
Rethinking Balance of Payments Constraints in a Globalized World

MAREK DABROWSKI

In this chapter I confront the traditional balance of payments (BoP) analytical framework (with its focus on the size of a country's current account imbalance and its external liabilities) with the contemporary realities of highly integrated international capital markets and cross-country capital mobility. In so doing I challenge the conventional wisdom about BoP constraints with respect to the individual national economy and offer an alternative approach to this policy dilemma.

I start with a short historical analysis and some stylized facts that illustrate an increasing contradiction between the rigorous and quite schematic treatment of persistent current account deficits and increasing cross-border capital mobility. Then I provide an indepth analysis of the

Marek Dabrowski is chairman of the CASE Supervisory Council, chairman of the Supervisory Board of CASE Ukraine, and member of the Board of Trustees of the Institute for the Economy in Transition in Moscow. An earlier version of this paper, entitled Current Account Imbalances and Monetary Union (Conceptual Issues), was presented at the third EUROFRAME Conference on Economic Policy Issues in the European Union, Berlin, June 2, 2006, and published in CASE Studies and Analyses no. 330 under the current title. The author is very grateful to participants of both conferences for their critical and constructive comments. James Cabot helped him edit the intermediate version. In addition, he thanks Wojciech Paczynski, Artur Radziwill, Christoph B. Rosenberg, and Jacek Rostowski for the opportunity to discuss with them several issues analyzed in this chapter. Their comments helped him to conceptualize his analysis and inspired some of the ideas and arguments presented here, but the content and quality as well as the opinions and conclusions are his sole responsibility.

conceptual limitations of a traditional BoP analytical framework based on the assumption of fixed residence of capital owners and attempt to make this concept more flexible. In the next section I challenge “home country bias” originating from the Feldstein-Horioka puzzle. Then in the following section I present alternative assumptions reflecting the contemporary realities of a world of unrestricted capital movement and the resulting alternative analytical framework with respect to BoP constraints (including the special case of monetary union). Finally, I discuss the policy implications of the new analytical framework, before offering closing remarks and conclusions.

My analysis concentrates mostly on conceptual issues with only selective reference to empirical evidence provided by other authors. Thus this is a nontechnical and nonformalized policy discussion rather than a standard academic analysis based on rigorous theoretical modeling and quantitative techniques of statistical or econometric verification.

Historical Background: From a Closed Economy to the Globalized World

The economic history of most of the 20th century (after the Great Depression and until at least the beginning of the 1980s) was characterized by far-reaching trade protectionism and capital movement restrictions, the collapse of the gold standard and an increasing number of national fiat currencies (at least partly inconvertible), and the rapidly increasing role of governments in economic life and ownership of productive assets, including the determination of saving and investment decisions. Under these circumstances an analytical framework concentrating on a single national economy, either closed or only partly open, seemed a highly accurate approach.

The assumptions that (1) a particular national economy functions in at least partial isolation from the rest of the world and (2) the national government is fully sovereign in many important economic policy areas affect a large number of theoretical models and practical policy recommendations related, for example, to monetary and fiscal policies, demand management, countercyclical fine-tuning, domestic income redistribution, and external balances. Authors may not articulate or even be aware of these assumptions but rather implicitly accept them or take them as givens. One of the best examples relates to the implicit assumption that a national monetary authority has a full and effective monopoly in issuing money and is able to prevent economic agents from currency substitution, an assumption that has become increasingly irrelevant in the era of globalization (Dabrowski 2001, 2004).

We live in a world of much greater transborder capital mobility than was the case in the 1960s or 1970s, thanks to several factors:

- advancing capital account liberalization, which affected not only developed but also some developing countries;¹
- liberalization of financial markets and banking systems;
- transnational expansion of large banks and other financial corporations;
- privatization of banks and other financial institutions; and
- rapid progress in information and communication technologies (ICT), which helped to integrate technically discrete financial markets into the single global market, decreased transaction costs in the financial industry, and contributed to several financial sector innovations.

Although the question of whether the world economy has returned to the pre-World War I relative scale of international capital flows remains open, the current level of international capital market integration is definitely closer to that era than to the first three decades after World War II.²

In a world of mostly unrestricted capital flows and increasing integration of financial markets, owners of capital are seeking the highest expected rate of return irrespective of national boundaries. As individual economies offer various rates of return (which may be determined by a number of factors such as labor costs, tax burden, regulatory environment, effective protection of property rights, and economic and political risks) and, at the same time, represent various rates of national saving, some countries become savings importers and others savings exporters. Assuming that these differences persist over a longer period of time, the investment-savings imbalances may be sustainable.

This becomes even more obvious in the case of the Economic and Monetary Union (EMU) or any other monetary union where cross-country capital flows can be seen as capital movement between two regions of one country rather than traditional BoP between separate countries. However, such an interpretation of the nature of capital flows and (automatically) resulting current account imbalances contradicts a traditional BoP analytical framework based on the explicit or implicit assumption that today's current account deficit must be compensated by future current account surpluses (i.e., a current account must be balanced at least over the long term). As a consequence, the traditional analytical framework assumes that net capital inflow leads to the accumulation of a country's external liabilities, which (1) cannot grow indefinitely, (2) must be repaid at some point, and (3), as they increase, increase the vulnerability of the country's external position.

