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Are current account surpluses in some EU members a problem for the rest?

Large and Chronic Current Account Surpluses: Problems, Policies and Prospects

Rafael Doménech
Copenhagen, 8 October 2015

Introduction

- Some European countries show large current account (*CA*) surpluses. **Are these surpluses reflecting imbalances that should be corrected?**
- **Two different answers** to this question:
  - **Yes**: at the national level, surpluses may be suboptimal and, at the international level, they contribute to instability and may hurt growth and employment in other countries (paradox of thrift)
  - **No clear** evidence that surpluses are suboptimal and that the spillovers of the policies implemented to correct them may benefit countries where the crisis is deeper
- The **current account balance** is one indicator (among many others) that is the result of many **endogenous variables and decisions** of agents in decentralised economies, and should not be interpreted as a **synonym for competitiveness**

Introduction

- **Better strategy**: the saving/investment gap reflected in the current account balance should be evaluated in terms of its **efficiency to increase the current and future welfare** of the society
- In the evaluation of *CA* balances, **globalisation and investment opportunities abroad** should also be taken into account -> **GDP vs. GNI**
- The **introduction of the euro** eliminated exchange rate risks among members, contributing to increase saving/investment gaps (vs. Feldstein-Horioka puzzle)
- This presentation:
  - analyses some of the differences and similarities between countries with *CA* surpluses, and
  - focuses on the question of the need to rebalance these surpluses

Introduction

- Although there are **some differences** between these countries in terms of
  - openness, changes in world export shares and competitiveness, and
  - the composition of savings and investment rates,

  … surpluses are mainly explained by **high saving rates**
- These *CA* surpluses do not imply low levels of **consumption**, higher rates of **unemployment** or low **investment.** There is no clear evidence that surpluses either affect **potential growth** or are **suboptimal** at the national level
- At the **international level**, it is difficult to ensure that correcting policies in surplus economies will benefit **specific countries** (e.g. those with higher U)
- **Avoid benign neglect**: countries should **monitor** *CA* imbalances, and their **causes, uses and effects**, to ensure that there is no misallocation of resources

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Chronic surplus countries: similarities and differences

- A useful **decomposition**:

$$\frac{CA}{GDP} = \frac{S-I}{GDP} = \frac{(S_h - I_h)+(S_f - I_f)+(S_g - I_g)}{GDP}$$

$$= \frac{X - M + IB + TR}{GDP}$$

- A large and persistent current account surplus is the result of:
  - a large and persistent gap between savings (*S*) and investment (*I*) for households, firms and the government
  - A large and persistent gap between exports (*X*) and imports (*M*), when net income balance (*IB*) and unrequired transfers (*TR*) are small

Chronic surplus countries: similarities and differences

Significant differences in export performance

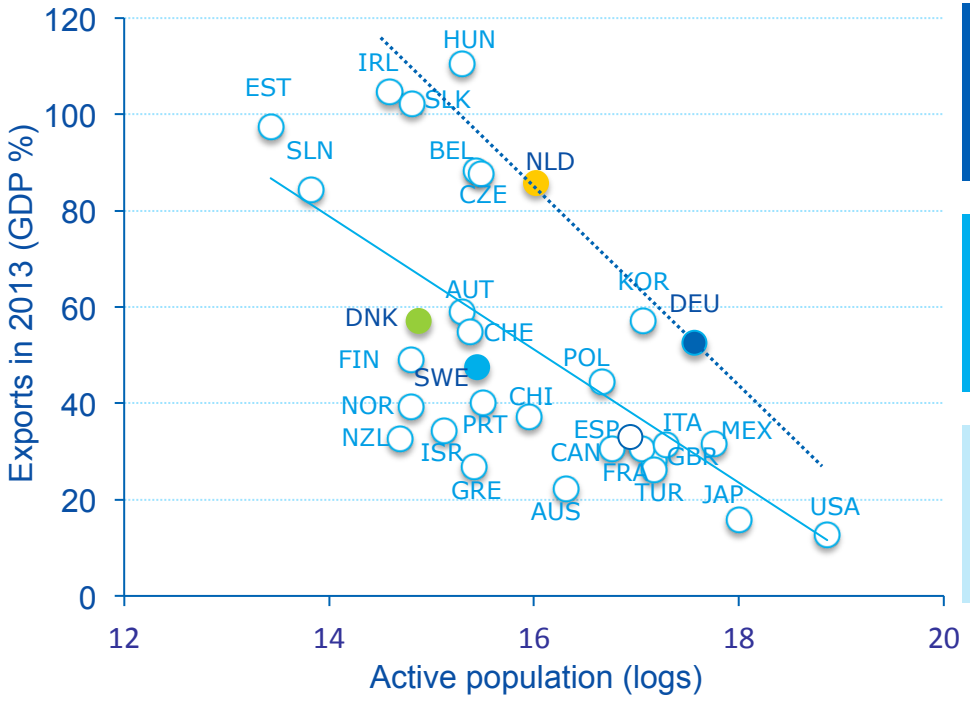
- Germany, Finland, Netherlands and Sweden have shown large and persistent surpluses in their current accounts
- There are some similarities but also **important differences in potential determinants of their current account balances** and export performance
- **Fact 1**: important differences in openness, after controlling for size
- **Fact 2**: different performance in their shares of world exports (1999-2011):
  - Similar changes in shares and differences in export prices changes (DEU vs. NLD)
  - Similar export prices changes and different changes in shares (DEU vs. FIN and SWE)
- **Fact 2**: differences in productivity, which could explain Facts 1 and 2 but not why these countries show large and persistent current account balances

Chronic surplus countries: similarities and differences

Significant differences in openness …

GDP share of exports and country size

Source: Andrés and Doménech (2015)



