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Asymmetric credit growth and current account imbalances in the euro area

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Abstract

The euro-area crisis is often linked to the emergence of current account imbalances. As most of the deficit countries experienced pronounced credit booms at the same time that these imbalances were building up, this paper investigates the link between domestic credit developments and the current account balance. Using a panel error correction specification, the estimation results show that flows of bank loans to the non-financial private sector are a significant determinant of the current account and that they – together with changes in competitiveness – constituted the most important factor driving the build-up of current account imbalances in the deficit countries. Accordingly, impeding an increase in private sector indebtedness seems to be a promising way to dampen the formation of unsustainable current account imbalances.

Keywords: banks, credit growth, current account imbalances, euro area
JEL Classifications: E50, F32, F45, G21

1. Introduction

The euro-area crisis is often linked to the emergence of current account imbalances. When capital inflows receded, the deficit countries started to undergo a far-reaching adjustment process that was accompanied by severe negative repercussions for the real economy and the banking system. As a consequence, identifying the deeper causes of the current account imbalances that led to the crisis has been high on the policy agenda.

Up to the outbreak of the crisis, current account deficits were perceived as the result of a welcome catch-up process of lower-income countries (see, for example, Blanchard and Giavazzi, 2002; Campa and Gavilan, 2011; Schmitz and von Hagen, 2011). Research in immediate response to the crisis identified competitiveness and fiscal imbalances as the main causes (see, for example, Arghyrou and Chortareas, 2008; Belke and Dreger, 2013; Schnabl and Wollmershäuser, 2013; Zemanek, Belke, and Schnabl, 2010). More recently, attention has shifted to domestic demand and financial factors as the main drivers of current account imbalances.

Since the Eurosystem's interest rate policy is directed at the euro-area average, EMU countries were characterized by widely diverging monetary policy conditions (see, for example, Ahrend, 2010). Building on a modified version of the Walters (1990) critique, Wyplosz (2013) argues that, in countries where monetary policy was too loose, domestic demand boomed and led to a deterioration of the current account. The loss of competitiveness was then a mere reflection of the increase in demand, not the cause of the current account imbalances. Comunale and Hessel (2014) apply this idea to the data and show that domestic demand fluctuations at the frequency of the financial cycle are the main driver of current account dynamics, whereas changes in competitiveness play only a minor role.

I link these contributions to the literature on the relation between domestic and external debt dynamics. Lane and McQuade (2014) find that domestic credit growth is driven by net debt inflows. However, this result is less clear-cut when net debt flows are instrumented to address potential endogeneity concerns. Based on a cointegration analysis, Cuestas and Staehr (2015) show that domestic credit error corrects deviations from its long-run relation with net

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