1. Among large developing countries, China and India continue capital account restrictions, although on a smaller scale than before.

2. See, for example, Ferguson (2004, 186–93), who claims that the scale of globalization was greater before World War I than now and who associates this historical phenomenon with the existence of the liberal British Empire (“Anglobalization” in the author’s terminology).

Table 3.1 Current account deficits in new EU member states and current and potential EU candidates, 1999–2007 (percent of GDP)

Country	1999	2000	2001	2002	2003	2004	2005	2006	2007 ^a
Albania	2.2	-3.6	-3.6	-7.1	-5.3	-3.9	-6.5 ^a	-5.9 ^a	-7.4
Bosnia and Herzegovina	-8.3	-7.5	-13.3	-19.1	-20.9	-19.7	-21.7	-11.5	-15.3
Bulgaria	-5.0	-5.6	-5.6	-2.4	-5.5	-6.6	-12.0	-15.8	-20.3
Croatia	-7.1	-2.5	-3.6	-8.3	-6.1	-5.1	-6.4	-7.8	-8.4
Czech Republic	-2.4	-4.7	-5.3	-5.7	-6.3	-5.2	-1.6	-3.1	-3.4
Estonia	-4.4	-5.4	-5.2	-10.6	-11.3	-12.3	-10.0	-15.5	-16.9
Hungary	-7.8	-8.4	-6.0	-7.0	-7.9	-8.4	-6.8	-6.5	-5.6
Latvia	-8.9	-4.8	-7.6	-6.6	-8.2	-12.9	-12.6	-21.1	-25.3
Lithuania	-11.0	-5.9	-4.7	-5.2	-6.9	-7.7	-7.1	-10.9	-14.0
Macedonia	-2.7	-1.9	-7.2	-9.4	-3.3	-7.7	-1.3	-0.4	-2.8
Malta	-3.7	-12.5	-3.8	2.7	-2.8	-6.3	-8.0	-6.1 ^a	-9.4
Poland	-7.4	-5.8	-2.8	-2.5	-2.1	-4.2	-1.7	-2.3	-3.7
Romania	-4.1	-3.7	-5.5	-3.3	-5.8	-8.4	-8.7	-10.3	-13.8
Serbia	n.a.	-1.7	-2.4	-7.9	-7.0	-11.7	-8.5	-11.5 ^a	-14.7
Slovakia	-4.8	-3.3	-8.3	-8.0	-6.0	-7.8	-8.6	-8.3	-5.3
Turkey	-0.7	-5.0	2.4	-0.8	-3.3	-5.2	-6.2	-7.9	-7.5

n.a. = not available

a. Estimates.

Source: International Monetary Fund, *World Economic Outlook* database, October 2007, table 31, 259.

The overall attitude toward the European Union new member states (NMS) is the best example of this misconception: EU accession radically improved their reputation and decreased their risk premia compared with other emerging-market economies (see Schadler et al. 2006). For many reasons, NMS offer a higher rate of return and therefore attract a substantial amount of foreign investment. And for those that will join the EMU in the next few years, financial markets consider the exchange rate risk negligible, additionally stimulating capital inflow.³

The fastest-growing Baltic countries, which represent the most prudent monetary and fiscal fundamentals and the most flexible and business-friendly microeconomic environment, attracted the largest net capital inflows and ran the highest current account deficits (more than 10 percent of GDP and, in the case of Latvia, more than 20 percent) for many years (see table 3.1). Paradoxically, they are considered externally fragile and

3. Slovenia joined the EMU on January 1, 2007, as the first NMS. Cyprus and Malta joined the EMU on January 1, 2008. Three NMS—Estonia since 1992, Bulgaria since 1997, and Lithuania since 2001—run euro-denominated currency boards, so they already belong (in an economic sense) to the eurozone. The same may be assumed with respect to two non-currency board ERM-2 (Exchange Rate Mechanism, which implies a peg to the euro for candidates to the join the EMU) members, Latvia and Slovakia, where the risk of depreciation seems to be minimal.

vulnerable in several policy analyses, that use the traditional BoP analytical framework (Deutsche Bundesbank 2006, Lane and Milesi-Ferretti 2006, World Bank 2007).

This contradiction between contemporary realities and the conventional instruments for assessing a country's macroeconomic health calls for rethinking the analytical approach with respect to a country's external constraints. As BoP and the related statistical tool of international investment position (IIP) usually play a crucial role in standard analyses of a country's external sustainability, the task of rethinking must start from identifying all explicit and implicit assumptions behind these concepts and understanding their analytical limitations.