Larger economies are more open than smaller ones

Germany and Netherlands are relatively more open than Finland and Sweden, …

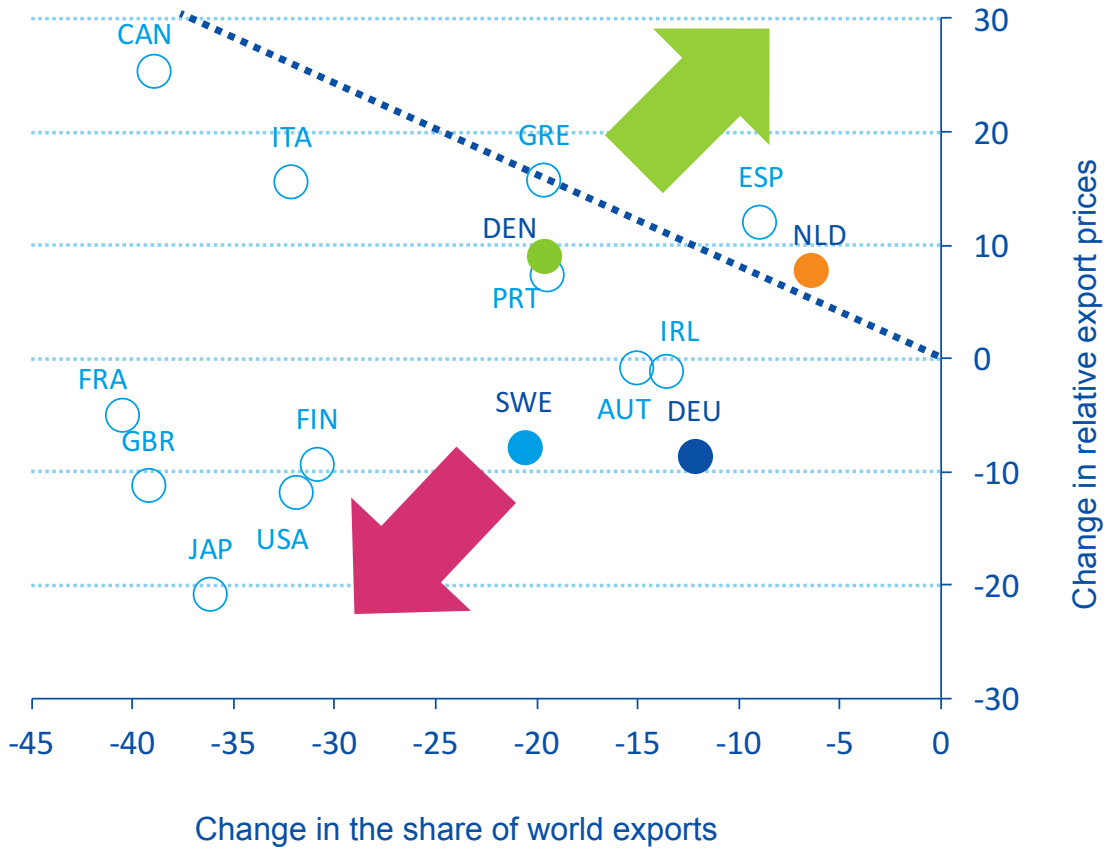
… even after taking into account the sizes of their economies

Chronic surplus countries: similarities and differences

… in changing shares of world exports ...

World export shares and REERs based on export price deflators, rate of change 1999-2011, (%)

Source: Cardoso, Correa and Doménech (2012)

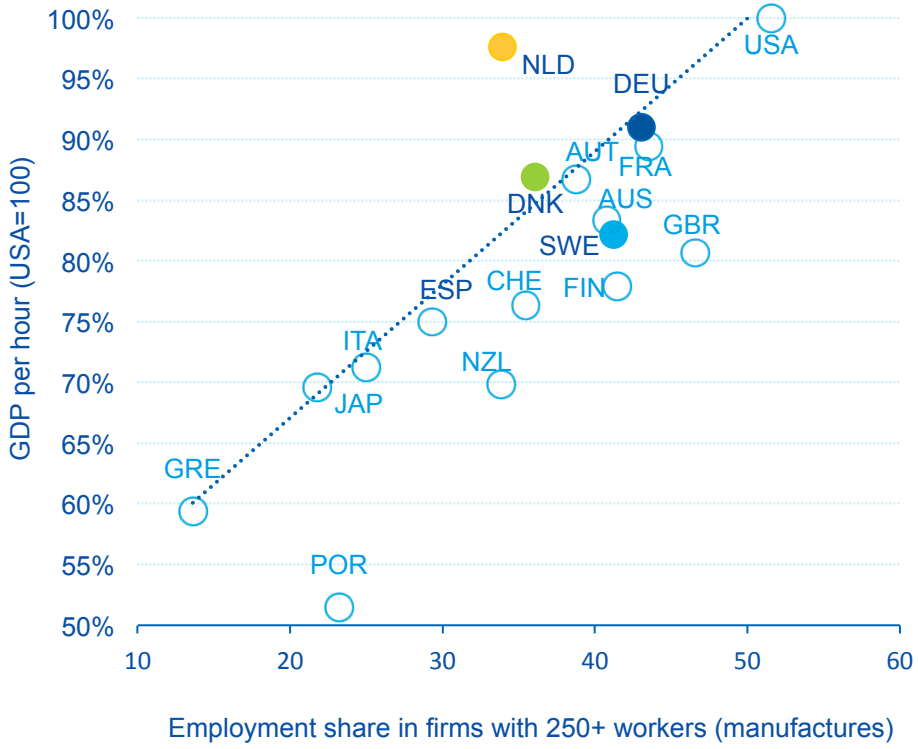


Chronic surplus countries: similarities and differences

… and in labour productivity

GDP per hour and average firm size, 2010

Source: Andrés and Doménech (2015) based on OECD *Entrepreneurship at a Glance* (2013)



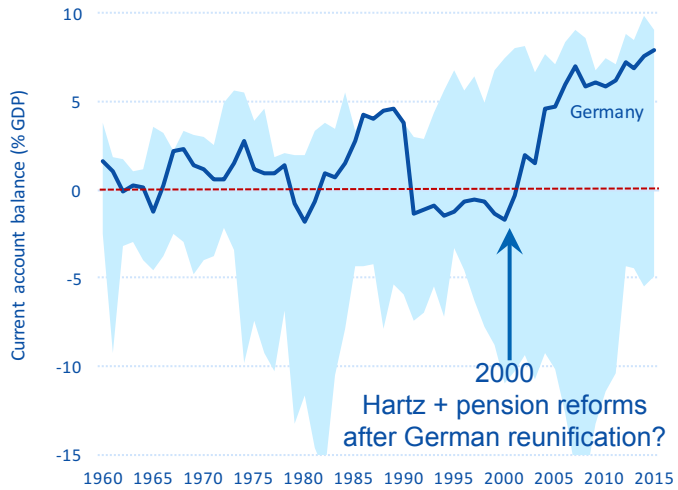
Export performance depends on productivity and the size of firms (which also determines investment abroad, e.g. MNEs)

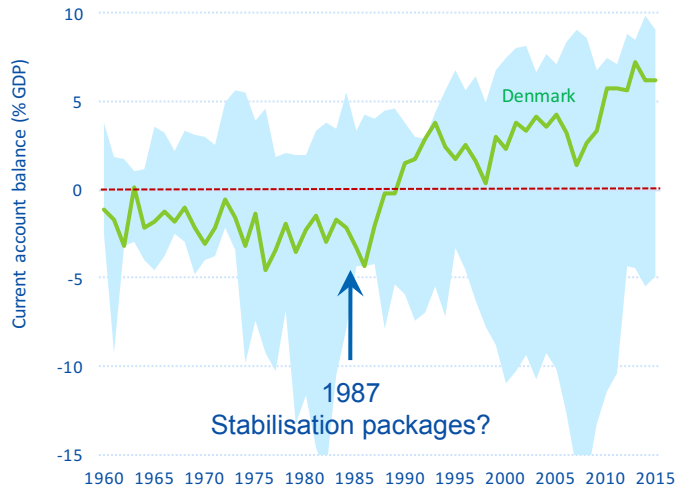
Countries with surpluses show similar share of employment in manufacturing firms with 250+ workers …

