Discussion of Current Account Imabalances in the Southern Euro Area: Causes, Consequences, and Remedies

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Goal, main results, policy implications

- The paper analyzes causes, consequences and policy implications of large current account (CA) deficits in the Southern Euro area

- Main results are as follows:
  - According to panel regressions, the European Monetary Union and the euro have allowed to finance investment at a higher level than domestic saving (that have declined), by giving the countries access to an international financial markets
  - According to equilibrium models, the CA deficits are excessive (larger than levels justified by the fundamentals) and, hence, risky for macroeconomic stability

- Policy implications: fiscal consolidation, internal devaluation, structural measures enhancing productivity/competitiveness, regulatory financial policies

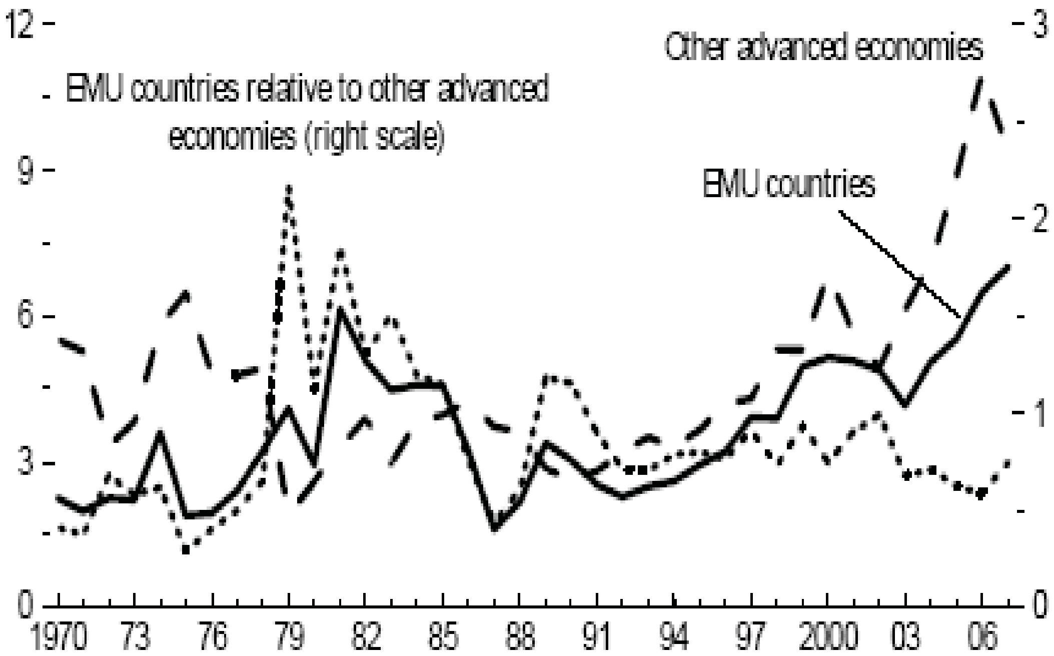
General remarks

- At global level, Faruqee and Lee (2008) find that the global dispersion of CA has increased steadily, consistently with higher financial globalization. Role of intertemporal trade and international risk sharing (Feldestein-Horioka puzzle)

- Convergence process in the euro area, taking into account of the monetary union and international dimensions

- Some other related contributions: Schmitz and Von Hagen (2009) suggest the introduction of the euro has favored some financial diversion; Decressin and Stavrev (2009) find that CA divergences across euro-area countries are smaller and have not risen relative to those across 13 other advanced economies with more flexible exchange rates

Figure 1. Current Account Dispersions
(Standard deviation of current accounts)



Sources: WEO, 2008, and IMF staff calculations.
1/ Based on current account balances in percent of GDP. Divergences are measured by the standard deviations across EMU countries and across the other advanced countries, respectively.

- From Decressin and Stavrev (2009)

The sign of the EMU and euro dummy variables seem plausible; however more discussion/robustness would be helpful

- Theoretically, the impact can be positive, as higher financial integration can make more efficient allocation of savings and effective risk sharing, stimulating saving (if households are not only risk adverse but also cautious/prudent)

- From the empirical point of view:

  – (a) It is not easy to distinguish EMU-related effects from euro-related effects, as the two structural changes are strictly related and there is strong interaction; for example the euro can be thought a driving force/catalyst of EMU

  – (b) Interpretation of the euro dummy: (borrowed) monetary policy credibility? Impact of euro on the domestic financial systems?