BoP and IIP Concepts and Their Limitations

BoP is a statistical concept that can provide a picture of a country's external transactions during a given period of time (usually a quarter or year). BoP illustrates external flows, whereas the related concept of IIP deals with stocks, providing a picture of a country's external assets and liabilities at a given time. Obviously, the accuracy and analytical usefulness of both tools depend very much on the availability and quality of statistical data, which may be a serious problem in many countries for a variety of reasons.

As with any statistical concept, BoP and IIP cannot provide answers to all questions or fit well the specifics of every country in every period; those who wish to use these tools for analytical purposes must be fully aware of their limitations. What are the most frequent simplifications with respect to BoP and IIP analyses?

First, analyses of external transactions may involve different ways of defining what is "foreign" versus "domestic": by residency, by currency, or by jurisdiction. In closed economies with inconvertible currencies, these are almost identical, but this is not the case in the highly integrated global economy.⁴ Both BoP and IIP are based on residency, so they do not necessarily provide a correct picture of currency mismatches and vulnerabilities. Because transactions are conducted in various currencies, the same concern applies to the denomination of assets and liabilities. As a result, exchange rate fluctuations may cause (sometimes substantial) valuation differences in assets and liabilities (see, for example, Lane and Milesi-Ferretti 2005 regarding the United States in the early 2000s).

Second, in statistical and analytical practice, BoP and IIP often involve an additional implicit (i.e., not clearly articulated and not always well recognized) assumption that capital ownership residency is fixed (or at least that its change is highly unlikely). This means that investment in country

4. I am very grateful to Christoph B. Rosenberg for drawing my attention to this distinction.

A, financed by savings from country B,⁵ will “belong” to the latter, including its right to repatriate a factor income (interest or dividend) and, eventually, the invested capital stock. In subsequent sections of this chapter I challenge this assumption.

Third, BoP summarizes all kinds of external transactions conducted by a country’s residents, and IIP covers all their external assets and liabilities. While both statistical tools allow for a broad disaggregation of the analyzed flows and stocks by various categories and subcategories, most analysts limit their efforts to observing and commenting on “crude” aggregates such as a country’s current account balance or net investment position, an approach that inevitably leads to simplified judgments and conclusions.

For example, BoP covers both private and government transactions, and IIP both private and public assets and liabilities. Analysis of only the “crude” aggregates assumes implicitly their homogeneous character and a kind of national collective responsibility for all of them. The widely used statistical/analytical methodology, under which private external debt is added to the public (or publicly guaranteed) external debt (IMF 2006, tables 37–41), is the best example here: Each loan obtained by a domestic agent from a foreign creditor is considered a country’s liability, even if it does not involve explicit or implicit government guarantees. Such an approach could be justified in the case of centrally planned economies with dominant public ownership and government control of external transactions, but it is not appropriate for market economies fully integrated with the outside world and with a dominant role for private ownership and private transactions.

Fourth, the additional complication comes from the simplified and sometimes confusing terminology common to many analyses.⁶ For example, any current account deficit is considered evidence of a country’s borrowing, and any foreign liability evidence of its debt. This interpretation disregards various components of capital flows (credit, equity transactions, and transfers) and may lead to serious mistakes in policy conclusions and recommendations, especially as one looks at these indicators mostly from the point of view of the simple external sustainability formulas (see below). For example, countries that offer a favorable business climate and bring in a lot of foreign investments (which usually accompany large current account deficits) may be considered macroeconomically vulnerable (as in the case of the Baltic states described in the previ-

5. For this discussion I assume a very simple model of the global economy consisting of two countries, A and B.

6. For example, Lane and Milesi-Ferretti (2005) frequently use notions of “creditor countries/nations” and “debtor countries/nations,” having in mind all kinds of capital account transactions (i.e., not only credit flows). In IMF (2002) the very similar methodology of sustainability analysis has been proposed for both fiscal and current account deficits.

ous section). On the other hand, countries with a poor business climate and resulting sustainable net capital outflow (the example of many countries in the Commonwealth of Independent States and Middle East) enjoy current account surpluses that are usually considered a sign of macroeconomic health.

These analytical simplifications and implicit assumptions have far-reaching consequences for understanding the nature of BoP constraints. Even accepting the existence of investment-saving imbalances (for which there is vast empirical evidence), they will be temporary deviations as a country's IIP is expected to come back to equilibrium over the medium to long term.

Looking for Greater Flexibility in Analyzing BoP Constraints

The phenomenon of large current account imbalances has not gone unnoticed by economic theorists, who over the last two decades have developed several theoretical models of BoP that analyze both causes and consequences of current account imbalances, particularly for countries that are capital importers. Both theory and policy-oriented analytical methodology have demonstrated considerable progress and flexibility in response to the new circumstances.

Regarding the causes of current account imbalances, the emphasis has gradually shifted from an analysis of the demand factors (excessive spending due to lax monetary, fiscal, or income policies leading to a current account deficit that must be financed by external borrowing) toward the "push" or "supply-side" factors (excessive savings that must be invested elsewhere).