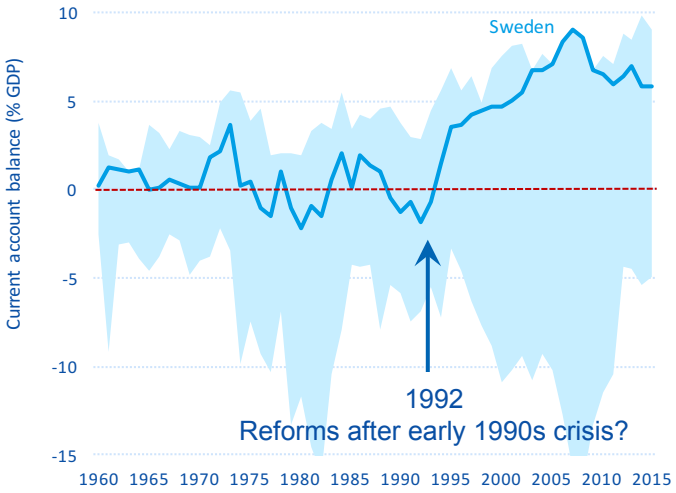
… but significant differences in productivity levels

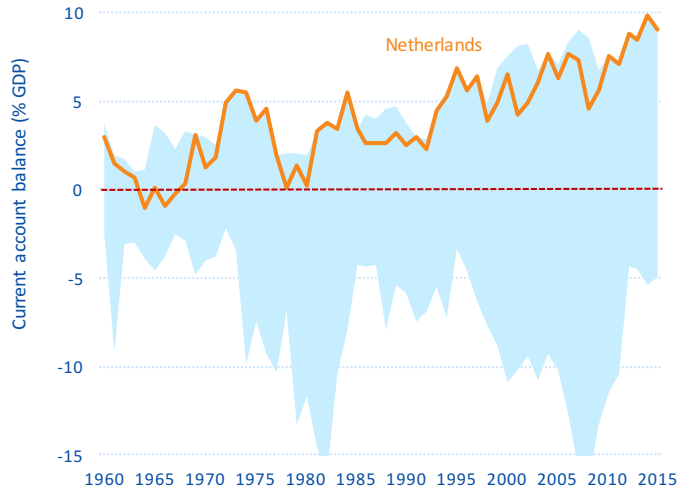
Chronic surplus countries: similarities and differences

Persistent surpluses began after different episodes ...



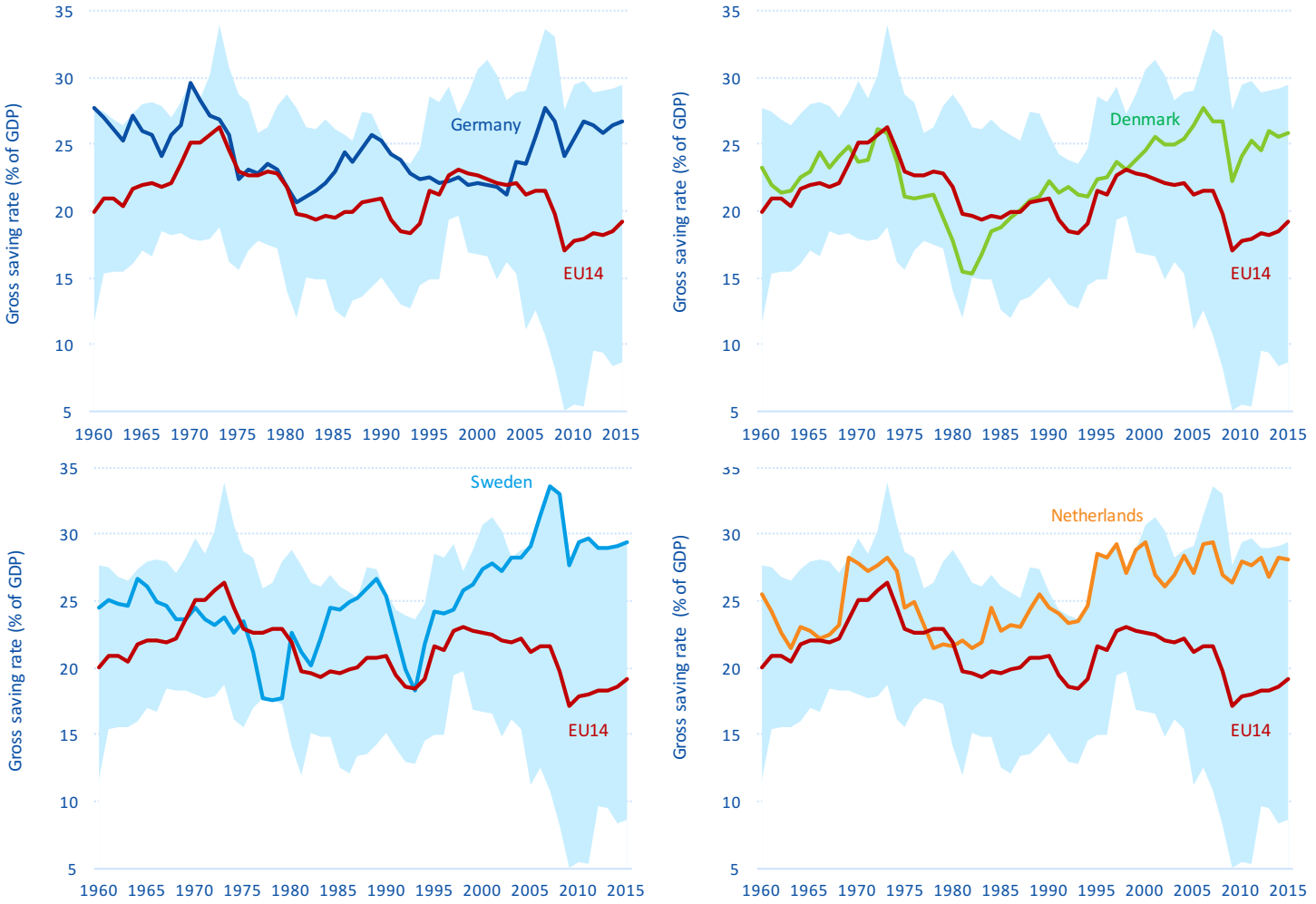






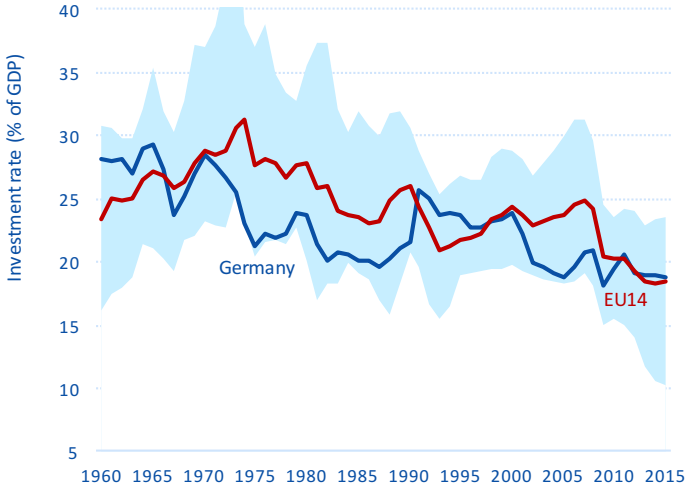
Chronic surplus countries: similarities and differences

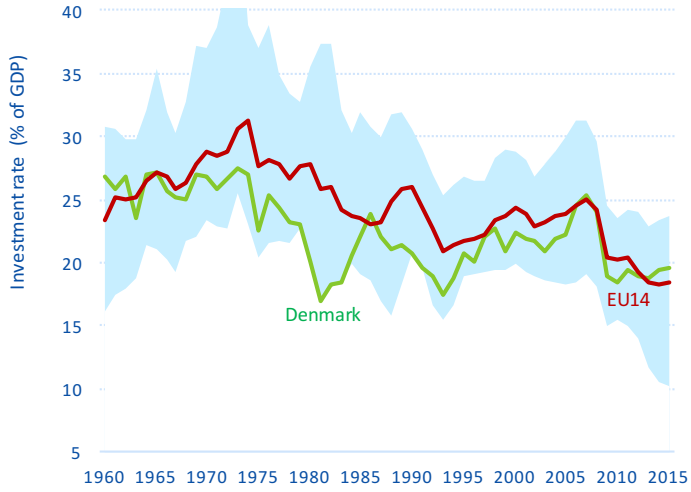
… reflecting higher national saving rates, whereas ...

