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Current account imbalances and financial integration in the euro area

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While the current account of the euro area as a whole has remained almost balanced in the past two decades, several member countries have sizeable deficits or surpluses. In this paper, we interpret these imbalances as indicators of net capital flows among the euro-area countries. We distinguish between balances against the euro zone and the rest of the world and examine these for the EU-15 countries. We find that for euro members the net flows follow differences in per-capita incomes, even before the introduction of the euro. Our results show further that with the introduction of the common currency the elasticity with respect to per-capita incomes of net capital flows within the euro area has increased for the members of the euro zone. This increase can neither be observed for the flows between the euro members and the rest of the world nor for the flows between the countries that stayed outside the monetary union and the euro zone. We interpret this as evidence for increasing financial integration in the euro area. There is also some evidence suggesting that the introduction of the euro has led to some financial diversion.

1. Introduction

The observation of rising and persistent global imbalances has been the focus of lively debate among policy makers and academic economists in recent years. Most of that debate has concentrated on the large U.S. current account deficit and its main counterpart, the large current account surpluses of countries in Asia. Europe has not attracted much attention in this debate, most likely because European

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countries and the European Union as a whole have a long tradition of keeping their current accounts relatively close to balance (see Ahearne and von Hagen, 2005). Nevertheless, current account developments in Europe deserve attention, since current account imbalances within the EU and, in particular, among the countries participating in European Monetary Union (EMU) have grown considerably in recent years and are similar in size relative to GDP as those of the US or China. In view of these, policy makers in Europe have become concerned about the sustainability of the common currency.

A natural question to ask is whether these imbalances can be explained by fundamental economic factors. EMU itself may, in fact, be one of these fundamental factors. One of the most important benefits to be expected from monetary union is deeper financial market integration, as markets become more transparent and transaction costs are diminished. In addition, Arellano and Heathcote (2010) show that permanent restrictions on domestic monetary policy can increase sovereign borrower's credibility in international financial markets and consequently increase a country's international financial integration. Recent empirical studies have indeed found evidence suggesting that financial market integration has increased due to the introduction of the common currency.[1] That financial integration has increased can be inferred from both price and quantity data in financial markets. Regarding price data, correlations in bond returns are very high in the euro area and, until recently, spreads across government bond yields have narrowed.[2] Asset prices in the euro area increasingly conform to the law of one price, as they should in integrated markets; see e.g. Jappelli and Pagano (2008), Pagano and von Thadden (2004) and Laopodis (2008) for bond markets and Lane and Walti (2007), Davis et al. (2005) and Kim et al. (2006) for stock markets.

Regarding quantity data, the introduction of the euro has led to a significant increase in cross-border asset holdings. Lane (2006) finds that, controlling for other relevant influences, bilateral bond holdings in the euro area are almost twice the size of bilateral holdings among other countries. Lane and Milesi-Ferretti (2007) document a similar effect of EMU on cross-border equity holdings. Lane and Milesi-Ferreti (2008) document that, with the creation of the euro, cross-border asset and liability positions increased faster in Europe than in the rest of the world. Based on a gravity model of international asset holdings, Pels (2010) finds a significant euro effect in bilateral asset positions. Berkel (2006) finds a similar result for German gross portfolio flows in a panel covering 47 countries from 1987 to 2002. Spiegel (2009a) shows that Portugal and Greece significantly increased their borrowing from euro-area countries while reducing their borrowing from non-euro area countries, an observation which leads to the question whether the introduction of the common currency might have induced financial diversion similar to the possibility of trade diversion in the creation of a free trade area.

Hale and Spiegel (2008) pursue this issue further. Based on micro-level data for private bonds issued in 22 countries, they find that the increase in euro-denominated issues operated predominantly along the extensive rather than the intensive margin, i.e., it represents predominantly new market participants in euro-denominated bond market rather than rising volumes of market participants that were active in the European market before EMU. Spiegel (2009b) shows that cross-border commercial bank claims among euro-area countries increased significantly relative to non-euro area countries and that this effect results predominantly from deeper financial integration. In sum, EMU has reduced the home bias that was previously found in national financial portfolios in the euro area (Lane, 2008).

Increased financial market integration in the euro area naturally leads to larger net capital flows among the member countries, and this should be reflected in their statistical counterparts, i.e., current account balances.[3] In this paper, we exploit a new data set to pursue that argument. Since current account data of individual countries vis-à-vis the euro area and the rest of the world do not exist, we

[1] For e.g. Lane (2008) provides a survey of recent studies of financial market integration in Europe.

[2] The recent widening of those spreads during the financial crisis that began in 2008 can be attributed to markets pricing differences in sovereign bond risk and is, therefore, not a contradiction to the proposition of increased market integration. Schuknecht et al. (2009) and Bernoth et al. (2004) show that investors were asking for differentiated risk premiums on sovereign bonds in the euro area even before the crisis.

[3] Slavov (2009) finds for a panel of 128 countries that current account balances of common currency arrangements (currency boards and currency unions) are more highly correlated with fundamental factors than current accounts of non-participants. And indeed, he can show that this greater sensitivity to fundamentals leads to larger current account imbalances.