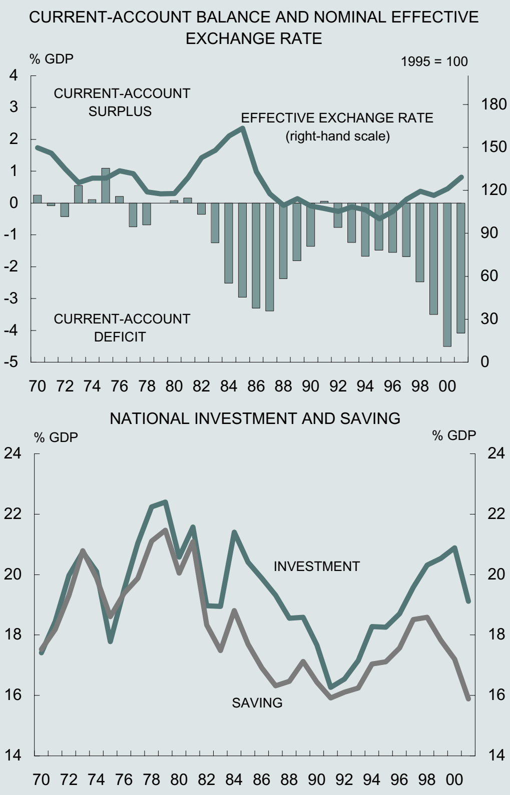
Sources: OECD, Eurostat and IMF.

As mentioned above, the nature of the capital flows is also an important factor in any assessment of an external disequilibrium. In recent years, the United States has been the recipient of large capital inflows in the form of share acquisitions (through direct and portfolio investment), associated with the boom in the high-technology sectors (see Chart 4). Indeed, the high potential growth rate of the US economy and the dollar's safe-haven status (which means, for example, that the dollar is the main central bank reserve currency) are factors that tend to encourage a stable demand for assets issued by US agents. In 2001, however, the pattern of previous years changed and the bulk of the capital inflows were channelled through debt (loans and fixed-income securities), while

(3) In fact, the basic balance showed a large deficit during the period 1998-2001, which can partly be explained by the significant depreciation of the euro in this period. The return to surplus on the basic balance, towards the end of 2001, coincided with the start of a period in which the euro recovered somewhat on the foreign exchange markets.

CHART 2

The current-account balance, saving and investment in the United States



Source: International Monetary Fund.

direct investment and the purchase of shares dropped significantly.

In order to assess the likelihood of the deficit being reduced it is also worth analysing the financial position of resident sectors. Chart 5 shows how the widening of the US deficit up to 2001 was attributable to a substantial reduction in the net lending of corporations and, especially, of households, which was only partly offset by the improvement in public finances. In this respect, the sharp increase in the indebtedness of the private sector over the last decade has been notable. In the case of households, outstanding debt rose to 75% of GDP, and in that of non-financial corporations, to somewhat less than 70%. While the recently recorded levels of indebtedness of corporations are similar to those of the late 1980s, those of households are much higher than the levels seen in recent decades, while the savings ratio is much lower (see lower panel of Chart 5). Even if it is argued that, were the capital gains obtained on the holdings of the real and financial assets to be taken into account, the fall in the household saving ratio would not have been so significant, this ratio can still be expected to pick up. In the absence

CHART 3

External assets and liabilities in the US

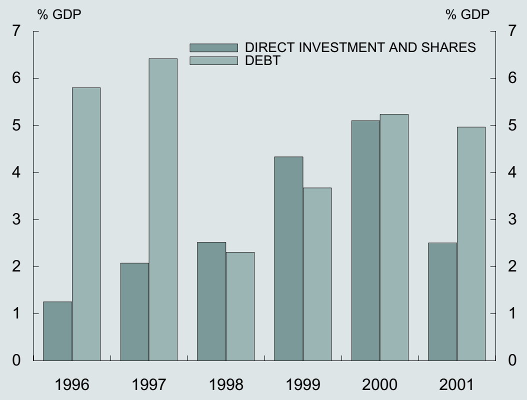
Source: International Monetary Fund.
(a) External assets - external liabilities.

of an expansionary fiscal policy, this would lead to adjustment in the external deficit.