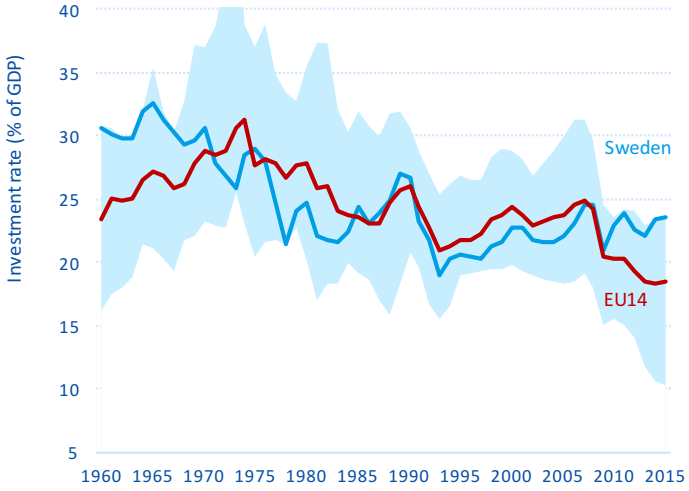


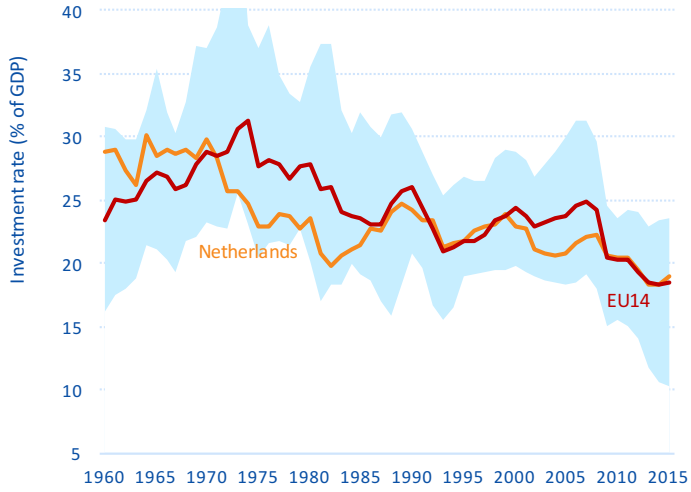
Chronic surplus countries: similarities and differences

… investment rates are similar to EU14 and 1980s levels









Chronic surplus countries: similarities and differences

Determinants of current account balances

- Economists have estimated “thousands/millions of models” with different determinants of current account balances:
  - Investment
  - Economic growth and relative income
  - Fiscal balance
  - Institutional quality (e.g. civil liberties)
  - Openness, terms of trade, oil balance, initial net foreign assets …
  - Financial integration
  - Demographic variables: population growth, dependency ratio, aging speed, …
- In some specifications, large and persistent deviations from fundamentals

(*) See Lane and Milesi-Ferretti (2007), Ca’Zorzi et al (2012) or Darvas (2015).

Chronic surplus countries: similarities and differences

Determinants of current account balances

- **Deviations** of current account balances **from model estimates** (residuals) are usually interpreted as **excessive**, calling for policy actions to correct these imbalances*
- **Alternative explanations**:
  - Models may be good at estimating common patterns but not necessarily at explaining country specific imbalances
  - Heterogeneity in coefficients or omitted variables (e.g. fiscal structure) may explain large residuals for some countries
  - Change in structural parameters (e.g. discount factor)
  - Interaction between variables (e.g. institutions and aging)

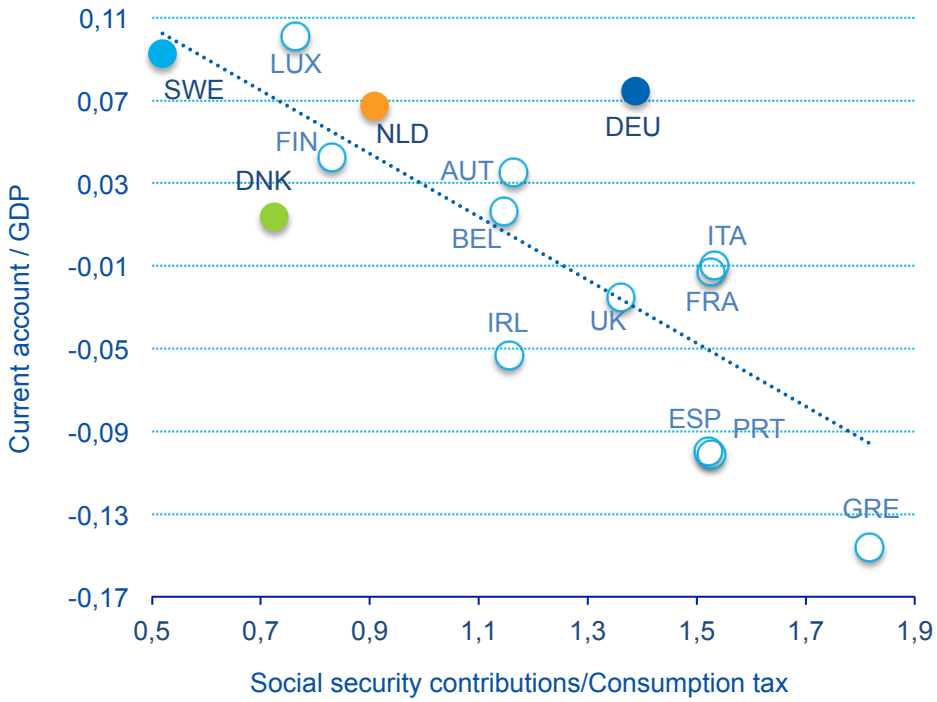
(*) See Darvas (2015) or Fratzscher (2015).

