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## Current accounts and oil price fluctuations in oil-exporting countries: The role of financial development<sup>☆</sup>



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### A B S T R A C T

Oil-exporting countries usually experience large current account improvements following a sharp increase in oil prices. In this paper, we investigate this oil price-current account relationship on a sample of 27 oil-exporting economies. Relying upon the estimation of panel smooth transition regression models over the 1980–2010 period, we provide evidence that refines the traditional interpretation of oil price effects on current accounts. While current accounts are positively affected by oil price variations, this effect is nonlinear and depends critically on the degree of financial development of oil-exporting economies. More specifically, oil price variations exert a stronger impact on the current account position for less financially developed countries, this influence diminishing with financial deepness.

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## 1. Introduction

For many oil-producing countries, oil windfalls constitute a significant source of foreign exchange and income. Indeed, as a result of the almost \$ 50 per barrel increase in oil prices over the 2002–2010

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period, global oil exports have boomed. For a broad sample of exporting countries, the value of fuel export earnings more than tripled to nearly \$ 1500 billion in 2010, being well above the previous 1980 peak in real terms.<sup>1</sup> Given the economic significance of oil gains, the way oil producers allocate their revenue windfalls has become an issue of key importance for both academics and economic policy makers. In particular, revenue windfalls allocation has, by definition, important implications for countries' current balances and then for the global pattern of current account imbalances (Blanchard and Milesi-Ferretti, 2009; Helbling et al., 2011; Arezki and Hasanov, 2013).

One key issue when dealing with resource revenue management—that has however received little attention in the literature on oil exporters—is the countries' level of financial development and its potential impact on resources' allocation. Indeed, countries with more developed financial systems, as they are relatively self-sufficient, are expected to invest a large portion of their savings in their domestic market. This mechanism is not a new one and was already being discussed in the literature related to the Feldstein–Horioka puzzle: countries with more developed financial systems should enjoy a high saving–investment correlation and then low external imbalances. International financial integration has led to a renewed interest in the role of financial development on global imbalances.<sup>2</sup> As suggested by Caballero et al. (2008) and Mendoza et al. (2009) among others, while financial integration favors capital mobility, heterogeneous degrees of financial development in different regions may explain the configuration of global imbalances.

Our paper falls into this strand of the literature and aims at investigating the oil price–current account nexus in oil-exporting economies by paying special attention to the degree of financial development. Going further than the existing literature, our contribution is twofold. Firstly, we extend the traditional analysis of the role played by financial development on oil countries' current accounts,<sup>3</sup> by investigating its *indirect* impact through the relationship between oil prices and current accounts. The baseline idea is the following: as financial deepening may serve both to achieve stabilization (by removing borrowing constraints) and precautionary savings (by creating a sovereign fund and rising foreign reserves), one can expect that financial deepness may affect the response of current account to oil price changes. Specifically, a well-developed financial system, by channeling more successfully oil revenue towards domestic investment and by lessening the need for precautionary saving, is likely to turn oil revenue windfalls into higher domestic investments. Therefore, a well-developed financial system may attenuate the positive impact of oil prices on the current account. Secondly, we test for the presence of nonlinearities in order to evaluate the extent to which the degree of financial development may mitigate this relationship. Including such threshold effects allows us to extend previous literature (see, e.g., Arezki and Hasanov, 2013) by accounting for and modeling the potential nonlinear impact exerted by the degree of financial development on the oil price–current account nexus. In this respect, our paper is part of a series of works highlighting the evidence of nonlinearities associated to oil prices,<sup>4</sup> current account patterns<sup>5</sup> and financial development.<sup>6</sup>

To address this nonlinear dynamics and investigate those interactions, our empirical analysis relies on a Panel Smooth Transition Regression (PSTR) specification for a sample of 27 oil exporters spanning the years 1980–2010. A major strength of this approach is to derive coefficients of current account responses to oil price changes which may vary between countries and with time, depending on the

<sup>1</sup> Source: IMF, International Financial Statistics. Fuel export earnings include 26 emerging and developing countries for which fuel exports exceed 50 percent of total exports. To estimate export earnings in real terms, we use the 2005 U.S. consumer price index.

<sup>2</sup> See, e.g., Chinn and Ito (2007) and Gruber and Kamin (2009).

<sup>3</sup> See references in Section 2.

<sup>4</sup> Hamilton (2009) lists three main contributions in this area: Hamilton (2003) who finds a bigger effect exerted by oil price increases than oil price decreases, Kilian (2009) who shows that price increases caused by surging global demand may have less effect than those brought about losses in supply, and Blanchard and Galí (2010) who evidence a higher resilience to oil price shocks over time.

<sup>5</sup> Chinn and Ito (2007) have shown that the assumption of linearity between current accounts and their main determinants may be quite restrictive for Asian countries. In particular, they find that the relationship between net savings and financial development is nonlinear, depending on the financial openness and the development of the legal system.

<sup>6</sup> Recent evidence highlights that the level of financial development exerts a nonlinear influence on economic growth. See Fung (2009) and Rousseau and Wachtel (2011) among others.

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