**ECONOMIC
AND MONETARY
DEVELOPMENTS**

Output,
demand and the
labour market

Box 4

THE ANATOMY OF CURRENT ACCOUNT REVERSALS

In the years leading up to the global financial crisis, several euro area countries recorded large and persistent current account deficits. Since the onset of the crisis, some of these countries have witnessed a significant correction in their current account balance while, for others, the adjustment is still ongoing. Against this backdrop, this box sheds some light on the anatomy of current account reversals in the advanced economies – episodes in which sizeable current account deficits narrowed substantially in a relatively short period of time.

Identification of current account reversals

Current account reversals can be triggered by a variety of internal and external factors.[1] For instance, a country with a current account deficit may be implementing a strategy of fiscal consolidation, which will act to reduce the current account deficit through higher public savings. External factors, such as a sudden stop in capital inflows, can also play a role. All these factors have in common that they are conducive to a reduction in domestic activity and thus also the current account deficit.

To identify past episodes of current account reversals, this box applies a simple and transparent rule to the current account data of 33 advanced economies, including all 17 euro area countries, over the period 1970-2010. More specifically, for an observation to qualify as the starting point of a reversal, the following conditions have to be met: (1) the initial current account deficit exceeds 4% of GDP; and (2) the average current account deficit over the next three years is reduced by at least 1.5% of GDP and within this period by at least one third compared with the initial level. The first requirement ensures that only reversals of quantitatively significant deficits are captured, while the second one guarantees that the current account adjustment itself is of considerable magnitude and takes place in a relatively short period of time. This definition closely follows the standard methodology used in the literature.[2]

Accordingly, there were 48 episodes of current account reversals in the advanced economies between 1970 and 2010. To get an idea of a "typical" reversal, this box focuses mainly on the median of each relevant indicator during these episodes.

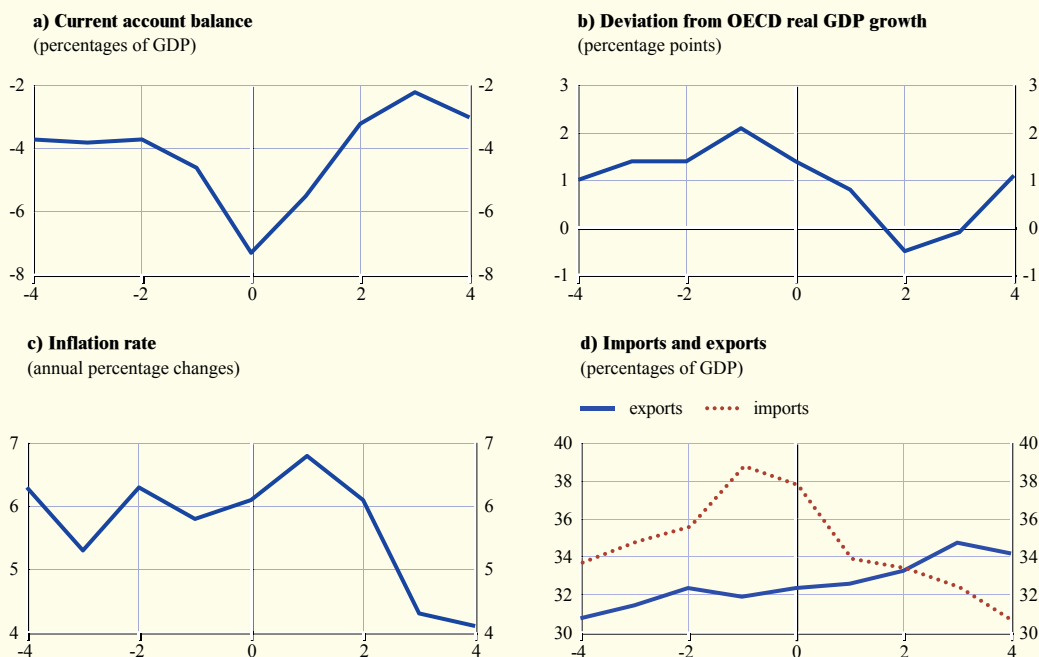**Adjustments during current account reversals**

The years leading up to a typical current account reversal in the advanced economies are characterised by buoyant GDP growth, higher inflation, an appreciation in the real effective exchange rate and a worsening current account balance (see Chart A). The start of the reversal then typically coincides with an abrupt slowdown in real GDP growth. While growth does not enter negative territory in the median episode, it declines temporarily relative to overall growth in the OECD countries. In addition, the real effective exchange rate tends to depreciate during a

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1   See, for instance, Milesi-Ferretti, G.-M. and Razin, A. "Sharp reductions in current account deficits. An empirical analysis", *European Economic Review*, Vol. 42, 1998.
2   See, for instance, Freund, C., "Current account adjustment in industrial countries", *Journal of International Money and Finance*, Vol. 24, 2005. In contrast to the literature, however, this box studies the sustainability of reversals ex post, rather than imposing a sustainability condition ex ante.

Chart A Adjustment paths during a "typical" (median) current account reversal

(annual frequency)

a) Current account balance
(percentages of GDP)

b) Deviation from OECD real GDP growth
(percentage points)

c) Inflation rate
(annual percentage changes)

d) Imports and exports
(percentages of GDP)

exports ····· imports

Source: ECB staff.
Notes: t=0 is the year in which the current account balance reaches its trough. The charts are based on 48 current account reversals in a sample covering 33 advanced economies (including all 17 euro area countries) over the period 1970-2010.

reversal, although there is considerable variation across episodes in the magnitude and timing of this exchange rate adjustment (see Chart B).