Chronic surplus countries: similarities and differences

Additional determinants of current account balances

Fiscal structure and the current account, 2007

Source: Boscá, Doménech and Ferri (2013)



The lower the ratio of social security contributions over consumption taxes the larger the surplus of the current account over GDP

The reduction of this ratio is known as a fiscal devaluation, as it makes exports cheaper relative to imports

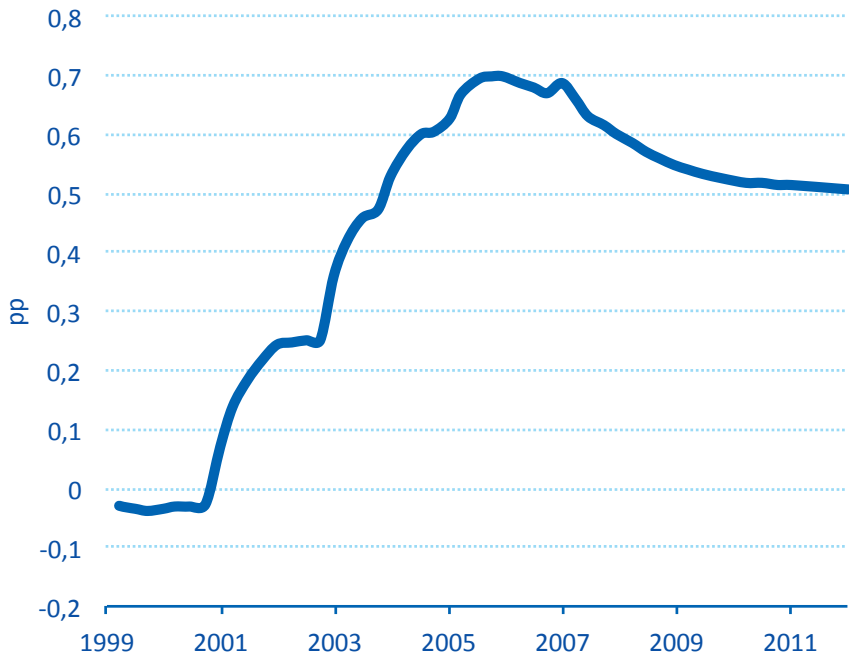
Additionally, capital income taxes may also contribute to increasing the saving rate and the CA surplus

Chronic surplus countries: similarities and differences

Additional determinants of current account balances

Impact on the German current account of a permanent time-preference shock

Source: Gadatsch, Stähler and Weigert (2015)



Changes in demographics and time-preference shocks also have significant effects on the current account balance:

A permanent increase in the German discount factor β from 0.992 (real interest rate of 3.2%) to 0.9932 (2.74%) …

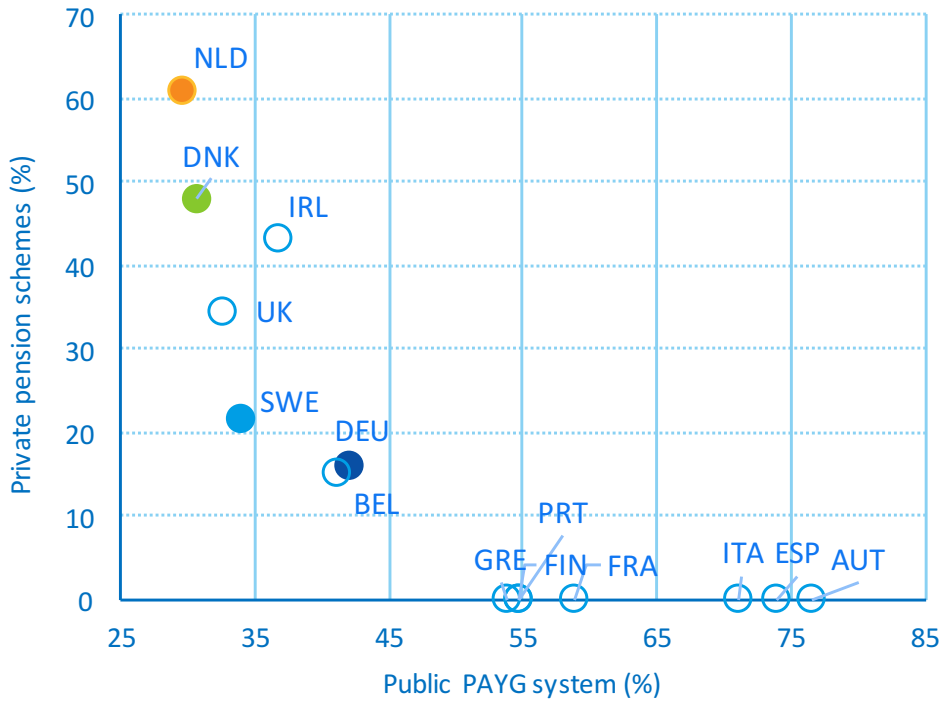
... could have generated a positive and persistent increase in the current account, combined with the reform agenda in the 2000s

Chronic surplus countries: similarities and differences

Additional determinants of current account balances

Gross pension replacement rates from public pensions and private schemes, 2013

Source: OECD Pensions at a Glance (2013)



Countries with CA surplus have low public pensions replacement rates …

… and high replacement rates from private schemes (both voluntary and compulsory)

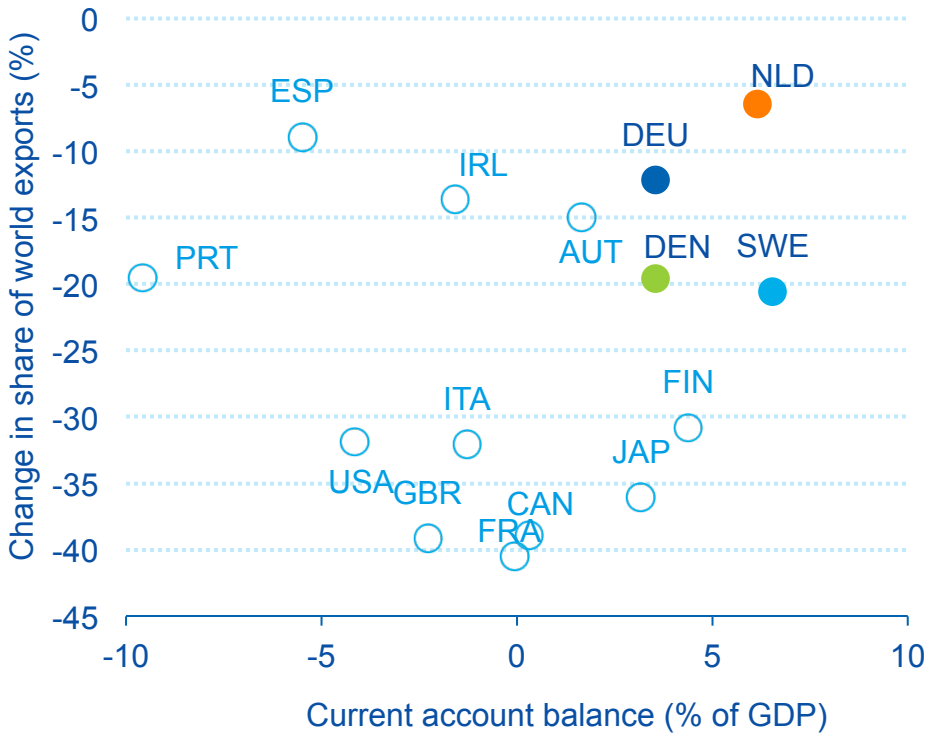
Notional accounts and increased contributions of the funded pension schemes increase saving rates

Chronic surplus countries: similarities and differences

Current account balances and export performance

World export shares and current account balances, 1999-2011 (%)

Source: Data from Cardoso, Correa and Doménech (2012) and AMECO



Current account balances are not a synonym for export performance:

between 1999 and 2011, some countries with large surpluses have been losing export share (e.g. Finland) …

… while others with large deficits (e.g. Spain) had better export performances than countries with *CA* surpluses

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2. Should governments rebalance large current account surpluses?

