Box 3

CURRENT ACCOUNT BALANCES ACROSS THE EURO AREA COUNTRIES FROM A SAVINGS AND INVESTMENT PERSPECTIVE

The euro area's current account balance has been close to zero since the inception of Stage Three of EMU in 1999. However, current account balance developments in a number of euro area countries have diverged over that period (see Chart a). Between 1998 and 2006 in Spain and Greece current account deficits as a share of GDP rose markedly. In 2006 these two countries together with Portugal experienced the highest current account deficits as a share of GDP of the euro area countries. In the same period Germany's current account deficit turned into a surplus, and the current account surplus of the Netherlands increased further. These two countries together with Luxembourg and Finland registered the highest current account surpluses in 2006. Changes in the current account balances of other euro area countries were smaller. In this box sizeable changes in current account balances over the period from 1998 to 2006 are assessed mainly from a savings and investment perspective. Such a perspective provides an indication of how developments in current account balances are related to the evolution of investment and saving activities.

In accounting terms, the current account may be defined as the difference between gross national savings and gross fixed capital formation[1]. In many euro area countries, developments

1 For a derivation of this definition, see for instance the IMF "Balance of Payments Manual", 1993, p. 13.

in the current account balances are related to a combination of changes in these two components (see Chart b). However, the significant deterioration in the current account balances of Spain and Greece since 1998 was mainly associated with a rise in gross fixed capital formation, particularly in the private sector. A sectoral breakdown of gross fixed capital formation by construction, equipment and other investment shows that the increase in Spain's current account deficit since 1998 was primarily related to rising construction investment as a share of GDP (see Chart c). As can be seen from Chart d), over recent years the size of the construction sector relative to GDP has grown significantly in Spain, and it is now the second largest in the euro area after that of Ireland. As regards savings, in Spain, a rise in gross government savings largely neutralised the effect of a fall in gross private savings. In Greece, the rise in the current account deficit was associated with a rise in both equipment and construction investment as shares of GDP. Moreover, the ratio of gross national savings to GDP has declined since 1998 and in 2006 reached the second lowest level in the euro area, after Portugal (see Chart e).

Turning to the countries which saw a significant improvement in their current account balances between 1998 and 2006, in Germany and the Netherlands this improvement was partly associated with a fall in gross fixed capital formation. In particular, falling construction investment as a share of GDP contributed to the improvement in the current account balance of Germany. This reflected a sustained correction in construction, following a boom in the sector related to reunification.

Some differences in national current account balances across countries and regions are a normal feature of a monetary union, as capital flows reflect savings and investment decisions, favouring member states and regions with better growth prospects and higher expected rates of return, for instance, related to catching-up processes and successful structural reforms. In the context of the euro area, the Single Market has improved the free movement of goods, services and capital, while the introduction of the euro – together with financial market liberalisation – has resulted in lower financing costs and increased access to finance in some countries. These factors may have contributed to divergent developments in current account balances across euro area countries. Moreover, current account balances may diverge across countries as a natural result of responses to asymmetric shocks.

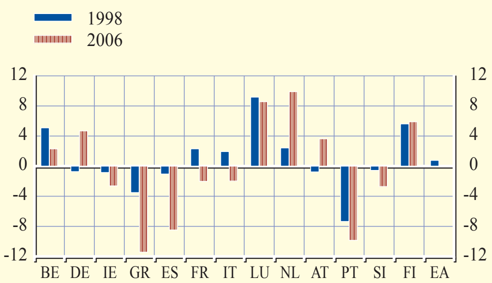
However, there is also the possibility that large current account deficits reflect macroeconomic imbalances or structural rigidities such as a lack of price and wage flexibility. For example, large current account deficits that reflect a lack of savings accompanied by strong borrowing could be an indicator of adverse competitiveness developments or of overly optimistic expectations regarding future income growth and returns on investment. This, in turn, could possibly lead to increased vulnerability of some economies related to overinvestment. In practice, it is not straightforward to distinguish between these different factors and to determine the equilibrium path of a current account balance.

As shown in Chart f), there is some evidence that current account balances tend to be related to price and cost competitiveness developments. For example, countries with large current account deficits or worsening current account balances often exhibit cumulated losses in price competitiveness, and vice versa[2]. Divergent price and cost competitiveness developments

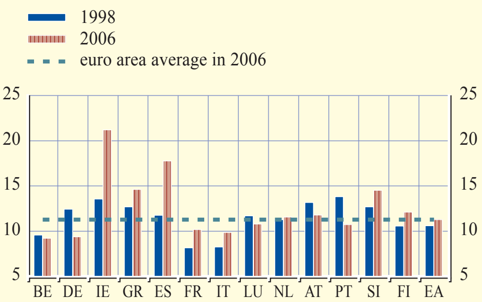
2 For a discussion on current account balances and competitiveness indicators, see Deutsche Bundesbank, "Current account balances and price competitiveness in the euro area", Monthly Report, Vol. 59, No 6, June 2007.

