Box 9

RECENT DEVELOPMENTS IN THE INCOME ACCOUNT OF SELECTED EURO AREA COUNTRIES

A number of euro area countries which recorded large current account deficits prior to the financial crisis are currently undergoing a process of external adjustment.[1] However, most of these countries also accumulated large net foreign liabilities, which are typically associated with payments to foreign residents, for instance in the form of interest payments or dividends.[2] These flows are recorded in the (investment) income account, which, in turn, is part of the current account. In other words, the income account represents a feedback loop through which stock imbalances built up in the past lead to income payments which complicate the correction of current account deficits. Against this backdrop, this box sheds some light on the recent developments in the income account of euro area countries undergoing external rebalancing. The box also looks at the implications of these developments for the sustainability of the ongoing external adjustment in the euro area.

The role of the income balance in external adjustment

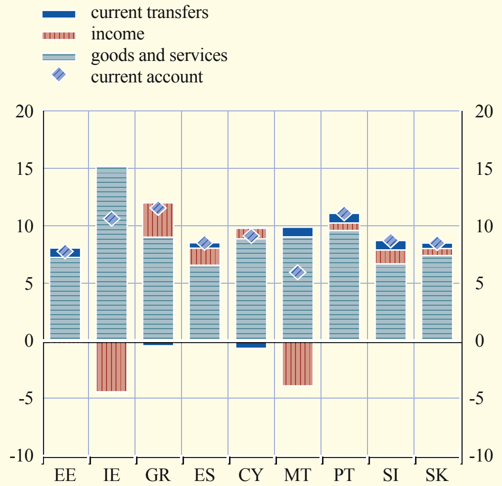
Between 2008 and 2012, all euro area countries with pre-crisis current account deficits in excess of 4% of GDP recorded significant improvements in their current account balance. However, the contribution of the income balance to this external rebalancing was, in most cases, either small or negative (see Chart A). More specifically, among the countries with large pre-crisis current

1 Large current account deficits above 4% of GDP correspond to the threshold used in the scoreboard for the Macroeconomic Imbalance Procedure. In 2008, large current account deficits were recorded in Cyprus, Estonia, Greece, Ireland, Malta, Portugal, Slovakia, Slovenia and Spain.

2 Investment income may also take other forms, such as remittances of branch profits and retained earnings of direct investment enterprises. By contrast, capital gains and losses (e.g. on account of price changes affecting the market value of foreign investments) should be recorded as a valuation effect in the international investment position. While the income balance also includes compensation of employees, this item typically plays a marginal role in the euro area. For an analysis of recent developments in net international investment positions, see the box entitled "Net foreign liabilities in selected euro area countries", *Monthly Bulletin*, ECB, April 2013.

Chart A Contributions to the change in the current account balance between 2008 and 2012

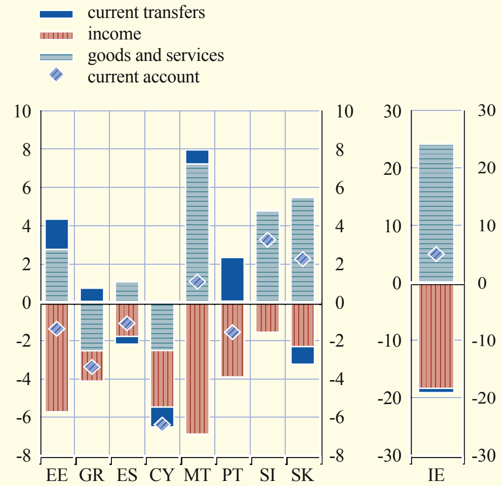
(percentages of GDP)



Sources: Eurostat and national statistical institutes.

Chart B Breakdown of the current account balance in 2012

(percentages of GDP)



Sources: Eurostat and national statistical institutes.

account deficits, Ireland and Malta (and to some extent Estonia) witnessed a deterioration in the income account, whereas Spain, Cyprus, Portugal, Slovenia and Slovakia saw some small improvements. In Greece the improvement was larger, partly as a result of the so-called private sector involvement (PSI). All of these countries continued to record deficits in the income balance in 2012 (see Chart B).