Most recently, the role of demand versus supply-side factors has been discussed in the context of the so-called global imbalances (for an analytical overview, see IMF 2005, chapter 2). On the one hand, Bernanke (2005) has offered an interesting concept of the "global savings glut," referring to a phenomenon of persistent current account surpluses in regions such as East Asia and the Middle East. These surpluses must be accommodated by other economies, such as the United States, other Anglo-Saxon developed countries, or the EU NMS (Macfarlane 2005). On the other hand, Gros, Mayer, and Ubide (2006, chapter 4) criticize the hypotheses of "global savings glut" and "global liquidity glut," arguing that the latter caused by the lax monetary policies of the main industrialized countries (primarily the United States and the United Kingdom).

The traditional analytical framework has considered a persistent current account deficit as an unsustainable phenomenon and a serious risk factor that may provoke a speculative attack against a debtor's currency

and cause a currency crisis.⁷ There is a large body of analytical literature on so-called early warning indicators, trying to determine both what level of current account deficit and how long a run may signal a currency crisis (Kaminsky, Lizondo, and Reinhart 1998; Milesi-Ferretti and Razin 1998). Such analytical studies became particularly popular and appealing in the second half of the 1990s after the Mexican and Asian crises. In their extreme version they led Lawrence Summers (1996) to warn that *any* current account deficit in excess of 5 percent of GDP should be cause for concern. This declaration gave birth to the “5 Percent Doctrine,” adopted by both the IMF and private investors in the late 1990s (some analysts even used the threshold of 4 percent).

However, clear empirical evidence (not every country running a persistent current account deficit becomes a victim of currency crisis, and crises occur in countries whose current account is either in surplus or in balance) has called for a more flexible analytical approach, which has gone in at least two directions.

First, various intertemporal BoP models acknowledge the possibility of a current account deficit as long as imported savings generate a higher rate of investment and a high rate of return from these investments, enabling the repayment of the borrowed money (Obstfeld and Rogoff 1996, chapter 2). Second, FDI and other long-term investments are distinguished from pure borrowing or short-term portfolio flows: The former are considered a more sustainable and less risky source of financing for current account deficits than the latter.

While the above analytical modifications allow for greater flexibility in assessing current account imbalances (particularly the deficits), they do not depart completely from “home country bias,” the assumption of fixed character of capital ownership residency. Most of the analyses assume that savings invested abroad will eventually return to the home country, or at least that the negative net investment position will generate an outflow of factor income (i.e., interest or dividends paid to the foreign residents who imported the capital). In the next section I challenge the assumption of “home country bias.”

Challenging “Home Country Bias”

The argument in favor of “home country bias” in investing gross national savings originates from a well-known paper by Feldstein and Horioka (1980). The authors presented a strong correlation between incremental

7. Disregarding a residency-based rather than currency-based nature of BoP statistics, which does not necessarily provides a good picture of currency mismatches and vulnerabilities (see the previous section).

investment and saving in OECD member countries in the 1960s and first half of the 1970s.

The Feldstein-Horioka puzzle needs a correct interpretation, however. The authors analyzed investment and saving trends in a world of partly inconvertible currencies⁸ and broad restrictions on capital movement, so their empirical results were unavoidable at that time.⁹ But the Feldstein-Horioka puzzle cannot be interpreted to mean that “home country bias” is permanently applicable.

Various authors (Roubini 1988, Taylor 1994) subsequently challenged Feldstein and Horioka’s (1980) findings, but others (Eichengreen 1992, Jones and Obstfeld 1997) tried to confirm the results in relation to the pre-World War II gold standard era. More recent studies based on 1990s data do not confirm the strong evidence of the Feldstein-Horioka puzzle, at least in relation to EU countries (Blanchard and Giavazzi 2002, Héricourt and Maurel 2005). Nonetheless, Feldstein (2005) himself has tried to defend the contemporary relevance of his earlier findings, at least in relation to large OECD countries.

The world economy has changed radically, and globalization has progressed rapidly since the publication of Feldstein and Horioka’s (1980) paper. We now live in a world of substantial and increasing current account imbalances both in individual countries and in their regional groups (figure 3.1). Yet the same has been true in the past. Obstfeld and Rogoff (1995) cite Canada’s high (up to 10 percent of GDP or more) and persistent current account deficit, financed mostly by the sustained inflow of British capital for at least three decades, from the 1880s until the beginning of World War I. And Ferguson (2004, 188–89) gives evidence of the persistent character of large-scale capital exports from the United Kingdom to British colonies at the end of the 19th and beginning of the 20th centuries.¹⁰