Three necessary conditions

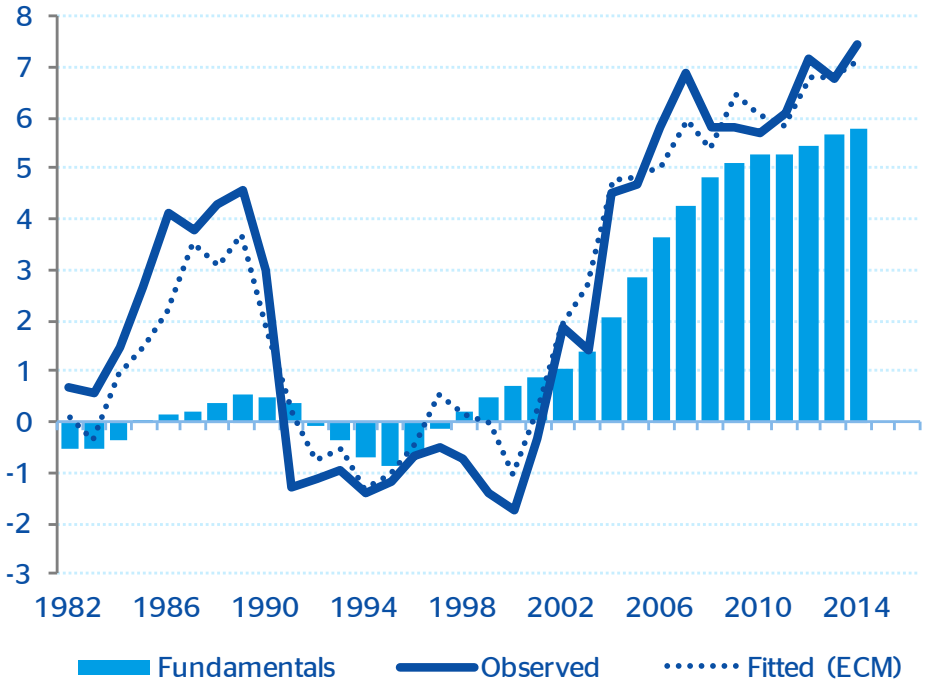
- **Necessary conditions**:
  - 1 Identify **market failures or negative externalities** that make large and chronic current account surpluses suboptimal
  - 2 Design of **appropriate policies**: the political economy of public policies
  - 3 **Implementation** of these policies: good institutional quality to ensure effectiveness
- These four European countries satisfy the third condition but I have serious doubts about the other two:
  - 2 Revealed preferences: if the private sector desires a high saving rate, could governments obtain the support of public opinion to embark on large budget deficits?
  - 1 Show that the saving/investment gap is not optimal: a very difficult task

2. Should governments rebalance large current account surpluses?

1. Model uncertainty

Germany: current account balance, 1982-2014

Source: BBVA Research (October, 2015)



Policy interventions are based on estimations of large deviations of CA from levels determined by fundamentals (e.g. Darvas, 2015)

But there are "thousands/millions of models" -> problem of model selection and uncertainty about the results

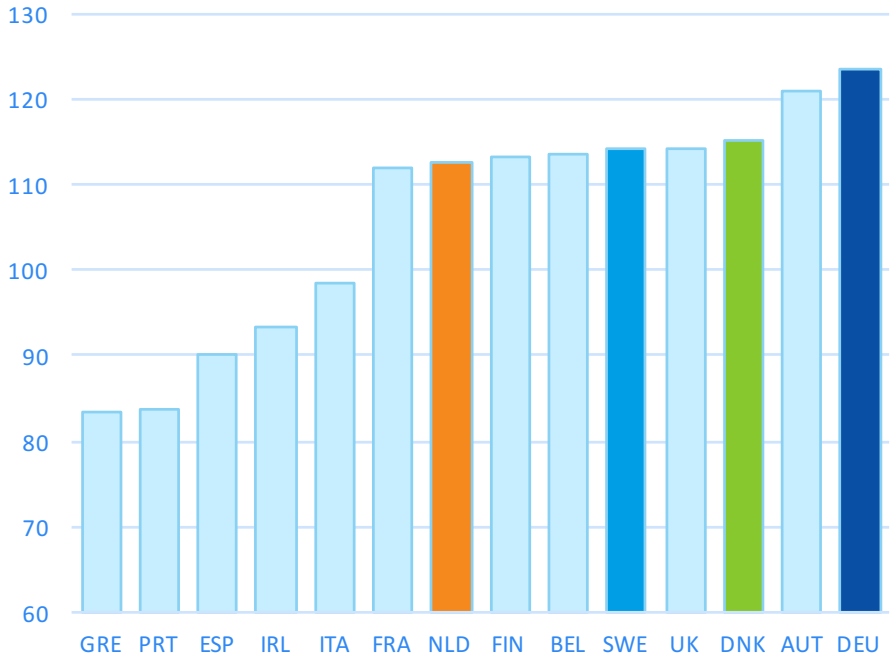
In 2012, our results showed the presence of large residuals for Germany, which in the current version of the model have disappeared

2. Should governments rebalance large current account surpluses?

2. Is consumption too low?

Actual individual consumption per capita in PPS, 2014

Source: Data from Eurostat (October, 2015)



Actual individual consumption per capita in surplus countries well above EU28 average

It is difficult to justify that these countries should increase their consumption levels …

… particularly when they have rapidly aging populations, and after pension reforms that reduce replacement rates*

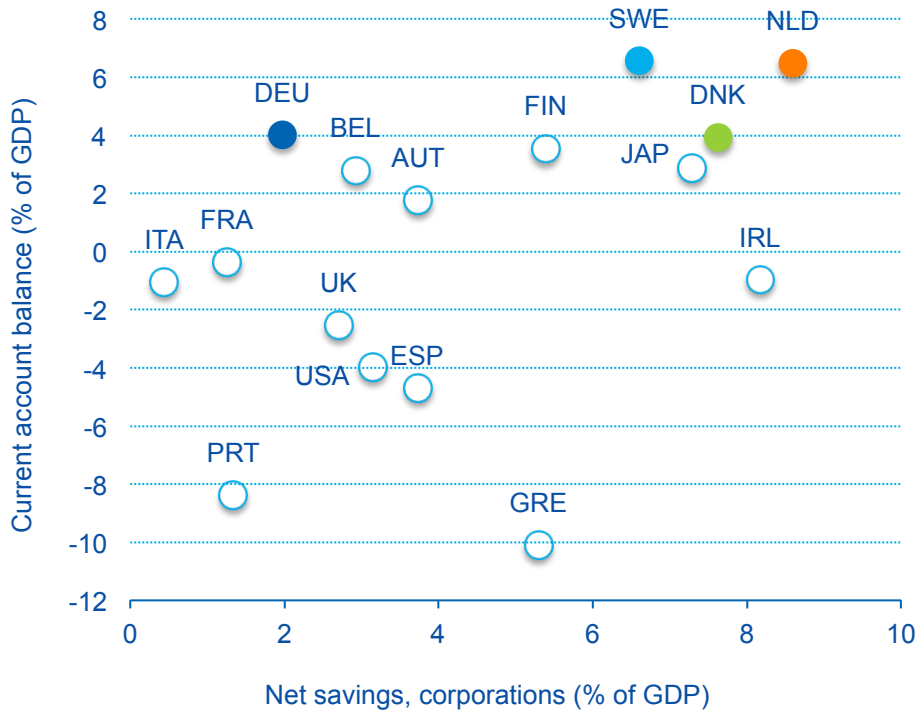
(*) See Kollmann, Ratto, Roeger and Vogel (2015).