In short, it has been seen that the information on the level of the current-account deficit in economies such as the United States is insufficient to assess its sustainability or the possibilities for a more or less immediate correction. Such an assessment requires further information, relating to the reasons for the deficit and the use that is being made of the external savings. In this case, analysis of balance sheets (especially those of households, in the United

CHART 4

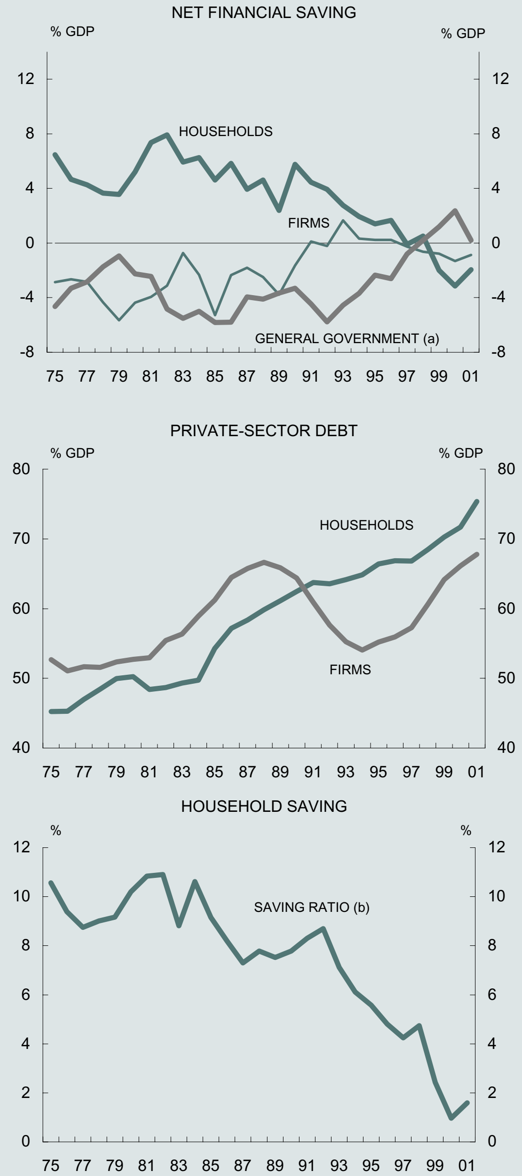
Capital inflows in the United States



Source: International Monetary Fund.

CHART 5

Saving and debt in the United States



Source: Federal Reserve.
(a) Federal Government only.
(b) As a percentage of household personal income.

States) provides significant information on possible future developments in the current-account deficit. This additional information, as will be seen in the following section, is also crucial to any assessment of changes in the balance of payments of the member countries of a monetary union.

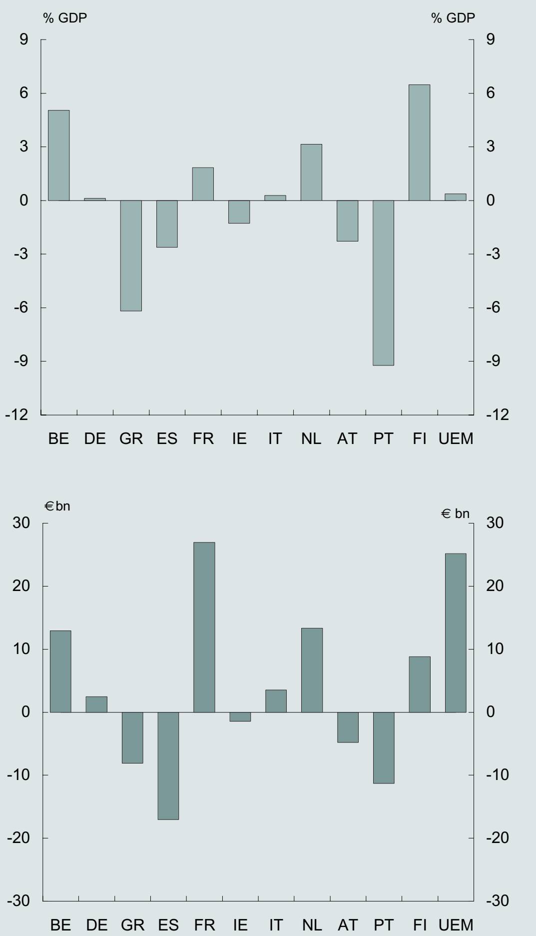
4. EXTERNAL DISEQUILIBRIUM IN THE MEMBER COUNTRIES OF A MONETARY UNION: THE CASE OF THE EURO AREA