Current account balances, savings, fixed capital formation and unit labour costs

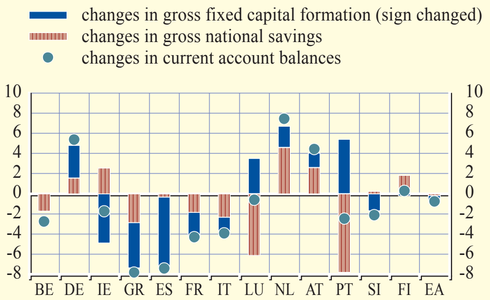
a) Current account balances
(percentages of GDP)



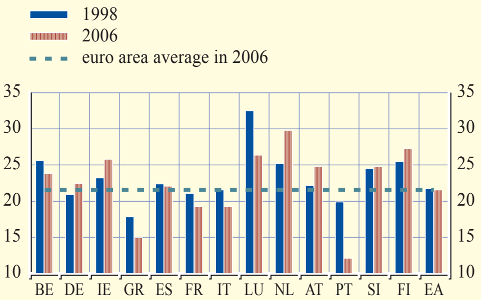
d) Gross fixed capital formation: construction
(percentages of GDP)



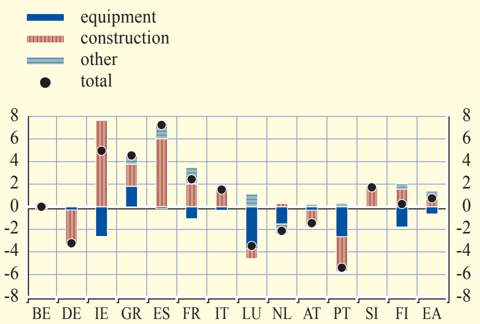
b) Changes in 1998-2006 in current account balances and their components
(percentage points) [1]



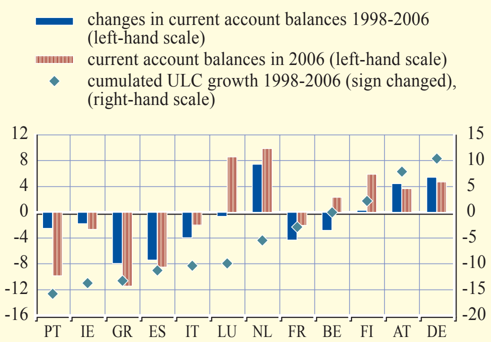
e) Gross national savings
(percentages of GDP)



c) Changes in 1998-2006 in gross fixed capital formation
(percentage points)



f) Current account balances and cumulated ULC [2]
(percentage points; percentages of GDP; percentages)



Source: ECB computations on European Commission data.
Note: Slovenia is not included in the euro area figures. Current account balances for individual euro area countries refer to the balance of current transactions with the rest of the world including other euro area countries.
1) In Chart b) a positive (negative) blue bar indicates a drop (rise) in gross fixed capital formation, leading to an improvement (deterioration) in the current account balance. A positive (negative) red hatched bar indicates a rise (drop) in gross savings, leading to an improvement (deterioration) in the current account balance. The statistical discrepancy between the actual current account and the difference between savings and investment in Chart b) mainly reflects net capital transfers and measurement errors.
2) In Chart f) a negative sign of cumulated unit labour costs (ULC) indicates an increase relative to the euro area average, i.e. a relative deterioration in cost competitiveness. Countries are ranked in ascending order according to changes in cumulated ULC compared with the euro area average.

might reflect normal and even desirable responses to catching-up processes and country-specific shocks. However, they may also be an indication of labour cost developments that are not economically justified and which in turn may reflect a lack of price and wage flexibility or overly optimistic expectations regarding future income growth in some countries. For this reason the interpretation of divergent developments in cost and price competitiveness indicators is difficult and developments need to be monitored carefully.

As national monetary and exchange rate policies are no longer options within the euro area, it is important to make sure that the remaining mechanisms of adjustment to shocks function properly. The efficient and smooth functioning of economic adjustments within the euro area requires the removal of institutional barriers to flexible wage and price-setting mechanisms as well as the completion of the Single Market and thus greater cross-border competition.