Box 8

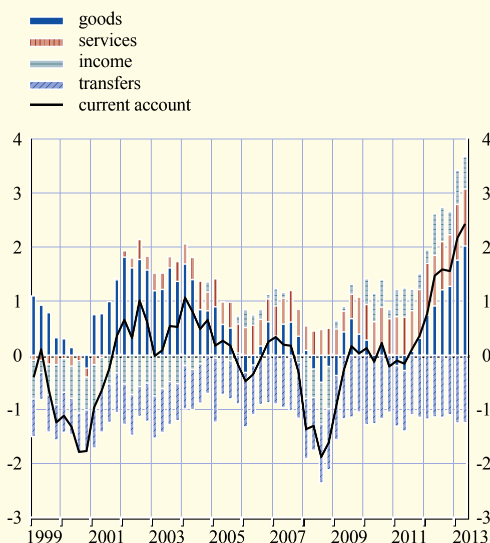
WHAT HAS DRIVEN THE RECENT EURO AREA CURRENT ACCOUNT IMPROVEMENT?

Since the start of the financial crisis, the euro area current account has reversed from a deficit of 1.9% of GDP in the third quarter of 2008 to a surplus of 2.4% in the second quarter of 2013 – the highest since the introduction of the single currency. This box identifies the main phases and driving factors behind this development, emphasising the role of the balances on goods and income as the major sources of the current account adjustment. While there is substantial heterogeneity at the country level, both stressed[1] and other euro area countries registered significant current account improvements.

The improvement in the euro area's current account since 2008 has proceeded in three broad phases: (i) a shift from a deficit to balance between the third quarter of 2008 and the third quarter of 2009; (ii) a roughly balanced current account from the fourth quarter of 2009 until the first quarter of 2011; and (iii) a growing surplus up to the second quarter of 2013 (see Chart A). During the initial phase, the balances on goods and income both turned from a deficit into a surplus, contributing 1.2 percentage points and 1 percentage point, respectively, to the overall

Chart A Euro area current account and its components

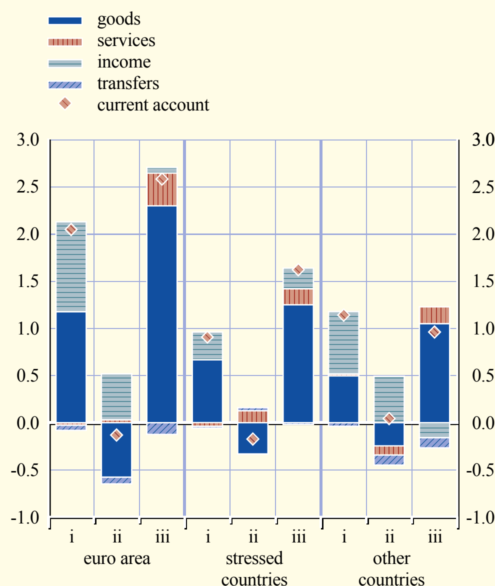
(four-quarter moving averages, percentages of GDP)



Source: ECB.
Note: Data refer to the period from the first quarter of 1999 to the second quarter of 2013.

Chart B Contributions of stressed and other countries to changes in the euro area current account balance

(percentages of GDP)



Source: ECB.
Notes: "Stressed countries" refers to Ireland, Greece, Spain, Italy and Portugal; "other countries" refers to the rest of the euro area. "i" refers to the period from the third quarter of 2008 to the third quarter of 2009, "ii" to the period from the fourth quarter of 2009 to the first quarter of 2011 and "iii" to the period from the second quarter of 2011 to the second quarter of 2013.

1 For the purpose of this box, the group of "stressed countries" comprises Ireland, Greece, Spain, Italy and Portugal. These countries were under stress during the period under review (third quarter of 2008 to second quarter of 2013) and experienced extra-euro area current account reversals of at least 3% of domestic GDP over that period.

improvement in the current account of 2.1% of euro area GDP over that period (see Chart B). During the second period, the current account remained balanced, with further improvement in the income balance outweighed by the deterioration in the balance on goods. In the third period, the current account balance improved markedly (2.6% of euro area GDP). The balance on goods was the fastest improving component during this phase, contributing 2.3 percentage points to the current account change. Both the income balance and the balance on services continued to improve mildly, contributing 0.1 and 0.4 percentage point, respectively. Changes in the balance on transfers were, in contrast, negligible in all phases.