In a monetary union, the member countries give up one of the main adjustment mechanisms for resolving their balance-of-payments problems, namely depreciation of their exchange rate, at least insofar as the relationship between their own currencies is concerned. At the same time, these problems become less acute. In particular, in those countries with less tradition of macroeconomic stability, the impossibility of depreciation of a country's currency against those of its partners in the union eliminates the exchange risk premium for investors. This reduces the level of interest rates required and encourages larger and more stable flows of capital into these economies, which would otherwise be subject to very strict scrutiny by the markets. In this respect, countries that have been successfully incorporated into a monetary union governed by a credible economic policy geared to macroeconomic stability should find it easier to obtain capital inflows to finance domestic investment, so that the sustainable level of the external deficit is higher.

In fact, the external sector of a country belonging to a monetary union could be analysed as though the economic relations of one region with others in the same country and with third countries were being examined. Indeed, it might be inferred that the importance of a current-account deficit in a monetary union is significantly lower. However, it should not be forgotten that, unlike in the case of the regions of a particular country, two significant instruments of adjustment may not be available to a monetary union. These are a fiscal policy for the union as a whole with sufficient stabilising potential and a high degree of labour mobility. As a result, the presence of a persistent current-account deficit

CHART 6

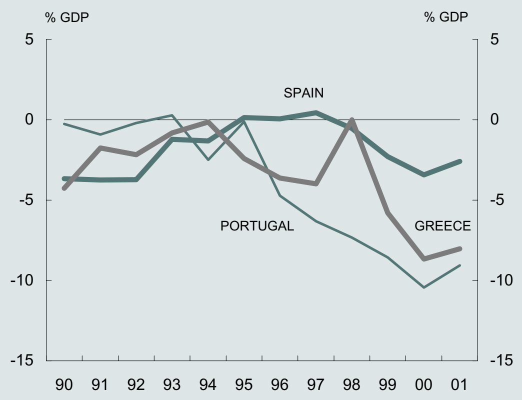
The current-account balance in the euro area in 2001



Source: OECD.

CHART 7

The current-account balance in Spain, Portugal and Greece



Source: International Monetary Fund.

in one country of a monetary union does not stop being relevant; it may be a sign of competitiveness problems that are holding down the country's growth potential and the adjustment required to correct such problems may be more costly than in the case of an economy with its own currency.

Looking at the euro area balance of payments, it can be seen that the general overall balance in the area is the result of a surplus in some countries and a relatively large deficit in others (see Chart 6) (4). In particular, as a percentage of GDP, Finland, Belgium and the Netherlands had the largest current-account surpluses in 2001, while the largest deficits were those of Portugal and Greece. Spain, along with Austria, also ran a large deficit; indeed Spain was the country with the largest deficit in absolute terms, but as a percentage of GDP it was much smaller than in Portugal and Greece. Clearly, there is no coincidence in the fact that this group includes the countries with the lowest income per capita in the euro area; these countries have the smallest capital endowments and the greatest possibilities for investment and high returns, which encourages the tapping of external saving so that headway can continue to be made in the process of real convergence. These countries have traditionally displayed persistent balance-of-payments current-account deficits (see Chart 7). Moreover, it is in these countries that membership of the euro area has represented a radical change in the economic policy regime, since they did not have a long tradition of stability, and the euro area has, among other consequences, entailed a sharp decline in interest rates, which has boosted domestic demand and indebtedness (5). Chart 8 shows how these three countries have, since 1997, displayed much higher growth of domestic demand, investment and bank lending to the private sector than the euro area as a whole.