The combination of real depreciation, which directs demand from foreign to domestic products, and the slowdown in aggregate demand, which rebalances the demand differentials vis-à-vis the trading partners, is conducive to adjustments in the trade balance with the rest of the world. Indeed, imports slow down abruptly during a typical current account reversal, while export growth gains momentum on the back of improvements in price competitiveness. As a result, the current account balance tends to adjust sharply when the reversal starts, with the most notable changes taking place over a horizon of around two years. The magnitude of the current account adjustment is largely explained by the initial current account balance. Typically, the current account adjustment is sustained over at least the first five years after the start of the reversal, without the current account deficit reverting to the previous peak over this period.

While the typical patterns of current account reversals provide useful insights, there is nevertheless considerable heterogeneity across episodes, particularly regarding the relative importance of the main adjustment mechanisms. Contractionary episodes, i.e. reversals associated with larger output losses, are generally characterised by less pronounced real effective exchange rate depreciation than non-contractionary reversals (see Chart C). This suggests that swift changes in the real exchange rate can help contain the adjustment costs in terms of output losses. In turn, real exchange rate adjustments can be facilitated by flexible nominal exchange rates, as well as labour and product markets in which prices and wages respond quickly to changes

Chart B Histogram of the peak-to-trough changes in the real effective exchange rate

(x-axis: peak-to-trough percentage changes; y-axis: percentages)
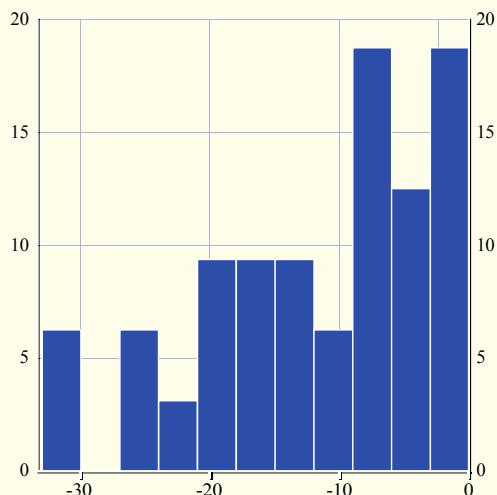
Source: ECB staff.
Note: The histogram refers to the percentage change in the real effective exchange rate from the peak over the four years before the reversal to the trough over the four years after the start of the reversal.

Chart C Contractionary and non-contractionary current account reversals

(annual frequency)

— contractionary
····· non-contractionary

a) Current account balance (percentages of GDP)

b) Deviation from OECD real GDP growth (percentage points)

c) Real effective exchange rate (index)

Source: ECB staff.
Notes: t=0 is the year in which the current account reaches its trough. Non-contractionary episodes are those in the upper quartile of all reversals, ordered according to the changes in GDP growth (correcting for OECD growth). Contractionary episodes are those in the bottom quartile.
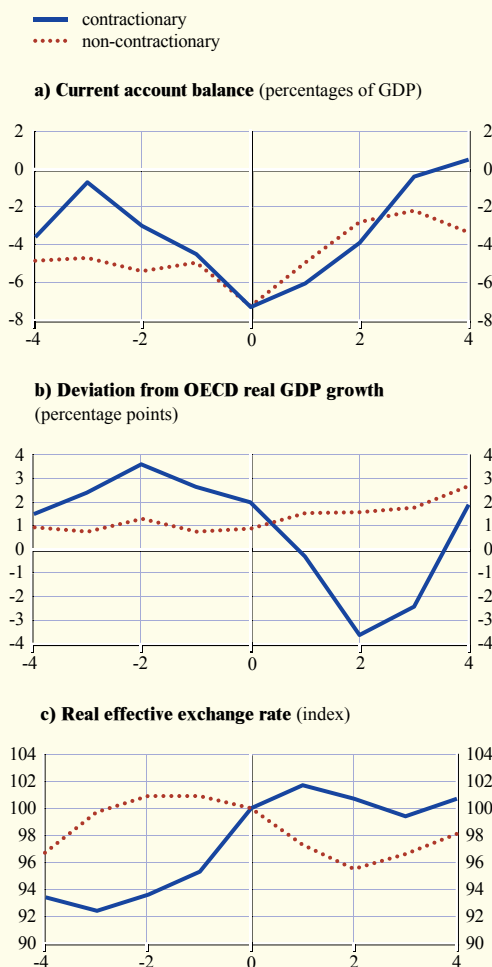
in economic conditions. Labour and product market flexibility is particularly important if the nominal exchange rate is not available to individual countries as an adjustment tool.

Conclusions

Empirical evidence shows that current account reversals in the advanced economies tend to be initially very sharp and the achieved adjustments sustained over several years. The adjustment is typically driven by a combination of a slowdown in GDP growth and a depreciation in the real effective exchange rate. It appears that a more pronounced real depreciation can help contain the adjustment costs in terms of output losses. In the case of individual euro area countries experiencing a correction in their current account deficits, a real effective exchange rate depreciation generally requires adjustments in prices and wages. This highlights the importance of structural reforms to enhance the flexibility of labour and product markets in euro area countries.