  – (c) Control for the very favorable international financial conditions/general trends during more recent years. They could have affected different euro area countries in a different way (long period of low interest rates, huge worldwide liquidity, stable macroeconomic outlook)

More robustness

- Following Chinn and Prasad (2003), you can include in the regressions:
  - Terms of trade volatility (higher volatility should increase CA, for precautionary saving reasons)
  - Square of relative per capita income to capture stage of development effects (to capture nonlinearities and U-shaped relationship)
  - Degree of openness (sum of exports and imports to GDP)

High uncertainty on long-run sustainable NFA/CA

- Relatively low number of observations under the monetary union regime

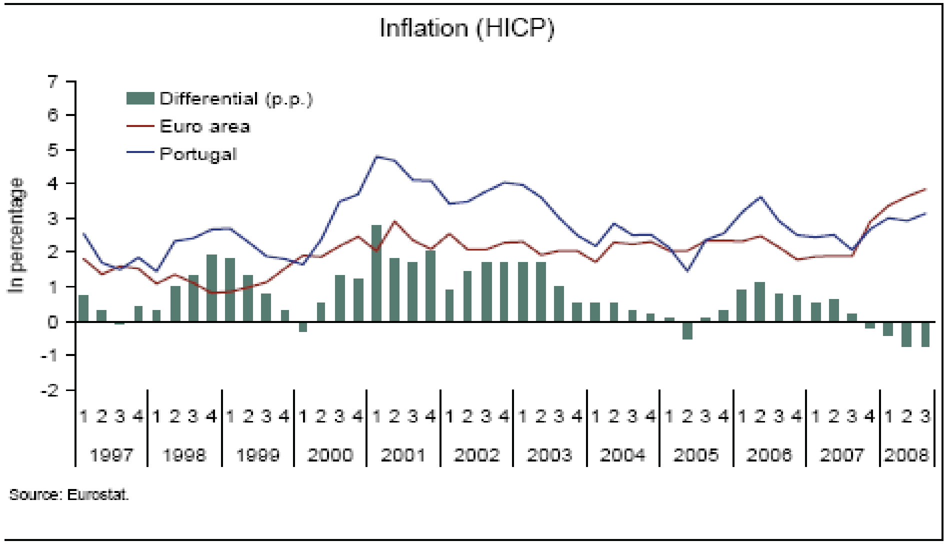
- Speed of CA adjustment is relatively low in a monetary union (in normal times)

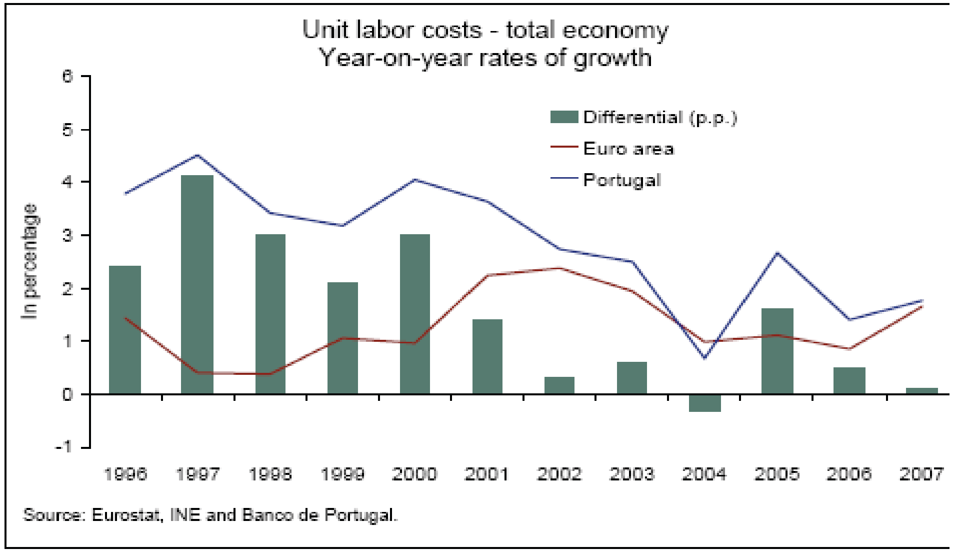
  - European Commission (2006): role of wage and price rigidities