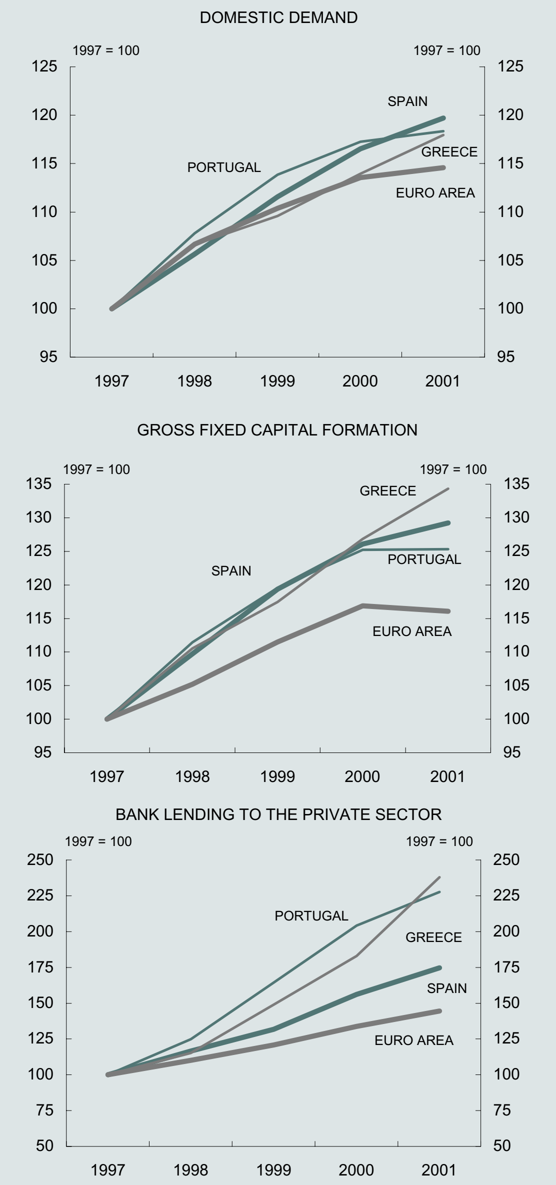
In some cases, such as Spain, the current level of the current-account deficit is the result of strong growth in domestic investment, which has not been offset by domestic saving. In fact, the latter has only held steady thanks to the

(4) In the country-level figures, the current-account balance vis-à-vis the rest of the world includes the balance vis-à-vis the other euro area countries. This means that it is impossible to establish whether the countries running a current-account deficit are also those contributing to the euro area deficit vis-à-vis the rest of the world, since an individual country's deficit can be made up of a surplus vis-à-vis the countries outside the euro area and a larger deficit vis-à-vis the rest of the euro area.

(5) In Blanchard and Giavazzi (2002) it is argued that the increasing economic integration between the euro area countries has led to a substantial reduction in the correlation between investment and national saving.

CHART 8

Economic developments in Spain, Portugal and Greece



Sources: International Monetary Fund and Eurostat.

contribution of general government in recent years (see Chart 9). In Portugal and Greece, moreover, part of the external deficit is explained by a reduction in national saving, and in particular, in private saving.

Unlike the situation in countries with their own currency, the external deficit of these states is hardly going to affect the euro exchange rate. First, this deficit has, up until now, been offset by the surplus in other countries. Second, those countries with high deficits represent a small part of the euro area as a whole, so that it seems unlikely that they set the trend for the external sector of the area (see, also, footnote 4). As seen in the lower panel of Chart 6, although their deficit is high in terms of GDP, in absolute terms Greece and Portugal account for a relatively small part of the overall deficit of the area. Also, as the case of the United States shows, even if these national deficits give rise to a euro area deficit, it would still not be possible to predict the short-run or even medium-run path of the exchange rate.