2. Should governments rebalance large current account surpluses?

3. Are corporate savings too high?

Current account balance and net savings of corporations, 1999-2013

Source: Data from AMECO (October, 2015)



In many countries, large CA surpluses are explained by net savings by corporations that in some economies reflect large retained profits

Large firms (particularly MNEs) decide to invest at home or abroad depending on expected returns and risk assesment

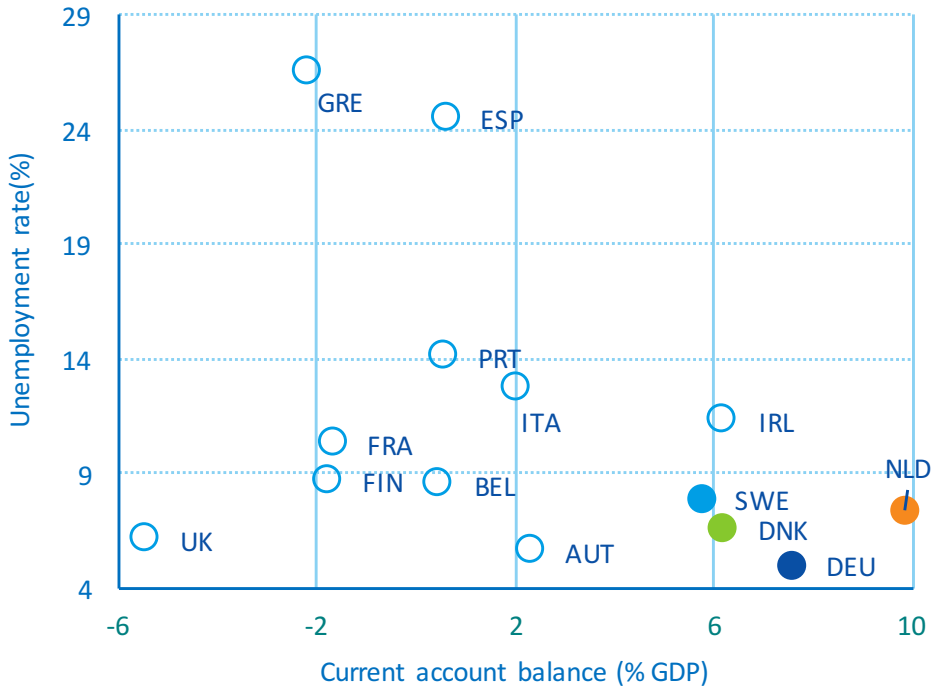
If expected returns (risks) are higher (lower) abroad than at home, it is optimal to invest in other countries

2. Should governments rebalance large current account surpluses?

4. Do current account surpluses increase unemployment?

Current account balances and unemployment rates, 2014

Source: AMECO (October, 2015)



In the years prior to the crisis, some countries (Spain, Portugal, etc.) had large deficits and lower unemployment rates

Using a symmetric line of reasoning, it could be argued that large CA surpluses may result in higher unemployment rates

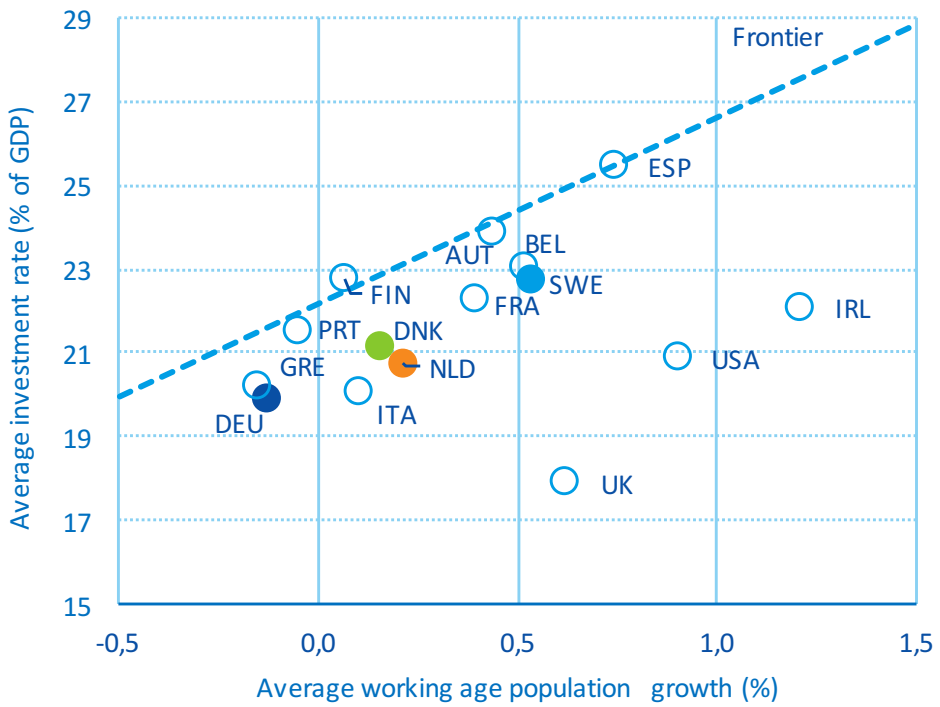
There is no evidence that large CA surpluses are at the cost of higher unemployment rates

2. Should governments rebalance large current account surpluses?

5. Is investment too low?

Investment rates and working-age population growth 2000-2014

Source: Data from AMECO (October, 2015)



Given working-age population growth, investment rates are close to the frontier obtained with standard growth models* ...

... much higher than in countries such as USA, UK or Ireland ...

