

Box 1.3: The cyclical component of current-account balances

This box shows data on the cyclically-adjusted current-account balances in the EU Member States. These data are particularly useful to the discussion of the nature of the adjustment in the vulnerable euro-area countries (Ireland, Greece, Spain, Cyprus, Portugal and Slovenia). For these countries, a key policy question is whether the current-account adjustment over the latest number of years has been cyclical (*i.e.* transitory) or non-cyclical (*i.e.* more permanent). If most of the reduction in the current-account deficits were cyclical, then one would expect the large deficits to reappear as soon as their economies recover and output gaps close. The available estimates suggest that most of the adjustment in the euro-area periphery has been non-cyclical. Therefore, one should not expect the current-account deficits in these countries to deteriorate over the foreseeable future to levels any close to those observed before the crisis.⁽¹⁾

The cycle, output, and demand

The business cycle consists of temporary movements in output and demand. The difference between output and domestic demand constitutes the trade balance, which in turn is the most important part of the current account. In that sense, the cyclical component of the trade balance directly follows from the cyclical components of changes in output and domestic demand. However, the trade balance is not only affected by the cyclical changes in domestic aggregates, but also by the cyclical movements in foreign demand and output.⁽²⁾ In this manner, imports reflect the cyclical component of domestic demand and foreign output. In contrast,

exports reflect (inter alia) cyclical effects in domestic output and foreign demand.

Table 1:
Current-account and cyclically-adjusted current-account balances

(% of GDP)	Current-account balance					Cycl. adj. Current-account balance				
	2007	2009	2011	2013	Δ07-13	2007	2009	2011	2013	Δ07-13
BE	3.9	0.7	0.5	0.1	-3.9	3.9	2.4	1.3	0.4	-3.4
BG	-25.2	-9.0	0.1	2.0	27.3	-20.8	-8.3	0.0	2.8	23.7
CZ	-5.1	-3.3	-3.5	-2.4	2.8	-2.0	-1.8	-3.0	-3.7	-1.8
DK	1.4	3.4	5.9	7.0	5.6	2.1	2.8	4.1	4.9	2.8
DE	7.5	6.1	6.3	7.0	-0.5	6.7	5.7	7.6	7.8	1.1
EE	-15.7	4.0	0.3	-2.1	13.6	-6.5	0.0	3.1	2.1	8.6
IE	-5.5	-2.3	1.2	7.0	12.5	-4.4	-3.2	1.4	8.5	12.9
EL	-17.6	-14.4	-11.7	-2.3	15.3	-16.8	-14.1	-15.8	-7.2	9.6
ES	-10.0	-4.8	-4.0	1.1	11.1	-10.0	-5.2	-5.6	-0.2	9.8
FR	-1.4	-1.8	-2.5	-1.9	-0.6	-1.2	-1.6	-2.5	-2.3	-1.1
HR	-6.9	-4.5	-1.1	0.8	7.7	-5.3	-4.0	-1.7	0.8	6.1
IT	-1.3	-2.0	-3.1	0.9	2.2	-1.0	-2.1	-3.2	-0.1	0.9
CY	-11.6	-10.7	-3.5	-1.7	9.9	-11.2	-9.0	-1.6	-1.4	9.9
LV	-22.4	8.6	-2.3	-1.6	20.8	-14.1	3.4	-7.4	-0.1	14.0
LT	-15.0	2.1	-3.9	0.1	15.1	-8.2	-2.4	-6.7	1.7	9.9
LU	10.1	7.3	6.6	6.4	-3.6	12.9	5.6	5.8	6.2	-6.7
HU	-7.4	-0.1	0.6	2.9	10.3	-7.1	-1.5	-1.3	1.4	8.5
MT	-4.0	-8.9	-1.0	1.7	5.7	-4.8	-6.6	0.5	4.2	9.0
NL	8.4	3.2	7.4	9.2	0.8	7.5	4.4	7.4	7.8	0.3
AT	4.0	2.7	1.5	2.9	-1.1	3.3	3.2	2.1	3.7	0.5
PL	-6.1	-3.1	-4.5	-1.6	4.5	-6.1	-0.5	-3.5	-1.5	4.6
PT	-10.2	-10.8	-7.2	0.4	10.6	-10.7	-10.7	-7.5	-0.8	9.9
RO	-13.6	-4.2	-4.5	-1.0	12.6	-10.8	-2.5	-5.1	-0.4	10.3
SI	-4.6	-0.4	0.2	4.9	9.5	-1.3	-1.1	-0.7	3.3	4.6
SK	-5.6	-2.5	-2.6	2.0	7.7	0.1	-0.9	-3.8	0.1	0.0
FI	4.2	2.0	-1.5	-0.2	-4.4	5.3	0.8	-1.6	-1.6	-6.9
SE	8.6	4.9	6.2	6.2	-2.3	8.4	5.7	6.8	6.3	-2.1
UK	-2.2	-1.4	-1.5	-3.8	-1.6	-2.0	-2.3	-2.7	-4.1	-2.1