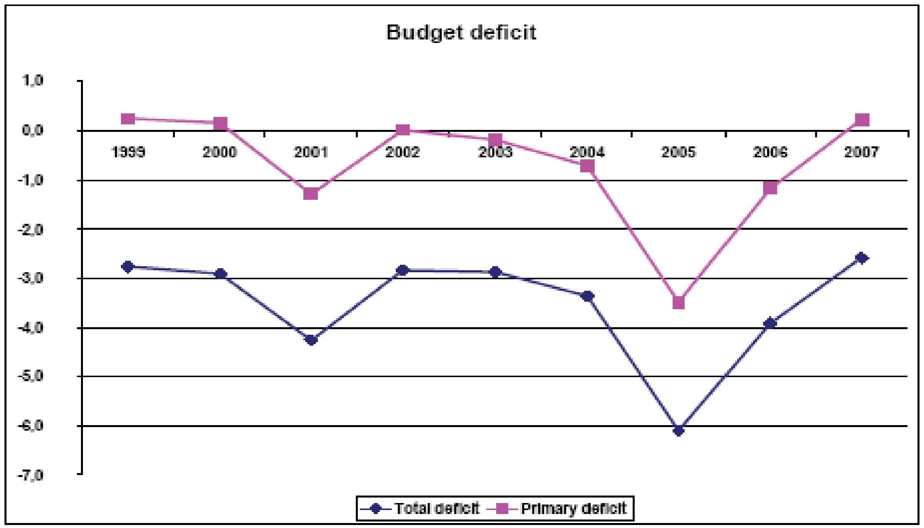
  - Bussire, Fratzscher and Müller (2004): the persistence is likely to be very high in a monetary union

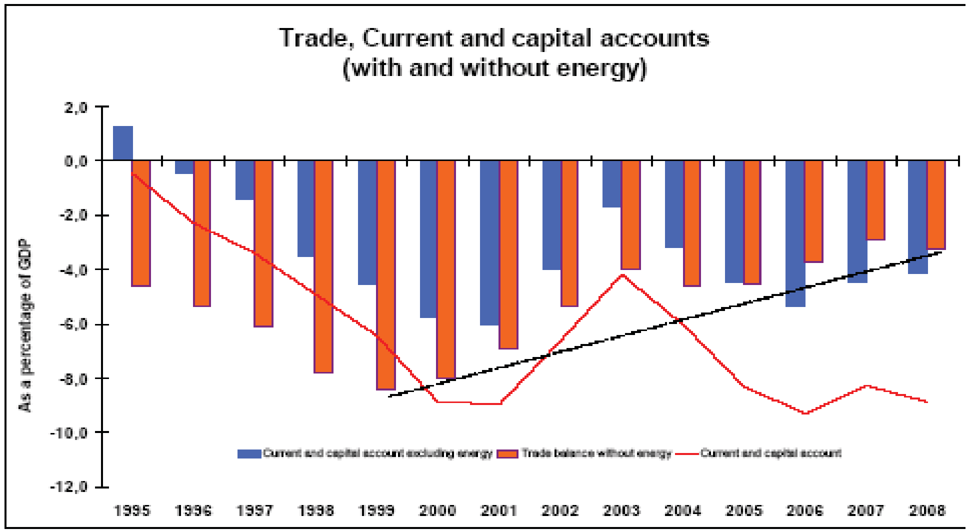
  - Decressin and Stavrev (2009): persistence of country-specific current account shocks in EMU countries is greater than in the other advanced economies

PORTUGUESE ECONOMY: FROM BOOM TO ADJUSTMENT









- From a 2008 discussion by Vitor Constancio

Long-run sustainable NFA/CA and liquidity issues

- Lack of an appropriate counterfactual such a country-specific crisis (that, differently from current crisis, does not imply the ECB intervention)

- More generally, how does large (but imperfect) financial integration affect the relationship between solvability, liquidity/sudden stops and current account (Milesi-Ferretti and Razin, 2008)?

