



The impact of financial regulation on current account balances



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ABSTRACT

Both global imbalances and financial market deregulation feature prominently among the potential causes of the global financial crisis, but they have been largely discussed separately. In this paper, we take a different angle and investigate the relationship between financial market regulation and current account balances, an area for which limited empirical evidence exists. We use a panel of countries over the period 1980–2010 and employ a novel empirical approach which allows us to simultaneously account for model uncertainty, current account persistence and unobserved heterogeneity. We find robust evidence that financial market regulations affect current account balances and that different aspects of these regulations can have opposing effects on the current account. In particular we find that easing bank entry barriers is negatively associated with the current account balance. In contrast, bank privatization and securities market deregulation tend to raise current account balances. Our results also highlight the importance to control for persistence and unobserved heterogeneity. Once we control for these factors, we find robust evidence for a wide range of current account theories in contrast to previous studies accounting for model uncertainty.

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1. Introduction

The role of current account imbalances in the global financial crisis and more recently in the euro area sovereign debt crisis is widely debated (e.g. Obstfeld, 2012; Chinn, 2013; Chen et al., 2012). Some authors go as far as seeing global imbalances prior to the crisis as the main cause of the crisis (e.g. Portes, 2009; King, 2009), while others take a more nuanced view and suggest that the root causes of the global current account imbalances and the financial crisis coincide (Obstfeld and Rogoff, 2010).¹ One such potential root cause is financial deregulation. Several authors have pointed to a link between financial deregulation and the crisis (e.g. Stiglitz, 2010; Keys et al., 2010), but the relationship between financial deregulation and current account imbalances has received little attention to date. Our main contribution in this paper is to take a step towards filling this gap by providing a thorough empirical analysis. Better understanding the link between financial regulation and the current account can help to inform the current policy discussions both on the design of more

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¹ Current account imbalances are not necessarily “bad” as they can reflect the optimal allocation of capital across time and space. However, they can also be symptoms of underlying domestic distortions, such as deficient financial market regulation, and spillover effects, for example arising from a sudden stop in deficit countries, can suggest a role for multilateral surveillance (Blanchard and Milesi-Ferretti, 2012).

robust regulatory frameworks of domestic and international financial markets and on how to better monitor and prevent global or regional imbalances.^{2,3}

To empirically investigate this link our approach builds on and contributes to the large literature estimating reduced form equations and including a wide range of potential current account determinants suggested by the theoretical and empirical literature (for early influential contribution see [DeBelle and Faruquee, 1996](#); [Calderón et al., 2002](#); [Chinn and Prasad, 2003](#)). [Ca' Zorzi et al. \(2012a,b\)](#) have recently criticized this standard empirical approach for ignoring the issue of model uncertainty given the large number of potential current account determinants and hence empirical models. They show that different economic and statistical criteria yield different models and no 'true' model appears to exist which can easily be labeled as superior to all others. They further demonstrate that model uncertainty is generally too large to draw any firm conclusions even about the sign of the coefficients. In order to address these challenges, [Ca' Zorzi et al. \(2012a\)](#) use Bayesian Model Averaging (BMA) techniques to account for model and parameter uncertainty. BMA allows examining a large number of potential models, weighting each one according to a fitness criterion, and providing a probability distribution for each coefficient estimate.

In this paper, we also use BMA techniques but extend the approach in [Ca' Zorzi et al. \(2012a\)](#) by considering a dynamic panel data setting and allowing for unobserved country-specific heterogeneity correlated with the regressors (e.g. [Moral-Benito, 2012](#)). By using a dynamic panel we allow for persistence in current account estimations, which is supported both from a theoretical standpoint, e.g. through habit formation in the consumption/saving behavior ([Bussiere et al., 2004](#); [Gruber, 2004](#)), as well as empirically (e.g. [Bussiere et al., 2004](#); [Calderón et al., 2002](#); [Arezki and Hasanov, 2009](#)).

Our findings suggest that extending [Ca' Zorzi et al. \(2012a\)](#) in this way has important implications. First, we find decisive evidence of persistence with the lagged dependent variable being one of the most robustly related current account determinants. Second, once we allow for dynamics and unobserved heterogeneity, we find robust evidence for a wide range of proposed current account theories. For example, we find strong evidence of a positive effect from fiscal balances on current accounts as well as proxies for demographics, stages of development, natural resource abundance and institutional quality. This contrasts with the findings in [Ca' Zorzi et al. \(2012a\)](#), who only find the net foreign asset position and the oil balance as robust current account determinants with an economically significant effect.

We pay particular attention the relationship between financial (de-)regulation and the current account. This relationship is theoretically ambiguous. On one hand, traditionally financial deregulation has been viewed to deepen financial markets, reduce transaction costs and facilitate risk management. This may encourage saving (e.g. [Edwards, 1996](#); [McKinnon, 1973](#); [Shaw, 1973](#)), and hence tends to raise the current account balance. On the other hand, financial deregulation may relax liquidity constraints, which could reduce the need for precautionary saving ([Mendoza et al., 2009](#)) and could fuel credit driven consumption and investment growth, and hence reduce the current account balance ([Ferrero, 2012](#); [Borio and Disyatat, 2011](#)). Which of these two effects dominates is therefore an empirical question.

Our results suggest that financial (de-)regulation is a robust determinant of the current account even after controlling for a wide range of competing theories and that the direction of the effect may depend on the particular area of deregulation. In particular, we find that the removal of bank entry barriers is negatively associated with the current account, consistent with the liquidity constraints view of financial deregulation. In contrast, we find that deregulating securities markets and privatizing banks tends to raise the current account balance. Hence, these aspects of deregulation seem to be more closely related to the saving enhancing view of financial deregulation, for example through a greater supply of and more sophisticated saving products. Our results therefore highlight the need to take a more nuanced view on financial deregulation, as different aspects can affect the current account in opposite ways.

The remainder of the paper is organized as follows. In [Section 2](#), we discuss the potential determinants of current account with special emphasis on financial regulation. [Section 3](#) outlines the econometric methodology that combines BMA with a correlated-random-effects panel estimator. [Section 4](#) presents and discusses the results. Finally, [Section 5](#) concludes.

2. Potential determinants of current account balances

2.1. Financial development and regulation

Financial (de-)regulation can affect the current account through the impact on saving and investment decisions.

The impact of financial (de-)regulation on investment is rather uncontroversial: by enhancing financial market development, financial deregulation is associated with higher investment (e.g. [Levine, 2005](#)). For example, [Caballero et al. \(2008\)](#) argue that underdeveloped financial markets led to a shortage of financial assets and hence investment opportunities in East Asia. This increased the demand for financial assets in the United States leading to capital outflows and current account surpluses in Asia. Similarly, inefficient financial intermediaries could drive a wedge between financial and capital returns to investment due to monitoring or transaction costs and lead to capital flowing from capital scarce to capital abundant countries ([Boyd and Smith, 1992](#); [Ju and Wei, 2010](#)).

² Examples of efforts to better monitor imbalances are the recent establishment of the G-20 Mutual Assessment Process (MAP) and the EU's Macroeconomic Imbalance Procedure (MIP).

³ While global imbalances have narrowed after the crisis, a substantial part of the reduction is likely due to cyclical factors, as demand has contracted more in deficit countries than in surplus countries. Once cyclical conditions normalize global imbalances are likely to widen again (e.g. [OECD, 2013](#)).

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