Persistence and Determinants of Current Account Balances

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*The views expressed in this presentation are those of the presenter and do not necessarily represent those of the IMF or IMF policy.

A Conundrum and a Question

- Interesting paper, especially juxtaposed with Joe Gagnon's paper…
  - Clower & Ito–exchange rate regime does not matter for CA persistence
  - Gagnon–exchange rate regime (China) matters a lot!
- Question–
  - Does the US dollar float?

SUMMARY

- Examine dynamics of current account for 70 countries, and associate stationarity of CA with intertemporal budget constraint (IBC)
  - Fail to reject unit root in many cases
  - But identify periods of "local non-stationarity" and "local stationarity"
- Lack of trade openness, net foreign assets, and financial development associated with greater CA persistence
- Exchange rate regime not a robust determinant of CA persistence, but…
  - EMEs with fixed e-rate more likely to have non-stationary CA
  - Euro membership more likely to lead to non-stationary
  - EMEs with fixed e-rate lower persistence in (combined) stationary & non-stationary regimes

COMMENT 1

- Not clear that IBC requires stationarity of CA. In standard small open economy model:

$$c_t^* = \left(\frac{r}{\theta}\right)\left\{b_t + \frac{1}{(1+r)}\sum_{j=0}^{\infty} E_t \frac{(Q_{t+j} - I_{t+j} - G_{t+j})}{(1+r)^j}\right\}$$

  then $CA_t^* = Y_t - I_t - G_t - \theta C_t^*$ will be a cointegrating vector and hence stationary (Ghosh, 1995 *Economic Journal*), but standard CA will not: $CA_t^* = Y_t - I_t - G_t - C_t^*$
- Hence, in a small open economy where there is consumption tilting (discount rate different from world interest rate), CA will be non-stationary even though IBC is satisfied
- Also Bohn (2007 *JME*) argues just need <u>some</u> degree of differencing of debt ratio to be stationary to satisfy IBC

COMMENT 2

- How plausible that exchange rate regime does not matter for CA persistence? Important for both individual countries with deficits, and for global imbalances (c.f. Gagnon paper)
  - Contrary to what profession has long believed (Friedman)
  - Contrary to common experience (e.g., Argentina 2002; Eastern Europe/Baltics, 2008—huge deficits under fixed exchange rates, until sharp adjustment); China surplus
  - But Clower & Ito do find that the likelihood of non-stationary CA for EMEs increases with fixed exchange rate, and for euro-area countries

Previous Literature

- Chinn and Wei–Fixed exchange rate regime does not matter for CA persistence (using simple AR(1))
- Ghosh, Terrones, Zettelmeyer–Regime *does* matter; important threshold effects for surplus/deficit
  - Floating regimes, simple AR(1) suffices
  - Fixed exchange rate, threshold effects:
    - Deficit countries, slow adjustment until deficit threshold reached, then sharp adjustment (because loss of financing)
    - Surplus countries, slow adjustment, and even slower when surplus threshold reached (build up NFA➔ larger CA surplus).
- In response, Chinn and Wei try threshold effects but find mixed/non-robust results on regime and CA persistence

WHY DON'T CHINN & WEI FIND REGIME MATTERS?

- Don't know. But …
- C&W use a "continuous" threshold (i.e., interaction between |CA| and CA), rather than true threshold effect (but forced adjustment due to loss of financing likely to be abrupt threshold effect, not continuous)
- C&W do not differentiate surplus & deficit countries when considering threshold effect (but GTZ (2008) show that is critical)
- C&W find especially mixed results due to <u>advanced/industrialized</u> economies

Re-Thinking Regime Classifications (for external adjustment)

- Recall, Clower & Ito finding that euro makes non-stationary CA more likely, and Chinn & Wei find regime results especially mixed for industrialized
- Perhaps another problem is regime classification:
  - Does the euro float? *Yes.* Do euro-area countries have a floating exchange rate? *Maybe not.*
  - Does the US dollar float? *Yes*. Do the US have a floating exchange rate? *Maybe not*
- When considering external adjustment, need to take account of how much trade is with countries that we are pegging to, or that are pegging to us; Ghosh, Qureshi, Tsangarides (in progress).

CONCLUSION

- Nice paper on an important topic
- Would like to see Markov-switching persistence regressions done in a way that allows to capture idea that for deficit countries fixed exchange rate regimes imply slow adjustment until threshold reached, then abrupt (and painful!) adjustment; surplus countries “never” forced to adjust under fixed exchange rate regime
- May need to re-think regime classification when considering external adjustment