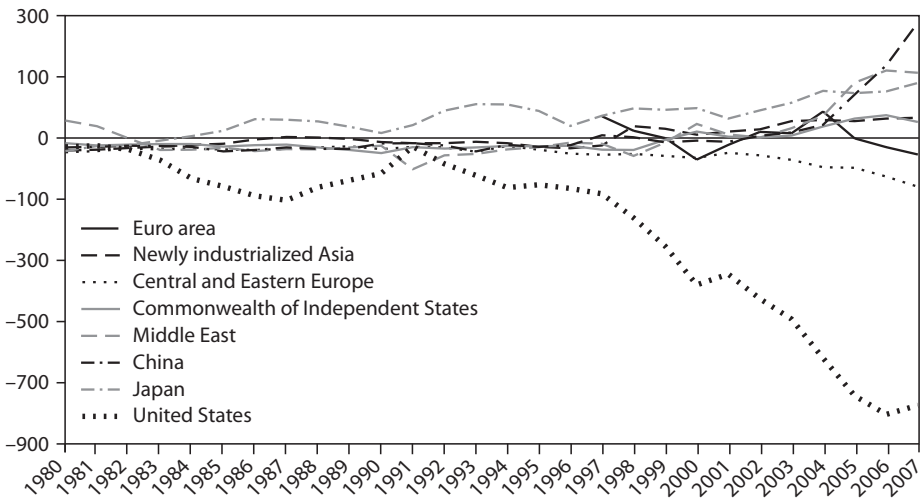
8. In the 1960s and 1970s most currencies were not fully convertible with respect to capital account transactions, and many countries also continued some form of current account restrictions.

9. Feldstein and Horioka (1980, 317) were aware that “with perfect world capital mobility, there should be no relation between domestic saving and domestic investment: saving in each country responds to the worldwide opportunities of investment while investment in that country is financed by the worldwide pool of capital. Conversely, if incremental saving tends to be invested in the country of origin, differences among countries in investment rates should correspond closely to differences in saving rates.” They also realized that capital mobility was “limited by institutional barriers and portfolio preferences” (Feldstein and Horioka 1980, 328).

10. Contemporary episodes of persistent current account deficits and surpluses have been analyzed in IMF (2007, chapter 3).

Figure 3.1 World current account imbalances, 1980–2007

billions of US dollars



Source: International Monetary Fund.

Alternative Analytical Framework

I suggest an alternative analytical framework based on the following assumptions, which seem to reflect more accurately the contemporary world economy:

1. There is unrestricted international capital movement—that is, there are no serious administrative, tax, or quasi-tax restrictions on the movement of savings from one country to another. The lack of restrictions does not necessarily indicate the same tax and regulatory regime in each country or the absence of any cross-border transaction costs. The differences in national tax and regulatory regimes as well as in national macroeconomic policies, political regimes and their stability, and other factors contribute to the expected country risk premium and thus influence the expected rate of return (see assumptions 3 and 4 below). Cross-border transaction costs may also reflect differences in legal and regulatory regimes (with respect to investment decisions, mergers, acquisitions, and the like), transportation and communication costs, and different languages and currencies (including the exchange rate risk; see below). Generally, I do not substantially consider transaction costs other than those associated with exchange rate risk and, for the sake of simplicity, omit them in my further analysis.

2. Major sources of capital do not have a country of origin, largely because of the transnational character of major corporations, financial institutions, and investment funds, even if they invest on behalf of the residents of a specific country. In addition, people (especially the wealthy) can easily change their country of residence along with their accumulated savings.¹¹
3. Investors represent the private sector and seek the highest rate of return in their investment/reinvestment decisions, regardless of which country their decisions concern. Each individual rate of return consists of two major components: (1) a country-related component, reflecting a country's tax and regulatory environment, provision of public goods, macroeconomic and political risk premium, and other factors that constitute a country's business or investment climate (see assumption 1 above); and (2) a project-related component.
4. There is not necessarily a diminishing rate of return in relation to a country-related component: Country A may offer a higher rate of return than country B for similar projects for a long period of time due to factors mentioned in assumption 3.¹²

These four assumptions challenge the relevance of a "home country bias" in investment decisions. The higher expected rate of return in the home country (as compared with others) can serve as the only rational explanation of any "home country bias" under the assumptions above.

The practical implications are as follows: The initial investment in country A by a resident of country B does not need to return (be repaid) to country B as long as country A offers a higher rate of return, notwithstanding the form of investment financing (credit or equity). The same applies to factor income from this investment (interest or dividend), which will be reinvested in country A instead of being transferred to country B.

However, if the expected rate of return in country A falls below that of country B for any reason (e.g., because of investment climate improvement in country B or its deterioration in country A), the direction of capital movement will change: Not only will capital that originated in coun-

11. This is not uncommon in world economic history. In the 19th and early 20th centuries, emigration from Europe to North America, Australia, and other colonies and dependent territories also involved capital export to these countries.

12. This particular assumption seems to distinguish my proposal from the Blanchard and Giavazzi (2002) model, which posits that current account position depends on the level of a country's development. Less developed countries (the authors concentrate on Portugal and Greece as less developed members of the eurozone) run current account deficits because they offer a higher rate of return in the process of catch-up growth. Richer countries, by contrast, become capital exporters. This implies an assumption on a diminishing rate of return in relation to a country-related component.

try B go back to this country but also residents of country A will move their capital and factor income to country B.