... and similar to countries (Spain, Portugal or Greece) where investment rates should be corrected by efficiency (affecting their position)

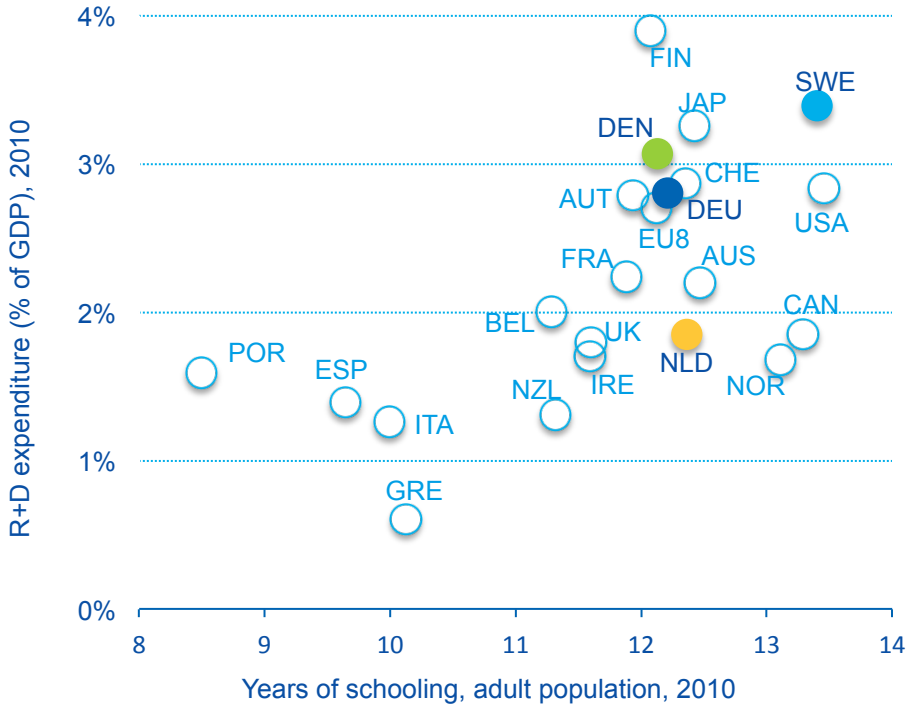
(*) The frontier has been obtained by solving for the investment rate in the Solow growth model as a function of population growth (*n*), the rate of technological progress (*g*), the output elasticity to capital (*a*) and capital in efficiency units for Spain. The slope of the frontier is given by (*g*+*n*), which is assumed to be equal to 5%, following Mankiw, Romer and Weil (1992).

2. Should governments rebalance large current account surpluses?

5. Is investment too low?

R+D expenditure and human capital

Source: Andrés and Doménech (2015) and de la Fuente and Doménech (2015)



Expenditures on research and development (as % of GDP) are well above the average of advanced economies ...

... as well as in human capital terms, giving an advantage in terms of potential growth

In the sample of four countries with large CA surpluses, only the Netherlands shows discrete levels of R+D expenditures

2. Should governments rebalance large current account surpluses?

6. Negative externalities on other (European) countries?

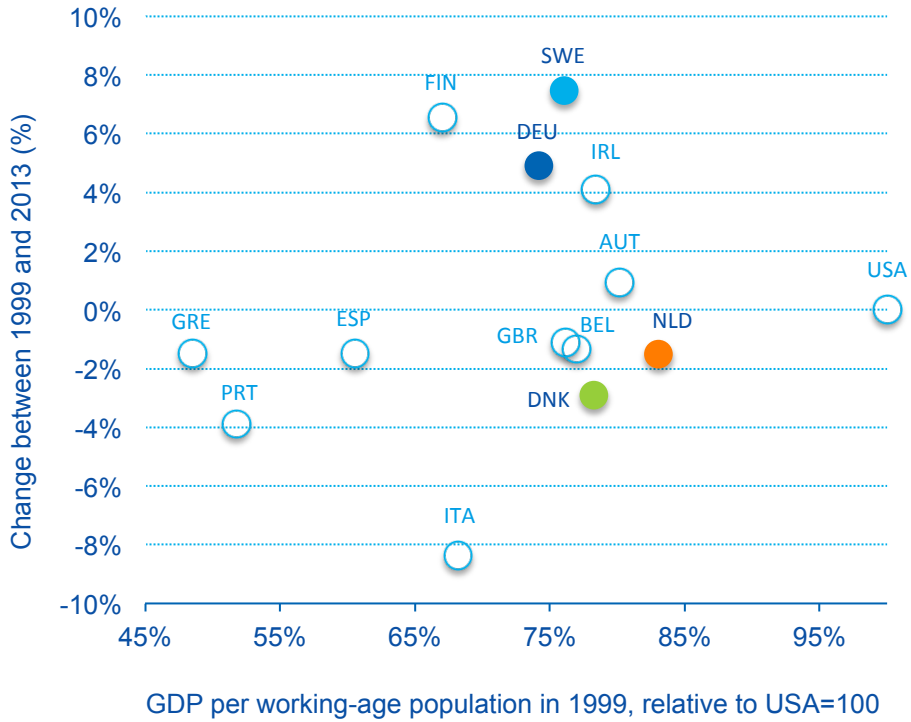
- **Main critique** to CA surpluses (e.g. Krugman 2013a and 2013b):
  - "in a world awash in savings, a world in which someone who decides to spend less and save more makes the whole world poorer" (paradox of thrift),
  - "by running inappropriate large surpluses, Germany is hurting growth and employment in the world at large", particularly in European peripheral countries
  - In the case of German and Dutch CA imbalances -> euro appreciation
- Growth models (Barro, Mankiw & Sala-i-Martin, 1995): **convergence** through *CA* imbalances -> **surpluses are equal to higher investment abroad** (e.g. German firms investing in Spain) -> **positive externality on other countries**
- **The balance** between negative (lack of foreign demand) and positive (FDI, low interest rates, convergence) externalities **depends on:** i) the level of **capital market integration**, and ii) **how capital flows are used**

2. Should governments rebalance large current account surpluses?

6. Negative externalities on other (European) countries?

Convergence in GDP per working-age population, 1999-2013

Source: Andrés and Doménech (2015)



The experience of the large CA imbalances in Europe after 1999 was negative. They did not favour convergence across countries

Capital mobility was inefficient: negative effects on deficit (misallocation of resources*) and surplus (negative valuation effects) countries

Looking forward, there is a trade-off between NIIP reductions and capital flows to countries with lower GDP per capita (balanced *CA*?)

(*) See Benigno, Converse and Fornaro (2015).

Conclusions

- Although there are **some differences** between surplus countries in terms of
  - openness, changes in world export shares and competitiveness, and
  - the composition of savings and investment rates,

  … surpluses are mainly explained by **high saving rates**
- So far, these *CA* surpluses are not implying low **consumption**, higher rates of **unemployment** or low **investment.** There is no clear evidence that surpluses affect **potential growth**, or that they are **suboptimal** at the national level
- At an **international level**, it is difficult to ensure that correcting policies in surplus economies will benefit **specific countries** (e.g. those with higher *U*)

Conclusions

- **Current account balances are neither good nor bad in themselves.** It is crucial to analyse how deficits or surpluses are used (proper evaluation of investment projects) and their effects over time
- When capital mobility is implemented inefficiently, it has negative effects on deficit (**misallocation of resources**) and surplus (**low ex-post returns and negative valuation effects**) countries
- When surplus countries export investment to deficit countries and it is used to increase productive capital (as in growth models), international **capital mobility is optimal** and **accelerates convergence** among them
- **Avoid benign neglect.** Surplus countries should **monitor** *CA* imbalances, and their **causes, uses and effects,** to ensure that there is no misallocation of resources and that investment abroad is optimal

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