However, this does not mean that the point will not be reached where an adjustment of these disequilibria becomes necessary. In principle, the most reasonable channels of adjustment should be national. Insofar as the currency of a country with balance-of-payments problems is the same as that of other countries, it is unlikely that these problems will reduce the attractiveness of assets denominated in that currency (6). In a monetary union, the importance of the balance of payments is smaller insofar as the solvency of the borrower is much more important than its nationality. Within the group of issuers active on international markets (large firms and credit institutions), what is important is their earnings prospects, and these, in a globalised economic system, are less and less associated with the economic developments in a particular country. Obviously, there may continue to be important national ties, because a significant part of the business of some credit institutions and corporations may still be concentrated in a national market.

In this respect, part of the process of correction of the external disequilibrium can be expected to be determined by the market itself. Thus, if credit institutions consider that their exposure to the sector of non-financial corporations and households is excessive, they will reduce the available credit or will make it more expensive, which will restrict domestic demand and, as a result, the external disequilibrium. Participants in securities markets will perform a similar task of risk monitoring and assessment. Insofar as this process may not be automatic or effective, the authorities (and in particular, the central bank, as guarantor of financial stability) shall perform a very important role; first, carrying out a rigorous banking supervision task, to ensure that institutions are properly valuing the risks implicit in their loans; and, second, analysing the financial situation

(6) That said, it is not possible to rule out the external disequilibrium of a specific country eventually affecting the other countries of the zone. In fact, some spillover effects can be expected, the strength of which will depend on the causes of the disequilibrium, its potential consequences for the exchange rate and interest rates, and any implications that may arise from the adjustment measures taken to correct the disequilibrium [see Catte (1998)].

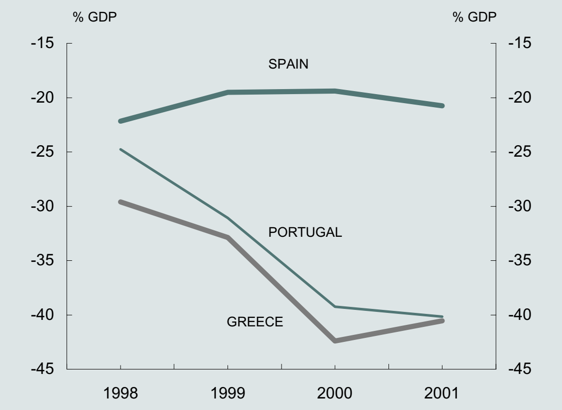
CHART 9

Saving and investment in Spain, Portugal and Greece

Source: Eurostat.

CHART 10

Net international investment position in Spain, Portugal and Greece (a)



Source: International Monetary Fund.
(a) External assets - external liabilities.

of the economic sectors and alerting to any potential sustainability problems that may be detected. Finally, the more reliable and comprehensive the information required from borrowers the more efficient will be the assessment of risks by the market.

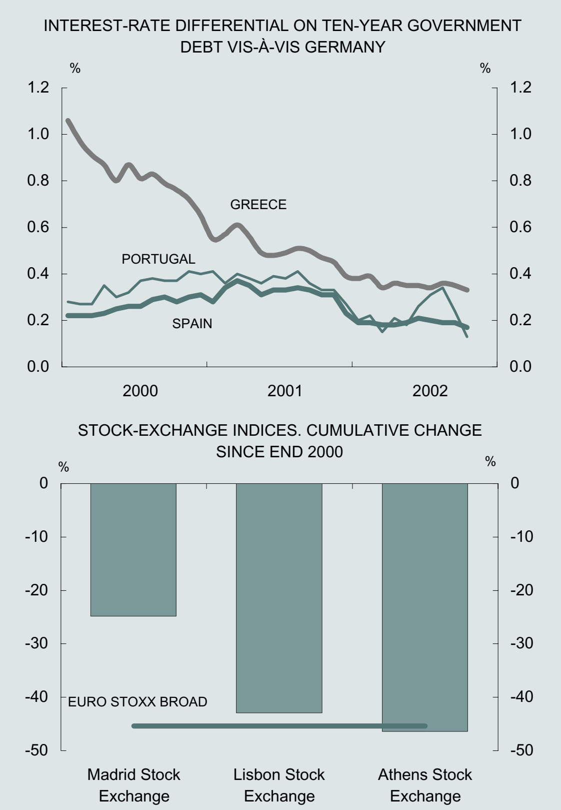
In the case of the three countries mentioned above there have been no problems financing the current-account deficit, although external borrowing (as opposed to direct investment or the sale of shares) has been the instrument used most to attract savings from the rest of the world. In terms of their international investment position, the cumulative current-account deficit has led to a substantial decline in Greece and Portugal, which came to a halt in 2001 (see Chart 10), while in Spain this position has remained stable despite the external deficit recorded.