The new assumptions proposed here do not mean that country A is immunized from the danger of capital outflow (with all the associated negative economic and social consequences). But the danger of such outflow comes from change in the country-related component of the expected rate of return (compared to other countries) rather than from the nonresident origin of the invested capital.

Do the country's current account and net IIP still matter under these assumptions? The answer is partly positive if countries A and B have different currencies and run uncoordinated monetary and fiscal policies. If investors consider the current account deficit of country A too high and the country's liabilities in foreign currency unsustainable, there may be an increase in country A's exchange rate risk premium (the expected depreciation of its currency against that of country B) and a decline in the expected rate of return. Substantial changes in the market perception of exchange rate risk premium may trigger a sudden capital outflow (both "domestic" and "foreign") and currency crisis.¹³

This analysis means that some elements of the traditional BoP analytical approach still hold, although the assumptions specified above somewhat weaken BoP constraints (at least interpreted in an "orthodox" way). In order to eliminate the exchange rate risk and BoP constraints completely, country A must have the same currency as country B or peg its currency to that of country B in a durable and credible way.

Thus, inside the monetary union, BoP constraints between members disappear, and intraunion capital flows resemble capital movement between two regions of one country rather than traditional BoP flows between separate countries. This is particularly true for the EMU, which comprises countries belonging to the European single market characterized by four major freedoms (free movement of goods, services, capital, and people).

Whether the concept of BoP, current account, and IIP of each member country of a monetary union makes analytical sense is an open question for further debate. Continuing the analogy with interregional capital flows in a national economy, it is apparent that most countries do not even compute interregional current account/financial flow statistics.

13. The earlier remarks about the residency-based rather than currency-based character of BoP statistics hold true and explain why I talk about the partial relevance of a current account imbalance alone. However, the dominant financial market sentiments (which consider current account imbalances as having some relevance) cannot be ignored. In addition, in many cases current account imbalances go hand in hand with currency mismatches or other serious vulnerabilities (for example, in the area of monetary or fiscal policy).

Policy Implications of the Alternative Analytical Framework

The alternative analytical framework offered in the previous two sections has broad policy implications for two categories of countries: (1) those that run their own sovereign currencies and (2) those that belong to monetary unions (with a particular emphasis on the EMU). Both categories involve countries that are opened to capital movement and have access to international capital markets. A substantial number of countries (especially less developed ones) either maintain restrictions on capital movement or, if they are formally open, do not have access to international capital markets (i.e., their public authorities and private entities are not able to either borrow or attract FDI and portfolio investment).

With respect to countries in the first category that are open to capital movement, BoP constraints still hold, but their actual meaning differs from the “traditional” (or simplified) approach described above. If international capital markets view the current account imbalance (especially the deficit) of any country or group of countries as sustainable, it may be run for a very long period of time, almost indefinitely, and other countries may become sustainable capital exporters.¹⁴ There is vast empirical evidence—both contemporary (Orsmond 2005) and historical (from the second half of the 19th and beginning of the 20th centuries)—to support the hypothesis of persistent cross-country investment-savings imbalances in the well-integrated global economy.

The market perception of sustainability is based on a country-specific assessment involving several economic and political variables that may be summarized as the expected rate of return in the long run. The exchange rate risk premium is one of the factors influencing the expected rate of return, and under some circumstances it may increase rapidly and trigger a sudden capital outflow. However, it is worth remembering that (1) the increase in exchange rate risk premium and resulting capital outflow may not be determined by the size of, or changes in, a country’s current account deficit or IIP but by other factors; and (2) if the exchange rate risk premium and capital outflow do increase, it will affect the behavior of all capital owners, irrespective of their country of residence.

14. The reasons why some countries or group of countries run permanently excessive saving rates (compared with their investment rates) merit a separate discussion as they are outside this chapter’s thematic agenda. Here I simply suggest possible hypotheses: poor investment climate diminishing national investment rate and encouraging capital flight; long-term demographic, institutional, and structural characteristics determining high national saving rates; windfall gains generated by fluctuations in commodity prices (the case of oil-producing countries in the early 2000s); systematic central bank interventions to keep exchange rate undervalued; and so forth.

Whether national economic policy can control the current account balance in an economy fully open to capital flows is an additional and very controversial issue. The room for maneuver for national monetary policy in a small open economy is very limited (see Dabrowski 2004). Attempts to target the current account or in any way engineer a current account-motivated exchange rate conflict with the anti-inflation mission of a central bank (Dabrowski 2003) and contradict the direct inflation targeting framework adopted by an increasing number of countries that run sovereign monetary policies (a strategy that requires a floating exchange rate).

