Journal of International Money and Finance 48 (2014) 291–313

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Current accounts and financial flows in the euro area

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A R T I C L E I N F O

Article history:
Available online 6 June 2014

JEL classification:
F32
F34
F36
F41

Keywords:
International financial flows
External imbalances
Current account
Euro area

A B S T R A C T

We construct a new database of bilateral financial flows among euro area countries and their major world partners and explore the role of financial links in the accumulation and then adjustment of current account imbalances in the euro area. The data show that the geography of financial flows can differ quite markedly from trade flow patterns and suggest that the nexus between surpluses in the 'core' with deficits in the periphery went along financial rather than trade interlinkages. In particular, the data document the dominant role of 'core' countries in financing the euro area periphery's current account deficits before the financial crisis, both directly and through intermediating financial flows from outside of the euro area. Most of this financing took the form of debt instruments. Following the withdrawal of private financing from 'core' countries during the crisis, the ECB-mediated funding and other official flows helped the periphery to refinance its liabilities and smoothen the external adjustment.

1. Introduction

Large external imbalances became a distinct feature of the economic landscape in the euro area in the run up to the crisis of 2007–8. Some of its members accumulated increasingly large and persistent current account deficits, while others posted high and equally persistent surpluses. At the onset of the crisis, the collective deficit of Greece, Ireland, Italy, Portugal and Spain was almost 7% of their GDP. The

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http://dx.doi.org/10.1016/j.jimonfin.2014.05.019
0261-5606/

surplus group, comprising Germany and the Netherlands among others, recorded a surplus of around 6% of their GDP. At the same time, the euro area as a whole, despite its economic weight and intensive participation in cross-border trade and finance, had a broadly balanced current account. This implies that the deficits were almost exclusively financed from the surpluses in other euro area countries.[1] Such 'downhill' capital flows from the capital-abundant 'core' to the catching-up periphery are a feature in line with theoretical predictions of inter-temporal approaches to the current account but hardly ever observed in reality (Lucas, 1990). The arrival of the crisis brought a 'sudden stop' to these flows (Merler and Pisani-Ferry, 2012). While the ECB-mediated flows softened the impact, external net borrowing of the deficit countries started to adjust quickly and, by the end of 2012, their current account positions were roughly balanced. On the other hand, current account surpluses have not substantially changed. As a result, the external position of the euro area has shifted into a surplus, which is expected to approach 3% of GDP if the current trends prevail (European Commission, 2014).

These developments highlight the role of financial flows and their geographical pattern both in the pre-crisis accumulation of imbalances and their post-crisis adjustment. The strength of financial linkages among the euro area countries has increased considerably in the pre-crisis period, riding on the wave of the global surge in gross financial flows and enjoying an additional boost from the establishment of the euro and, *inter alia*, the related convergence in capital costs (Lane, 2013; Hale and Obstfeld, 2014). The euro has thus resulted in the emergence of the 'euro bias' in the cross-border holdings of different classes of financial assets (see Section 4.1). For example, German banks were the main investors – directly and indirectly – in the Spanish construction sector. France, on the other hand, "specialized" in intermediating financial flows from non-euro area investors to the Mediterranean economies such as Italy and Greece.

We, therefore, investigate external positions of euro area countries in view of the boom in cross-border financial flows, both worldwide and in particular in the euro area. For this purpose, we build a new dataset of bilateral gross and net financial flows. We combine data on (mostly stocks of) different classes of foreign financial assets and derive the underlying flows by accounting for valuation changes. We then document the specific patterns of financial flows in the euro area and with main financial partners and analyze the way they contributed to the build-up and the ensuing adjustment of current account imbalances.

Several recent papers focused on bilateral financial linkages at the global level (see, e.g., Kubelec and Sá, 2010; Milesi-Ferretti et al., 2010; Gourinchas et al., 2012), while evidence on intra-euro area developments is rather scarce (see Waysand et al., 2010; Chen et al., 2013; or Hale and Obstfeld, 2014). Our work extends the existing literature in several aspects: first, the key conceptual contribution of this paper is to propose an approach to derive financial flows from the available data on stocks by estimating bilateral valuation effects on holdings of foreign assets. Such consistent data on cross-border financial flows has so far been missing and can be used for numerous analytical purposes. Most existing studies use bilateral *stocks* of foreign assets as reported in the original data sources, i.e., with mismatches between the reported bilateral liabilities from one country and the reported matching asset holdings from its partners. Second, the analysis zooms in on the situation in the euro area, which the bulk of existing research considers as a single entity. This often makes sense given the global perspective of much of this work. But it arguably hides important developments that are behind the accumulation of imbalances in the euro area and which are also shaping their adjustment and increasingly affecting the euro area's external position. Finally, we extend the time span of the data to cover the period 2001–12, which provides first insights into the behavior of financial flows in the period following the initial impact of the crisis. To our knowledge, none of the existing contributions goes beyond 2010. This does not allow them to analyze the effects of the euro area sovereign crisis on financial flows, which started in 2010, following the Greek public debt crisis and the launch of the EU- and IMF-sponsored adjustment program.

Our dataset documents several stylized findings: first, there has been an important degree of 'euro' bias in the gross as well as net financial flows. The current account deficits in the euro area periphery

[1] This applies to the *net* financing needs, which does not rule out important gross financial flows with the rest of the world, as will be documented in our paper.