Dissecting the recent developments in the income balance

To shed some light on the factors driving the developments in the income balance, it is useful to break down its change – relative to GDP – between 2008 and 2012 into four main components. First, changes in the income balance may arise from a decline or an increase in the stock of foreign assets and liabilities from which income is derived ("stock effect"). Second, investors may shift their funds between various investment categories (for example equity or debt securities) exhibiting different average yields ("composition effect"). Third, average yields on individual investment categories may vary over time ("yield effect"). For instance, remittances of branch profits may decline on the back of weak economic activity, leading to a lower yield on direct investments. Fourth, changes in nominal GDP mechanically alter the income-to-GDP ratio ("GDP effect"). For some of these effects, it is useful to study the assets and liabilities sides separately.

It turns out that the improvements in the income balance between 2008 and 2012 in Greece, Spain, Portugal and Slovenia predominantly reflected a decline in yields on external liabilities (see Chart C).[3] (Data for Cyprus and Slovakia are not available.) This effect more than offset the negative contributions resulting from the worsening of the net international investment position (i.i.p.), lower yields received on foreign assets and the decline in nominal GDP. As a result, the income account and the net i.i.p. moved in opposite directions in these four countries (see table), which is rather exceptional.

By contrast, in Ireland and Malta the decline in yields on foreign liabilities – particularly in the field of direct investment – was not large enough to compensate for the effects of the worsening net i.i.p. and other adverse effects. As a result, the income account deteriorated significantly in these two countries. At the same time, Estonia witnessed a slight deterioration in its income account, partly owing to adverse composition effects.

Overall, euro area countries with large pre-crisis current account deficits benefited from a decline in yields on their external liabilities. This was generally more pronounced than

Net international investment position and investment income balance

(percentages of GDP)

	Net international investment position		Investment income balance	
	2008	2012	2008	2012
Estonia	-76.7	-55.3	-6.3	-6.9
Ireland	-75.6	-108.2	-13.6	-18.3
Greece	-76.8	-114.5	-4.5	-1.4
Spain	-79.3	-91.4	-3.3	-1.8
Cyprus	-15.1	-87.7	-2.7	-1.7
Malta	2.6	8.5	-3.0	-5.6
Portugal	-96.2	-116.7	-4.5	-3.8
Slovenia	-35.9	-44.7	-2.8	-2.6
Slovakia	-59.5	-63.8	-4.9	-4.2

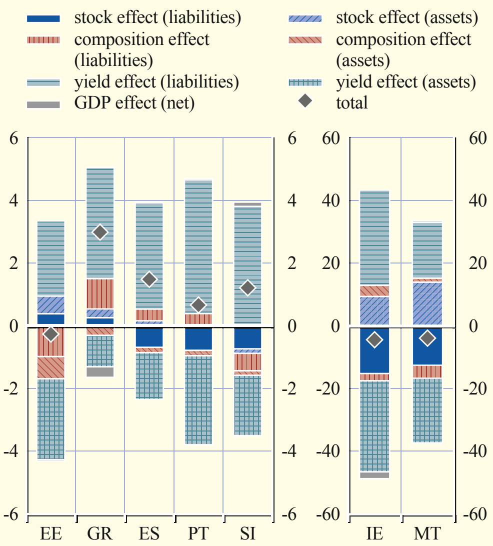
Sources: Eurostat and national statistical institutes.

3 Yields in year t are calculated as the ratio of the income payments in t and the outstanding stock at the end of t-1. In an environment of rapidly declining (increasing) stocks, the implied yield will be underestimated (overestimated).

the decline in yields on the assets side, partly reflecting the weakness of economic activity and strained financial conditions in stressed euro area countries, which put downward pressure on dividends, remittances of branch profits and other liabilities to foreign residents. In addition, the decline in yields on external liabilities was partly driven by idiosyncratic factors, such as the PSI in Greece, which led to a reduction in the interest paid on Greek sovereign bonds held by foreign residents.

Chart C Contributions to the change in the investment income balance between 2008 and 2012

(percentages of GDP)



Sources: Eurostat, national statistical institutes and ECB calculations.
Note: Cyprus and Slovakia are excluded owing to the unavailability of data from these countries.

Implications for the sustainability of external adjustment

This analysis shows that, in most cases, the income account has so far made only a small contribution, if any, to the ongoing rebalancing in those euro area countries with large pre-crisis current account deficits. In countries where the income balance has improved, this contribution largely reflected a decline in yields on external liabilities. To prevent a marked deterioration in the income balance, and therefore in the current account, once yields on foreign liabilities increase again, a reduction in net foreign liabilities through sustained improvements in the trade balance is indispensable in euro area countries undergoing external adjustment.