The potential of fiscal policy to correct current account imbalances is also questionable. The concept of twin deficits (i.e., a current account deficit resulting from fiscal deficit) can hardly find empirical support in a world of high capital mobility. Fiscal contraction widely considered as one of the measures to diminish current account imbalances may not necessarily bring the expected results due to the “crowding-in” effect (Rostowski 2001). Successful fiscal adjustment is usually perceived by investors as a factor that decreases country risk (by increasing the expected rate of return) and triggers bigger private capital inflow leading to higher account deficits. Obviously, fiscal consolidation is highly recommended for other policy reasons even if it cannot help to improve the current account position.

Regarding the second analyzed category, a common currency eliminates exchange rate risk with respect to capital flows in a monetary union, but there is still exchange rate risk with other currencies. In the eurozone, for example, this concerns capital flows denominated in US dollars, British pounds, Swiss francs, or Japanese yen: The BoP constraints hold for the entire common currency area (i.e., the eurozone) but not for individual member countries. For the latter, the entire analytical concept of BoP seems to lose its importance (Blanchard and Giavazzi 2002 reach a similar conclusion). So blaming the Baltic countries, which are part of the eurozone (but not the EMU), for their supposedly excessive and unsustainable current account deficits (Deutsche Bundesbank 2006, World Bank 2007) misses the point.

This radical conclusion does not mean that entering a monetary union immunizes a country from any macroeconomic or financial risk. Hypothetically, an entire common currency area (such as the eurozone) may become a victim of a BoP/currency crisis. An individual member country can suffer a public debt crisis as a result of irresponsible fiscal policy. It can also experience an unsustainable investment, credit, or asset bubble (and subsequent bust), but this is a matter of prudent lending/investment/financial intermediation rather than a traditional BoP problem. In fact, this kind of crisis can also happen in a national economic area without the participation of foreign investors. True, the impact of a “regional” crisis may affect the entire common currency area depending on the scale of the shock and other circumstances (similar to the impact of a “local” crisis in any individual country).

In addition, if the expected rate of return deteriorates for any reason (as compared to other countries forming a common market), the net direction of capital movement will reverse and the economy will have to adjust. However, this will affect both “foreign” and “domestic” capital, which will seek other investment destinations, and the geographic origin of capital and the previous BoP record will be irrelevant. Again, this can also happen in an individual country (among its regions) and must be addressed by means other than exchange rate adjustment.

Final Remarks and Conclusions

We live in an era of rapid globalization, which particularly affects cross-border capital flows and financial markets. The sovereignty of national economic policies and their ability to control individual economic processes and macroeconomic variables is gradually decreasing, particularly in areas of deeper regional integration like the European Union and EMU.

Several theoretical and analytical concepts elaborated with respect to closed or partly closed national economies have lost much (or all) of their practical relevance. Attempts to continue to use them as analytical tools and as the basis of policy prescriptions may do more harm than good. The traditional BoP concept and current account imbalance as an indicator of a country’s macroeconomic health are key examples.

In a world of free capital movement the geographic origin of capital has lost its importance, and capital invested abroad does not need to return to the country of “residence.” There is no “home country bias” in investment decisions any more; the expected rate of return is the key parameter determining these decisions. Some countries may offer a higher rate of return for a long period of time, becoming persistent capital importers, while others may offer a surplus saving on a sustainable basis.

If a country has a separate currency and runs its own monetary policy, the exchange rate risk remains and BoP constraints continue to hold some relevance (as one of the factors determining exchange rate risk). However, national economic policy has very limited possibilities to influence current account balance. Entering the monetary union eliminates entirely these constraints, although other kinds of macroeconomic constraints and risks remain in force. Whether these other risks are more severe in the absence of exchange rate risk and balance of payments constraints is another question. However, this question is definitely beyond the scope of this chapter.

References

- Bernanke, Ben. 2005. The Global Saving Glut and the U.S. Current Account Deficit. Speech at the Sandridge Lecture, 10 March. Richmond: Virginia Association of Economics. Available at www.federalreserve.gov (accessed on December 15, 2007).

