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Does capital mobility finance or cause a current account imbalance?

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Abstract

Using the Granger non-causality test, we find that the current account mostly Granger-causes the financial account of developed countries. For emerging market economies, however, the causality turns the other way around, although in the short run, depending upon the policy response imposed by each individual country toward the capital flows, there might be mixed results regarding the causality between the current account and the financial account. The financial account, as implied by its name, serves to finance the current account imbalance of developed countries, while capital mobility could push the current account into a state of imbalance in the case of emerging market economies. In addition, the causal results between the components of the financial account and the current account show that each component has different causal relationships with the current account. This means that countries without a sophisticated and sound financial system to channel funds to the proper location should exercise caution and not abruptly remove their restrictions on capital mobility. The pace and sequence of financial account liberalization should be heeded as well.

JEL classification: C32; F21; F32; F41

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1. Introduction

Haunted by the financial crises of the 1990s in emerging market economies (henceforth EMEs), there is increased concern that the U.S. might suffer a precipitous dollar depreciation together

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with a disorderly correction of its economy. This speculation is not groundless inasmuch as a persistent current account deficit has been perceived as being one of the leading indicators of the EME currency crises of the 1990s.[1] With the unprecedented growing current account deficits of the U.S. since the 1980s, it is hard to shrug off a possible devastating consequence, as warned by Obstfeld and Rogoff (2004) and Roubini and Setser (2004).[2] However, there is no shortage of arguments claiming that the U.S. is different and unique. As posited by McKinnon (2001) and Mann (2002), in view of the international dollar standard, the U.S. will not fall prey to sudden capital jitters like the EMEs.[3] Nevertheless, Bernake (2005) claims that the global savings glut is the cause of the U.S. current account deficit. As foreign investors seek out secure and profitable investments, the U.S. serves as a relatively reliable destination. Accordingly, the fears of there being an unsustainable current account deficit in the U.S. are overstated, particularly in the present era of globalization.[4]

With regard to adjusting an external imbalance, developed countries and developing countries are indeed different. Freund (2000) finds that the current account adjustments of developed countries are closely related to the business cycle. When an economy experiences a recession, the demand for foreign goods decreases and the current account improves. However, the current account deteriorates when the economy experiences an expansion. For developed countries, current account adjustments are more likely to be of only minor importance to the business cycle.[5] By contrast, the experiences of the EME currency crises of the 1990s indicate that a postponed current account adjustment plays a central role in dragging down the economy. A persistent current account deficit piles up net foreign debt and poses non-sustainability in the external balance. The ensuing reversal of the current account is usually accompanied by economic malaise.[6]

Chinn and Prasad (2003) also find that the factors that determine current accounts differ between developed and developing countries. One of the interesting findings is that the factors of the depth and sophistication of the financial system have a positive effect on the current account for developing countries, while the effect is not significant for developed countries.[7] This implies that with a mature financial system to channel funds in developed countries, a current account

[1] For how a persistent current account can ward off a pending currency crisis, see Corsetti, Pesenti, and Roubini (1999a) and Edwards (2002).

[2] Obstfeld and Rogoff (2004) estimate that for the U.S. to restore its external balance, the trade-weighted value of the U.S. dollar might have to depreciate 40%. Roubini and Setser (2004) consider different scenarios for possible U.S. current account adjustments in a global economic framework and argue that an unpleasant one seems unavoidable.

[3] McKinnon (2001) argues that with an international dollar standard, in which most of the world trade and assets are priced, there will be no such thing as a change of sentiment to abandon the U.S. dollar. Mann (2002) offers a broad view with three perspectives of the current account balance: one is national income, another is international trade, and the other is international capital markets. From them, she analyzes various possible scenarios for current account adjustments for the U.S.

[4] Bernake (2005) claims that the development and adoption of new technologies and rising productivity in the United States, together with the country's long-standing advantages such as low political risk, strong property rights, and a good regulatory environment, make the U.S. economy exceptionally attractive to international investors.

[5] In Freund (2000), 25 episodes of 25 industrialized countries between 1980 and 1997 are studied. Current account reversal begins when the current account deficit is about 5% of GDP, and it is associated with slowing income growth and a 10–20% real depreciation.

[6] The reversal of the current account is usually accompanied by a contractionary devaluation. See Frankel (2005).

[7] The indicator for financial deepening is proxied by M2 in terms of GDP. Chinn and Prasad (2003) use panel data analysis for 18 industrial and 71 developing countries over the 1971–1995 period and compare eight factors (selected from macroeconomic data) that affect either national saving or investment in order to examine whether the effects on the current account differ from developing to developed countries.