



External adjustment and the global crisis[☆]

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ARTICLE INFO

Article history:

Received 9 August 2011

Received in revised form 22 December 2011

Accepted 27 December 2011

Available online 4 January 2012

JEL classification:

F31

F32

Keywords:

Current account

Financial crisis

External adjustment

ABSTRACT

The period preceding the global financial crisis was characterized by a substantial widening of current account imbalances across the world. Since the onset of the crisis, these imbalances have contracted to a significant extent. In this paper, we analyze the ongoing process of external adjustment in advanced economies and emerging markets. We find that countries whose pre-crisis current account balances were in excess of what could be explained by standard economic fundamentals have experienced the largest contractions in their external balance. We subsequently examine the contributions of real exchange rates, domestic demand and domestic output to the adjustment process (allowing for differences across exchange rate regimes) and find that external adjustment in deficit countries was achieved primarily through demand compression, rather than expenditure switching. Finally, we show that changes in other investment flows were the main channel of financial account adjustment, with official external assistance and ECB liquidity cushioning the exit of private capital flows for some countries.

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1. Introduction

The period preceding the global financial crisis that began in 2008 was characterized by widening current account imbalances across the globe, reflecting a variety of factors: rising oil prices, credit booms and asset price bubbles, and generally easy external financing conditions. The global crisis was associated with a dramatic change in these conditions: sharp declines in asset prices and oil prices, tightening credit, and a drying-up of external finance for several heavily indebted countries, some of which turned to external assistance from the IMF and the European Union. Evidence on the impact of the crisis on output and demand suggests that countries running large current account deficits during the pre-crisis years were the most severely affected, with declines in domestic demand being particularly dramatic (Lane and Milesi-Ferretti, 2011).

In this paper, we analyze the external adjustment process following the financial crisis. Our hypothesis is that pre-crisis current account imbalances widened beyond levels consistent with sustainable medium-term positions. The emergence of large imbalances was facilitated by a benign global financial environment, with low risk aversion among lenders and borrowers coupled with over-

optimistic expectations about future growth in deficit countries and amplification mechanisms associated with rising housing and financial asset prices in recipient countries.¹ As a result, a number of countries borrowed heavily, with net external liabilities quickly expanding. For example, in 2000 average net external liabilities were around 36% of GDP in Greece, Portugal, and Spain, and around 38% of GDP in the Baltics. By the end of 2007, average net external liabilities amounted to 87% of GDP in the three euro countries and close to 70% of GDP in the Baltics. After this rapid expansion in external liabilities, external conditions changed drastically during the crisis, triggering a painful process of current account adjustment.

In our empirical analysis, we first seek to establish the extent to which current account balances prior to the crisis exceeded levels consistent with underlying economic fundamentals. We next ask whether the current account adjustment following the crisis was indeed sharper in countries where pre-crisis “excesses” were more evident. The answer to this question is a resounding yes—countries whose current account balances were in excess of what could be explained by standard economic fundamentals prior to the crisis also experienced the largest contractions in their external balance.

We subsequently examine how external adjustment has taken place. Have real exchange rate movements contributed through an expenditure-switching channel? Or has expenditure reduction been the primary mechanism for the closing of excessive deficits? Has the adjustment experience differed between countries with fixed

[☆] Revised version of paper prepared for the NBER-Sloan Global Financial Crisis Conference, Bretton Woods, June 3–4 2011. The views expressed in this paper are those of the authors and do not necessarily reflect those of the IMF or IMF policy.

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¹ On the relation between housing prices and current account balances see, for example, Aizenman and Jinjarak (2008).

versus flexible exchange rate regimes? The evidence suggests that the adjustment in deficit countries took place primarily through a compression of output and demand. In fact, among pegging countries, real effective exchange rates tended to appreciate in countries experiencing reductions in the current account deficit, while the correlation between changes in real exchange rates and changes in the current account balance was only weakly negative in countries with an intermediate or floating regime. Finally, we turn to a closer examination of the behavior of capital flows during this period. We ask two questions. First, we investigate what types of flows were associated with changes in current account balances. Second, we explore the role played by official flows (including automatic flows among member central banks within the euro area) in the adjustment process.

Our contribution is linked to the literature on global imbalances (see, for example, Obstfeld and Rogoff, 2010 and Blanchard and Milesi-Ferretti, 2010 for recent discussions). However, our focus is on the evolution of the current account balances relative to domestic GDP across a wide range of advanced economies and emerging markets, rather than on the absolute size of cross-border borrowing and lending. Our paper is also related to the burgeoning empirical literature seeking to explain medium-term current account behavior across countries (see, for example, Chinn and Prasad, 2003; Gruber and Kamin, 2007; Chinn and Ito, 2007; Lee et al., 2008 and Gagnon, 2011). While our empirical medium-term current account model is very related to the ones used in those papers, our primary goal is to exploit the model to construct a “fitted” current account series that allows us to check whether current account movements after the crisis have gone in the general direction of reducing divergences between actual and fitted current account balances. Finally, our work is linked to the literature on current account reversals and sudden stops (see Milesi-Ferretti and Razin, 2000, Adalet and Eichengreen, 2007 and Freund and Warnock, 2007, amongst others). While that literature largely focuses on country episodes of large current account improvements drawn from different time periods, we analyze the cross-section of current account adjustment for a specific time period, simultaneously looking at both deficit and surplus countries.