- Blanchard, Olivier, and Francesco Giavazzi. 2002. *Current Account Deficits in the Euro Area: The End of the Feldstein-Horioka Puzzle?* Brookings Papers on Economic Activity, no. 2: 147–86. Washington: Brookings Institution.
- Dabrowski, Marek. 2001. Global Integration of Financial Markets and Its Consequences for Transition Economies. In *Transition and Growth in Post-Communist Countries: The Ten-year Experience*, ed. Lucjan T. Orlowski. Northampton, MA: E. Elgar Publishing.
- Dabrowski, Marek. 2003. Disinflation Strategies and Their Effectiveness in Transition Economies. In *Disinflation in Transition Economies*, ed. Marek Dabrowski. Budapest: Central European University Press.
- Dabrowski, Marek. 2004. Costs and Benefits of Monetary Sovereignty in the Era of Globalization. In *Beyond Transition: Development Perspectives and Dilemmas*, eds. Marek Dabrowski, Ben Slay, and Jarek Neneman. Burlington, VT: Ashgate.
- Deutsche Bundesbank. 2006. Determinants of the Current Accounts in Central and East European EU Member States and the Role of German Direct Investment. *Monthly Report (January)*. Available at www.bundesbank.de (accessed on January 4, 2008).
- Eichengreen, Barry. 1992. *Golden Fetters*. New York: Oxford University Press.
- Feldstein, Martin. 2005. *Monetary Policy in a Changing International Environment: The Role of Capital Flows*. NBER Working Paper 11856. Cambridge, MA: National Bureau of Economic Research.
- Feldstein, Martin, and Charles Horioka. 1980. Domestic Saving and International Capital Flows. *Economic Journal* 90: 314–29.
- Ferguson, Niall. 2004. *Colossus: The Price of America's Empire*. Penguin Press.
- Gros, Daniel, Thomas Mayer, and Angel Ubide. 2006. *A World Out of Balance?* Special Report of the CEPS Macroeconomic Policy Group. Brussels: Centre for European Policy Studies.
- Héricourt, Jérôme, and Mathilde Maurel. 2005. *The Feldstein-Horioka Puzzle Revisited: A "European-Regional" Perspective*. William Davidson Institute Working Paper 763. Ann Arbor: The William Davidson Institute.
- IMF (International Monetary Fund). 2002. *Assessing Sustainability*. Washington: International Monetary Fund, Policy Development and Review Department. Available at www.imf.org (accessed on December 21, 2007).
- IMF (International Monetary Fund). 2005. *World Economic Outlook* (September). Washington.
- IMF (International Monetary Fund). 2006. *World Economic Outlook* (April). Washington.
- IMF (International Monetary Fund). 2007. *World Economic Outlook* (April). Washington.
- Jones, Matthew T., and Maurice Obstfeld. 1997. *Saving, Investment and Gold: A Reassessment of Historical Current Account Data*. NBER Working Paper 6103. Cambridge, MA: National Bureau of Economic Research.
- Kaminsky, Graciela, Saul Lizondo, and Carmen M. Reinhart. 1998. *Leading Indicators of Currency Crises*. IMF Staff Papers 45, no. 1. Washington: International Monetary Fund.
- Lane, Philip R., and Gian M. Milesi-Ferretti. 2005. *A Global Perspective on External Positions*. IMF Working Paper WP/05/161. Washington: International Monetary Fund.
- Lane, Philip R., and Gian M. Milesi-Ferretti. 2006. Capital Flows to Emerging Europe. Paper presented at the IMF-JVI-NBP Conference on "Labor and Capital Flows in Europe Following Enlargement," Warsaw, January 30–31. Available at www.jvi.org (accessed on November 27, 2007).
- Macfarlane, Ian. 2005. *What Are the Global Imbalances?* Reserve Bank of Australia Bulletin (October). Available at www.rba.gov.au (accessed on January 15, 2007).
- Milesi-Ferretti, Gian M., and Assaf Razin. 1998. *Current Account Reversals and Currency Crises: Empirical Regularities*. IMF Working Paper WP/98/89. Washington: International Monetary Fund.
- Obstfeld, Maurice, and Kenneth Rogoff. 1995. The Intertemporal Approach to the Current Account. In *Handbook of International Economics* 3, eds. Gene M. Grossman and Kenneth Rogoff. Amsterdam, San Diego, London: North-Holland Publishing Company.
- Obstfeld, Maurice, and Kenneth Rogoff. 1996. *Foundations of International Macroeconomics*. Cambridge, MA: MIT Press.

- Orsmond, David. 2005. *Recent Trends in World and Investment Pattern*. Reserve Bank of Australia Bulletin (October). Available at www.rba.gov.au (accessed on January 10, 2007).
- Rostowski, Jacek. 2001. The Approach to EU and EMU Membership: The Implication for Macroeconomic Policy in the Applicant Countries. In *The Eastern Enlargement of the EU*, eds. Marek Dabrowski and Jacek Rostowski. Boston/Dordrecht/London: Kluwer Academic Publishers.
- Roubini, Nouriel. 1988. *Current Account and Budget Deficits in an Intertemporal Model of Consumption and Taxation Smoothing. A Solution to the "Feldstein-Horioka Puzzle?"* NBER Working Paper 2773. Cambridge, MA: National Bureau of Economic Research.
- Schadler, Susan, Ashoka Mody, Abdul Abiad, and Daniel Leigh. 2006. *Growth in Central and Eastern European Countries of the European Union*. IMF Occasional Paper 252. Washington: International Monetary Fund.
- Summers, Lawrence H. 1996. Commentary. In *Volatile Capital Flows*, eds. Ricardo Hausmann and Liliana Rojas-Suarez. Washington: Inter-American Development Bank.
- Taylor, Alan M. 1994. *Domestic Saving and International Capital Flows Reconsidered*. NBER Working Paper 4892. Cambridge, MA: National Bureau of Economic Research.
- World Bank. 2007. *World Bank EU8+2 Regular Economic Report* (May). Washington. Available at <http://siteresources.worldbank.org> (accessed on January 10, 2007).