Source: European Commission estimates

Table 1 displays the non-adjusted and the cyclically-adjusted current-account balances,⁽³⁾ which would prevail if both the country in question and its trading partners closed their output gaps. Accounting for the cyclical component leads to a higher surplus or smaller deficit in 2013 in the economies whose output gap exceeds that of their trading partners, taking into account their external openness. For 2013, this is the case of Bulgaria, Germany, Estonia, Ireland, Latvia, Lithuania, Luxembourg, Malta and a few others. For the countries for which their output gap is inferior to the output gap of their trading partners, the closing of domestic and foreign output gaps would lead to smaller surpluses or larger deficits; this is notably the case of the Czech Republic, Denmark, Greece, Spain, Cyprus, Hungary, Netherlands, Portugal, Slovakia and a few others.

⁽¹⁾ For a similar assessment see Guillemette, Y. and D. Turner (2013), 'Policy Options to Durably Resolve Euro Area Imbalances,' OECD Economics Department Working Paper, 1035; Mersch, Y. (2013) 'The Overhaul of the Architecture of the Euro Area and the Return of Investor Confidence,' speech at the CFA Institute, London, and ECB *Monthly Bulletin* (Jan. 2014: 47-50). For a somewhat different perspective, see IMF *World Economic Outlook* (Oct. 2013: 45-8, and Ollivaud, P. and C. Schwelnuus (2013), 'The Post-crisis Narrowing of International Imbalances—Cyclical or Durable?' OECD Economics Department Working Paper, 1062.

⁽²⁾ The current account also adjusts in response to other factors (such as interest rates or the terms of trade) that also reflect the cycle. But usually, the cyclical component of the current account is estimated given the response of real aggregates (supply and demand).

⁽³⁾ These are estimates based on the methodology described in Salto, M. and A. Turrini (2010), 'Comparing Alternative Methodologies for Real Exchange Rate Assessment,' *European Economy—Economic Papers*, 427. The assessment is based on the Commission estimates for output gaps (see Table 14 of the statistical annex): output gaps for trading partners not available in AMECO are from the OECD. Estimates on the basis of IMF data and methodology (Phillips, S. *et al.* (2013), 'The External Balance Assessment (EBA) Methodology,' IMF Working Paper, 13/272) point to similar figures.

Adjustment in vulnerable countries

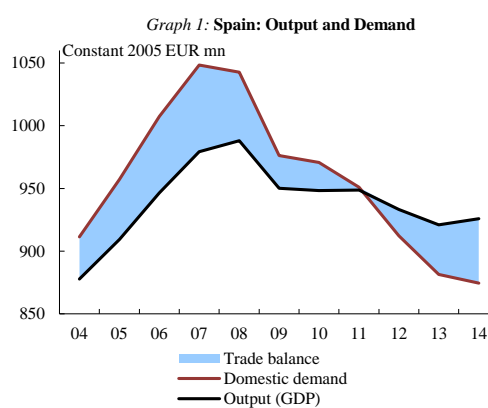
In 2007-13, there has been a substantial adjustment in the euro-area vulnerable Member States.⁽⁴⁾ On average, the current-account balances of Ireland, Greece, Spain, Cyprus, Portugal and Slovenia improved by more than 9 pps., and Spain, Ireland, Portugal and Slovenia now run surpluses. This adjustment is forecast to continue through 2015 (see Table 50 of the statistical annex), though with differences among these countries.

To discuss whether the adjustment of current-account deficits in the euro-area periphery has been cyclical or not raises two key questions: (1) Has the adjustment been rather due to a decline in domestic demand (and, by implication, imports) – or to changes in foreign demand (and thus exports and output)? (2) To what extent have these changes in domestic demand, output, and foreign demand been cyclical? The data show that most of the rebalancing in the vulnerable economies has been due to a contraction in their domestic demand (and thus imports). But much of this contraction has been non-cyclical, which may seem counter-intuitive at first sight.

The rebalancing of trade (and thus current-account) balances in the vulnerable countries is reflected in domestic demand declining faster than output (Graph 1 illustrates this for Spain.) Contracting private investment, particularly construction, was the main driver of this decline; private consumption has generally declined more than GDP and contributed to raising saving rates.⁽⁵⁾ The counter-cyclical increases in fiscal deficits initially slowed the narrowing of current-account deficits in a number of vulnerable countries, but fiscal consolidation has contributed to improving their current-account balances since 2009-10.