Stressed countries (Ireland, Greece, Spain, Italy and Portugal) were large contributors to the euro area current account improvement during the first and third phases. From the third quarter of 2008 to the third quarter of 2009, amid the global financial crisis, Ireland and Spain and – to a lesser extent – Greece, Italy and Portugal experienced current account reversals vis-à-vis their non-euro area trading partners.[2] During this phase, the stressed countries' goods balances jointly contributed 0.7 percentage point to the euro area current account improvement of 2.1% of GDP, with a further 0.3 percentage point improvement stemming from their income balances (see Chart B). Between the fourth quarter of 2009 and the first quarter of 2011, the joint surplus in their income balances disappeared. As tensions on sovereign debt markets in Greece, Ireland and Portugal intensified towards the end of this period, country-specific risk premia increased. This likely put upward pressure on external financing costs and hence reversed the surplus in stressed countries' income balances. On the other hand, GDP growth rebounded somewhat in all stressed countries except Greece over that period. This stabilised domestic demand and imports, such that the previous surplus in goods trade turned into a small deficit.

The strong current account improvement from the second quarter of 2011 onwards stemmed predominantly from the goods balance, both in stressed countries and in the remaining euro area countries, particularly in Germany.[3]

Pronounced import compression was the primary channel for goods balance corrections between the third quarter of 2008 and the third quarter of 2009 (see Chart C). This experience was shared by both stressed and other euro area countries. It is likely to reflect both income and substitution effects following a decline in domestic demand. Between the fourth quarter of 2009 and the first quarter of 2011, import

Chart C Contributions of exports and imports to changes in the euro area balance on goods

(percentages of GDP)

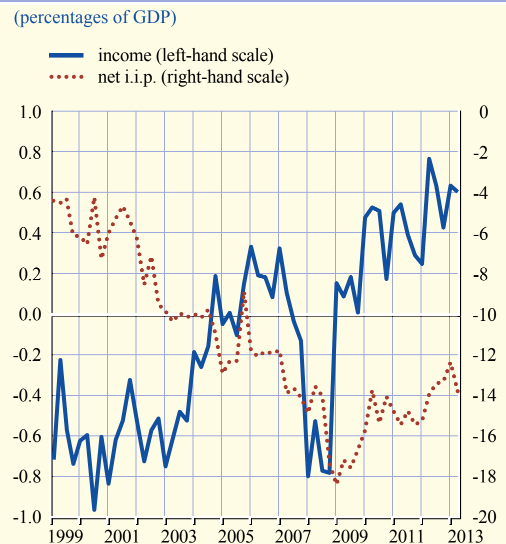
Source: ECB.
Notes: "Stressed countries" refers to Ireland, Greece, Spain, Italy and Portugal; "other countries" refers to the rest of the euro area. "i" refers to the period from the third quarter of 2008 to the third quarter of 2009, "ii" to the period from the fourth quarter of 2009 to the first quarter of 2011 and "iii" to the period from the second quarter of 2011 to the second quarter of 2013.

2 An external current account reversal is defined here as an improvement in the extra-euro area current account of more than 1% of domestic GDP between the third quarter of 2008 and the third quarter of 2009.
3 For an analysis of country-level current account developments vis-à-vis the rest of the world see the box entitled "Progress in the current account adjustment in the euro area in 2012", *Monthly Bulletin*, ECB, July 2013.

growth and export growth nearly cancelled each other out in both country groups. The significant improvement in the goods balance between the second quarter of 2011 and the second quarter of 2013 can be attributed to further export growth in both stressed and other countries, as well as renewed import compression in some of the stressed countries. The general shift from import compression (in the first period under review) to export growth (in the third period) as the main adjustment channel for the goods balance follows a typical pattern observed during current account reversals: imports tend to decline quickly on the back of weak domestic demand, while export growth lags behind as structural reforms and improvements in competitiveness that foster foreign demand take time to materialise.

Chart D Evolution of the net i.i.p. and income balance

(percentages of GDP)



Source: ECB.
Note: Data refer to the period from the first quarter of 1999 to the second quarter of 2013.

Having been a major source of adjustment in the euro area current account from the third quarter of 2008 to the third quarter of 2009, the income balance subsequently continued to improve – although at a slower pace. These improvements reflect mainly two factors: (i) exceptionally compressed yields on external liabilities of the euro area due to weak economic activity and improving public funding conditions; and (ii) a stock effect, i.e. a decline in the net external debt of the euro area since the first quarter of 2009. In line with the improving current account balance, the downward trend in the euro area net international investment position (i.i.p.) has reversed (see Chart D), which implies lower debt servicing costs and hence less downward pressure on the euro area's income balance in the future.