The remainder of the paper is organized as follows. Section 2 presents some stylized facts about the behavior of current account balances during the crisis and also provides a brief review of the theoretical literature on the external adjustment process in the event of a global financial shock. Section 3 presents an empirical analysis of current account behavior and adjustment mechanisms and also discusses alternative hypotheses on the factors driving post-crisis current account adjustment. Section 4 concludes.

2. The compression in current account balances, 2008–2010

Fig. 1 plots the standard deviation of the cross-country distribution of current account balances (expressed as ratios to GDP) over the 1995 to 2010 period.² The figure captures the sustained increase in dispersion over 1997 to 2008, with an especially sharp increase from 2004 onwards, followed by a substantial compression since 2008. Fig. 2 provides a selective view of the size of current account adjustment in different countries and regions. In particular, the figure shows the dramatic reduction in current account deficits in Central and Eastern Europe, the sizable but much smaller reduction in deficits in the euro area periphery, as well as the substantial decline in current account surpluses in China and oil exporters. The figure also illustrates that changes in the “oil balance” did not play a central role in the adjustment, with the rebound in oil prices in 2010 offsetting the decline in the early stages of the crisis.

² Our focus in this paper is on external balances vis-à-vis each country's GDP, since we are interested in country-level macroeconomic adjustment issues. For other purposes—for example, tracking global imbalances—it would be more appropriate to scale imbalances by global GDP.

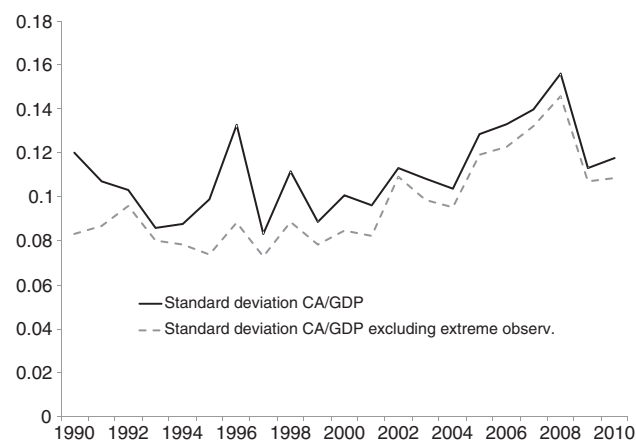


Fig. 1. Standard deviation of current account balances, 1990–2010. Note: Cross-country standard deviation of current account balances (ratios to GDP). Sample excludes Timor Leste. Sample excluding extreme observations (dotted line) also excludes Brunei Darussalam, Equatorial Guinea, Kuwait, Nicaragua, and Qatar. Source: International Monetary Fund, International Financial Statistics and World Economic Outlook databases.

Our baseline view is that the process of widening current account imbalances during the period preceding the full-blown crisis (in particular 2005 to mid-2008) reflected a variety of factors, among which asset price booms and easy access to external finance were particularly crucial.³ The crisis was associated with a sharp increase in risk aversion, declining asset prices, and significant downward revisions to growth expectations for a variety of countries. Indicators such as the VIX on the S&P 500 or the corporate bond spread between AAA-rated and BAA-rated bonds clearly point to tighter financial conditions.

In terms of a conceptual framework, the body of work on ‘sudden stops’ (that is, rapid narrowing of external imbalances) is clearly relevant for analyzing the experience of deficit countries.⁴ In particular, models in which there is a global change in financial conditions are helpful in thinking about the compression in the cross-country distribution of current account imbalances.⁵ Furthermore, viewing the crisis as a global financial shock is desirable since such a perspective is also capable of explaining the enormous decline in gross capital flows during the most acute phase of the crisis (Forbes and Warnock, 2011, Milesi-Ferretti and Tille, 2011).⁶

Such a global financial shock might be captured by an increase in the risk premium charged on external liabilities or by an increase in financial home bias. For instance, Blanchard et al. (2010) develop a model of a small, emerging economy in which these different types of shocks can be analyzed, and show that both an increase in financial home bias and an increase in the risk premium are associated with a narrowing of the external balance and a decline in domestic output.⁷ Similarly, in the IMF's Global Economic Model, a general-equilibrium macroeconomic model of the world economy, an increase in the risk premium on external debt can be shown to deliver a reduction in external imbalances and a decline in output in debtor countries (see,

³ See Blanchard and Milesi-Ferretti (2010) for a narrative of the different phases of global imbalances.

⁴ Mendoza (2010) is one prominent recent example.

⁵ For the purpose of looking at adjustment over a two-year window, we view the crisis as a global financial shock, even if it was initially concentrated in the U.S. before turning global in late 2008.

⁶ A shortcut is provided by Obstfeld and Rogoff (2001, 2007a, 2007b). These authors simply impose a sudden reduction in current account imbalances and work out the implications for real exchange rate behavior. However, since they focus on endowment economies, they cannot provide ancillary hypotheses concerning the behavior of output during sudden stop episodes.

⁷ However, the exchange rate response differs across the different types of financial shock.

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