In terms of the yields required on financial assets, the market does not seem to be penalising the securities issued by these countries. For example, the interest rate differentials on long-term government debt vis-à-vis Germany are still low and their trend is downwards (see Chart 11). In the case of Portugal, there was a temporary increase in mid-2002 linked to the unfavourable public finance developments in this country, which led to the initiation of the excessive deficit procedure to correct the situation. As for equity markets, the performance of the Lisbon and Athens stock markets in the last two years has been negative, but very similar to that of European indices, such as the Euro Stoxx. This seems to imply that the financial markets are not directly assessing the overall financing requirements of each country, but rather the specific financial position of each agent seeking funds.

In short, analysis of the balance of payments of the countries of a monetary union is still relevant. Even if the external disequilibrium of national economies is not going to have implications for the sustainability of the exchange rate, the current-account deficit is, although an imprecise one, an initial indicator of the competitiveness problems a country may be suffering from, which are potentially more worrying within a monetary union. Obviously, it is difficult to determine to what extent the external deficit is a symptom of such competitiveness problems or, rather, an efficient response by agents to a new environment, characterised by lower interest rates and greater investment opportunities, which enable a higher current-account deficit to be sustained in the long run. Such an assessment needs to be based on a large number of indicators, including both relative-price and market-share variables, as well as other variables relating to the financial position of corporations and households, and the solvency of credit institutions, their position in international markets and the maturity of their debts. Developments in the prices of national assets (government debt, private securities, the stock market) relative to the euro area as a whole and the ratings assigned to firms by rating agencies also offer relevant information on investor confidence in the domestic economic situation.

CHART 11

Fixed-income and equity-market yields



Sources: Banco de España and Reuters.

5. CONCLUSIONS

The information provided by the balance of payments is still useful for economic analysis and for economic policy formulation. However, its relative importance varies greatly, according to the degree of development and the design of economic policy in the country concerned. Thus, the current-account deficit is still a crucial indicator in emerging countries, in states with fixed or semi-fixed exchange-rate regimes and in those with highly volatile cross-border financial flows.

By contrast, in countries with flexible exchange-rate regimes, a high degree of development and economic policy credibility, or in those belonging to a monetary union with these characteristics, the possibility of a current-account imbalance giving rise to a balance-of-payments crisis is more remote. In these countries, the level of the external deficit is a poor indicator of the magnitude of the accumulated problems or imbalances, and the latter must be assessed on the basis of a wider set of indicators taking into account, among other elements, the financial position of national sectors (households, corporations and credit institutions) and the prices of national assets. In these circumstances, the current-account deficit is just one more indicator of the nature of the difficulties facing each economy and, in itself, provides little information on the need for its correction or on its potential effects.

In the case of a monetary union, such as the euro area, the information provided by the balance of payments is even less conclusive and needs to be supplemented by analysis of aspects of a more microeconomic type linked to financial stability, relating to the assessment of the risks and the vulnerability of the main economic sectors. These aspects, in the long run, determine the extent to which a specific level of the current account is or is not worrying. The greater ease of financing the external deficit within a monetary union in no way reduces the potential competitiveness problems that may arise in a national economy belonging to the euro area. Besides, the difficulty of detecting these problems and the higher potential cost of the adjustments needed to resolve them within a monetary union (given the impossibility of an exchange-rate devaluation) mean that the situation needs to be evaluated early so that solutions can be implemented promptly, thereby reducing the potential cost of adjustment.

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