In several vulnerable euro-area countries, rebalancing and output also benefited from robust

exports, despite sluggish world demand, thanks to gains in price and cost competitiveness (changes in relative prices) and non-cost competitiveness. Relative price developments within and among economies facilitate the necessary reallocation of resources from non-tradable to tradable sectors. In all the vulnerable countries, GDP deflators have risen at a slower pace than export prices, which in turn rise slower than import prices, reflecting those relative changes in prices.⁽⁶⁾ This pattern is likely to be maintained for some years, with the terms of trade, therefore, expected to support competitiveness.



Graph 2 shows the sizeable contribution from real export growth to current-account adjustment in most vulnerable countries.⁽⁷⁾ Portugal, Spain and Ireland outperformed average real export growth in the euro area in 2007-13, though their real exports grew slightly less than Germany's. In Greece and Cyprus, real exports did decline in 2007-13 (though less than GDP, thus leading to the positive contribution to the changes in current account depicted in the graph).

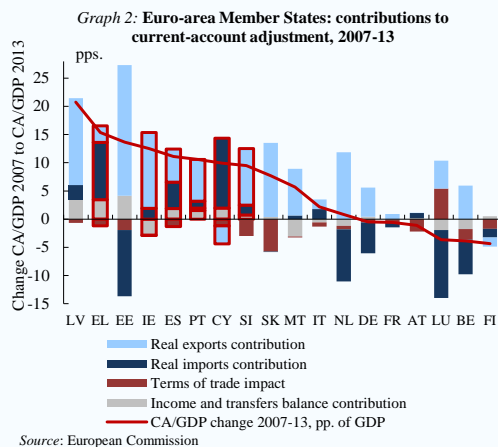
⁽⁴⁾ Here, the reference year is 2007 is used since it was the last year of the pre-crisis boom in global trade. In contrast, 2008 figures are partly affected by the trade slump in response to the crisis.

⁽⁵⁾ This behaviour runs counter the textbook response to a negative cyclical shock: consumption smoothing would entail a widening, rather than a narrowing, of the current-account deficit. Instead, the behaviour is consistent with a structural break in potential GDP (see for a discussion Aguiar, M. and G. Gopinath (2007), 'Emerging Market Business Cycles: The Cycle Is the Trend.' *Journal of Political Economy*, 115(1): 69-102).

⁽⁶⁾ See 'Labour Costs Pass-Through, Profits and Rebalancing in Vulnerable Member States,' *Quarterly Report on the Euro Area*, (2013-3):19-25, 'Ongoing Adjustment in the Euro Area Periphery,' box I.1 in the autumn 2012 forecasts, and 'Labour Costs, Margins and Prices in Rebalancing Economies,' box I.3 in the spring 2013 forecasts.

⁽⁷⁾ The Graph is based on differentials with respect to GDP growth. I.e., exports growing faster (or declining more slowly) than GDP contribute positively to the change in the current-account balance (in % of GDP). Likewise, imports contracting faster than GDP result into a positive contribution.

In contrast to exports, the vulnerable countries' imports have differed markedly from the patterns observed in the core euro-area countries, as well as from their pre-crisis trends.⁽⁸⁾ In the vulnerable countries, real imports receded strongly in 2007-13, which resulted in the positive contribution visible in Graph 2.⁽⁹⁾ A combined reading thus implies that the slump in domestic demand and imports dominates the adjustment in the vulnerable economies,⁽¹⁰⁾ though some of them also benefitted from improved export performance.



Non-cyclical is not the same as good news

While much of the current-account adjustment has been induced by domestic demand contractions, the question is how much of this stems from cyclical factors knowing that demand changes are typically associated with cyclical fluctuations. This may have led some observers to conclude that the current adjustment has been largely cyclical. During most business cycles, domestic demand fluctuates more than output, thus generating