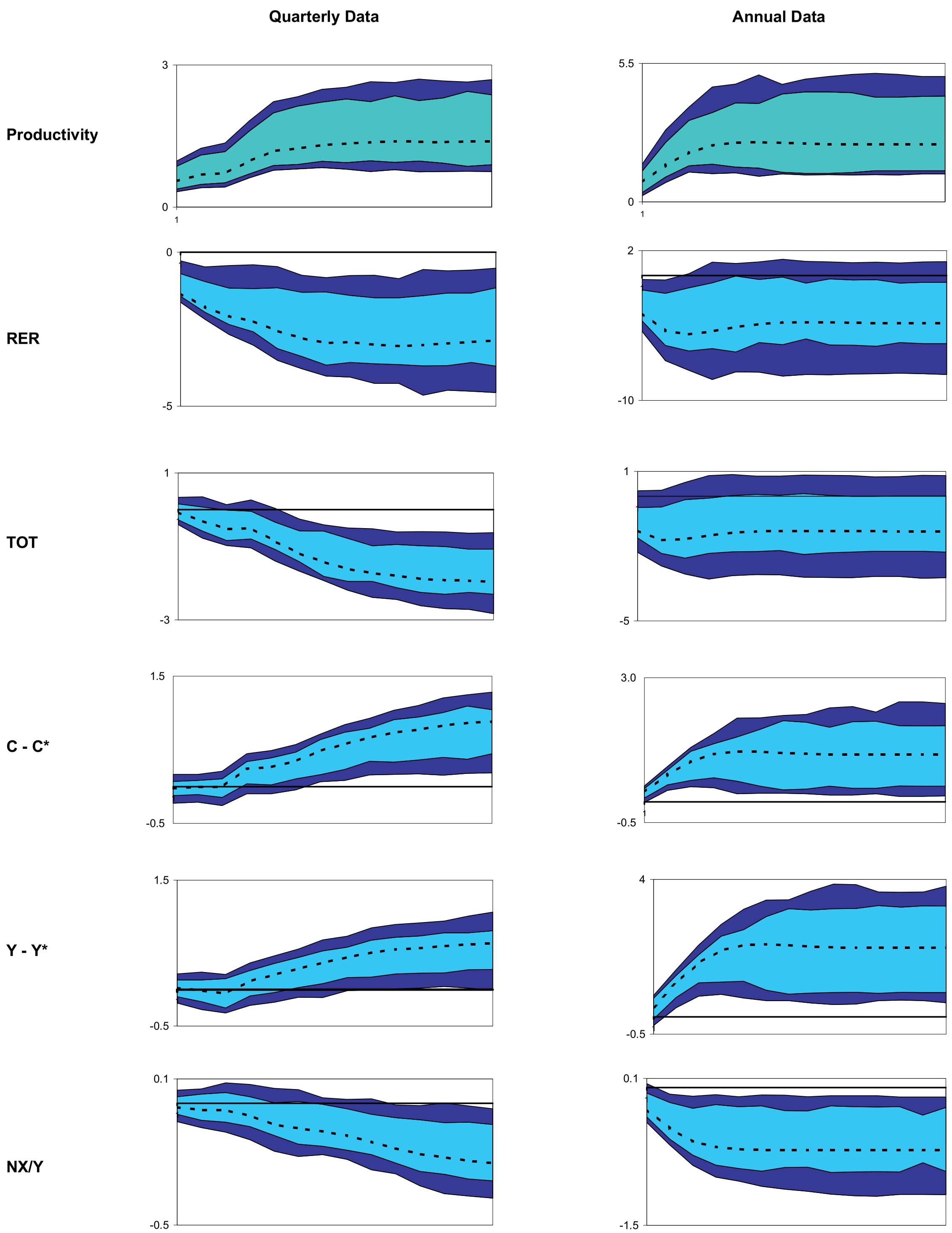
Policy Implications. Some caveats

- Fiscal consolidation as buffer against low private saving: however, fiscal effects on CA are a priori ambiguous (strength of Ricardian equivalence is crucial, see for example Erceg, Guerrieri and Gust 2005)

- Structural measures to improve productivity: they can further deteriorate the CA deficits because of strong wealth effect (even if the productivity increase is mainly in the tradable sector, see Corsetti, Dedola and Leduc 2006)

- Perhaps prudential macroeconomic financial regulation can give a big contribution, by systematically looking at balance sheets and financial institutions of borrower and lender countries

Figure 3
Impulse Responses to a Technology Shock in the Traded-Goods Sector



The first column describes the responses from a 6-variable VAR, using quarterly data. The variables are labor productivity, the real exchange rate, the terms of trade, relative consumtpion, relative output, and net exports. The second column shows the responses from a 4-variable VAR, using annual data. The variables are TFP, relative consumption, relative output, and, alternatively, the real exchange rate, the terms of trade, and net exports. All series are in percent.

Overall

- Very interesting paper and topic
- Possible extension to include acceding countries
- Relevant policy implications: appropriate euro area financial regulatory system and supervision