cyclical movements in current-account balances. However, the boom years before 2007 saw not only inflated domestic demand in the euro-area periphery; potential output also swelled (in particular in the construction sector) due to overly optimistic expectations resting on abundant credit and soaring asset prices. Arguably, the correction of these growth expectations driven by the reassessment of risk premia is permanent. The large domestic demand declines during the crisis have been mirrored in a significant slowdown of potential output. Consequently, the output gap measured against the estimated potential output is much smaller than the gap against the pre-crisis growth trend. Moreover, the output gap developments in the vulnerable countries do not differ much from their trading partners – but their current-account balances do. For example, in Ireland and Portugal output gaps dropped between 5 and 5½ pps. in 2007-13, which is as much or even less than in economies with milder gyrations of macroeconomic aggregates, such as France, the Netherlands or Denmark. Hence, current-account adjustment in most vulnerable countries appears largely non-cyclical because it is associated mainly with the deceleration in their potential output. Graph 3 illustrates this for Spain where the deviation of actual GDP from its pre-crisis trend has been much more substantial than the decline from the 2007 peak. Moreover, only part of the growth gap between Spain and its partners is due to output gap differentials. Instead, most of this growth divergence is due to the relative changes in potential GDP. The rebalancing thus owes a lot to the contraction in domestic demand, which in turn reflects a structural break in potential output.⁽¹¹⁾

Outlook

Once domestic output reaches or exceeds potential again, the ensuing demand will lead to a cyclical worsening of current-account balances. This could be particularly strong if output in these countries recovers faster than in their main partners. For

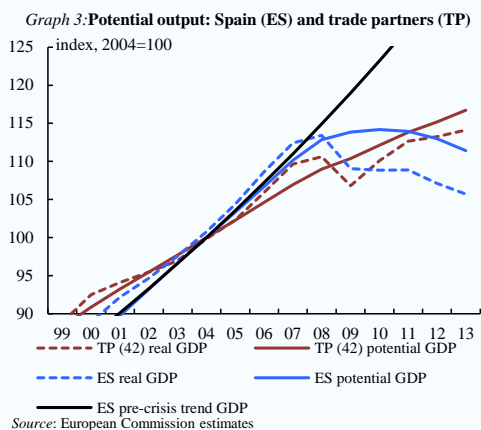
⁽⁸⁾ See also Kang and Shambaugh (2013), 'The Evolution of Current Account Deficits in the Euro Area Periphery and the Baltics: Many Paths to the Same Endpoint,' IMF Working Papers, 13/169.

⁽⁹⁾ In Spain, for instance, real exports growth slowed from cumulated +29% over 2001-07 to +14% during 2007-13 (compare with +36% and +9% in the euro area). In contrast, the Spanish real import growth of +55% during 2001-07 was followed by a decline of -21% during 2007-13 (compare with +36% and +2% in the euro area).

⁽¹⁰⁾ Note that a certain part of imported intermediate goods and services serves just to sustain exports. (This import content of exports varies between 22% for Spain and 43% in Ireland.) In that sense, the decline in imports hides an even stronger impact coming from the contraction in domestic final demand.

⁽¹¹⁾ Greece has, in this respect, been an exception. Much more of its output decline is currently attributed to cyclical factors: Its output gap declined from +3¼% of GDP in 2007 to -12¾% 2013, a number that exceeds the euro-area output gap by almost 10 pps. As a result, much more of its adjustment is estimated to be due to cyclical factors. This shows that conclusions on the cyclical and non-cyclical nature of rebalancing crucially hinge on the correctness of output gap estimates.

instance, the output gap in Ireland already closed vis-à-vis its partners, thus inducing a current-account balance that is slightly below its surplus in cyclically-adjusted terms. However, such cyclical worsening is unlikely to bring current-account balances to the pre-crisis levels any time soon.



The boom-and-crisis has left the euro-area periphery with a large stock of outstanding external debt. Among the vulnerable Member States, the current-account adjustment is only now stabilising their negative international investment position and external debt with respect to GDP. But the debt stocks continue to constrain the borrowing capacity

and demand prospects of the private and public sectors in these economies. A return of large current-account deficits is thus unlikely, as it would further rack up external debt. Instead, the vulnerable economies may require current-account surpluses over the medium term to bring down external indebtedness to sounder levels. The required extent of such surpluses in turn depends on the countries' growth prospects.

The question is thus not whether deficits reappear, but whether the surpluses will be sustained by permanently compressed imports and demand, or by expanding exports and output. This in turn will depend on the reforms in these countries as well as the behaviour of domestic demand in trading partners in the euro area and beyond. In view of deleveraging pressures on domestic demand, exports and export-oriented investment are the demand components with scope to underpin a resumption of potential growth and employment in the medium run. However, an export-led recovery requires further reallocation of labour and capital in the structural composition of the economy. Structural reforms that facilitate such re-orientation and changes in relative prices will boost potential output and export capacity – and thus relieve the pressure on imports to offset negative income balances. ⁽¹²⁾

⁽¹²⁾ See 'The Euro Area's Growth Prospects over the Coming Decade' and 'The Growth Impact of Structural Reforms,' *Quarterly Report on the Euro Area*, 2013 (4), 7-16 and 17-27.