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**Rethinking balance-of-payments constraints in a  
globalized world**

*Warsaw, August 2006*



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## **Abstract**

This paper confronts the traditional balance-of-payments (BoP) analytical framework (with its dominant focus on the size of a given country's current account imbalance and its external liabilities) with the contemporary realities of highly integrated international capital markets and cross-country capital mobility. Some key implicit assumptions of the traditional framework like those of a fixed residence of capital owners and home country bias are challenged and an alternative set of assumptions is offered. These reflect the unrestricted character of private capital flows (with no "home country bias" and fixed domicile) determined mostly by the expected rate of return. As a result, the importance of BoP constraints (in their "orthodox" interpretation) diminishes and they disappear completely with respect to individual member states within a highly integrated monetary union. This does not mean, however, immunization from other kinds of macroeconomic risks.



## **1. Introduction**

The purpose of this paper is to confront the traditional balance-of-payments (BoP) analytical framework (with its dominant 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<sup>1</sup>. As a result, we are going to challenge the conventional wisdom about BoP constraints with respect to the individual national economy and offer an alternative way of approaching this policy dilemma.

We will start with a short historical analysis and some stylized facts, which illustrate an increasing contradiction between the rigorous and quite schematic treatment of persistent current account deficits and increasing cross-border capital mobility (Section 2). Then we will analyze in-depth the conceptual limitations of a traditional BoP analytical framework based on the implicit assumption of fixed residence of capital owners (Section 3) and attempts to make this concept more flexible (Section 4). In Section 5 we challenge "home country bias" originating from the Feldstein-Horioka puzzle. Section 6 offers an alternative set of 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). In Section 7 we discuss the policy implications of the new analytical framework. Section 8 contains final remarks, conclusions and proposals with respect to future research.

Our analysis concentrates mostly on conceptual issues with only selective reference to empirical evidence provided by other authors. Thus, this is a non-technical and non-formalized policy essay rather than a standard academic paper based on rigorous theoretical modeling and quantitative techniques of statistical or econometric verification.

## **2. 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, being closed or only partly open, seemed to be a highly accurate approach.

The assumptions that a particular national economy functions in at least partial isolation from the rest of the world and the national government is fully sovereign in many important economic policy areas affected a large number of theoretical models and practical policy recommendations related, for example, to monetary and fiscal policies, demand management, counter-cyclical fine tuning, domestic income redistribution, external balances, etc. This assumption was not always explicitly articulated or even realized fully by individual authors but just implicitly accepted or taken as given. 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 which has become increasingly irrelevant in the era of globalization (see Dabrowski, 2001; 2004).

Presently, we live in a world of much bigger trans-border capital mobility than was the case in the decades of the 1960s or 1970s. There are several factors which have contributed to this increased mobility:

- advancing capital account liberalisation, which affected not only the developed countries but also several developing ones<sup>2</sup>;
- liberalisation of financial markets and banking systems;
- trans-national expansion of large banks and other financial corporations;
- privatisation of banks and other financial institutions previously often publicly owned;
- rapid progress in information and communication technologies (ICT), which helped to integrate technically individual financial markets into the single global market, decreased transaction costs in the financial industry and contributed to several financial sector innovations.

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<sup>1</sup> This is a revised version of the paper entitled "Current account imbalances and monetary union (conceptual issues)" prepared for the 3rd EUROFRAME Conference on Economic Policy Issues in the European Union, Berlin, June 2, 2006. I am grateful to participants of this conference for their critical and constructive comments to this earlier version. James Cabot helped me to edit the final version. In addition, I would like to thank Wojciech Paczynski, Artur Radziwill, Christoph B. Rosenberg and Jacek Rostowski for the opportunity to discuss with them several issues analyzed in this paper. While their comments helped me to conceptualize my analysis and inspired some ideas and arguments presented in this paper, its content and quality as well as the concrete opinions and conclusions presented here are my sole responsibility.

<sup>2</sup> Among big developing countries, China and India continue capital account restrictions although on a smaller scale than before.

Although the question of whether the world economy has returned to the pre-WWI relative scale of international capital flows remains open<sup>3</sup> the current level of international capital market integration is definitely closer to the pre-WWI era than to the first three decades following WWII.

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 disregarding national boundaries. As individual economies offer various rates of return (which may be determined by a numbers of factors such as labor costs, tax burden, regulatory environment, effective protection of property rights and various economic and political risks) and, at the same time, represent various rates of national saving, some countries become saving importers while others – saving exporters. Assuming that the above mentioned differences persist over a longer period of time, the saving-investment imbalances may have a sustainable character.

This becomes even more obvious in the case of Economic and Monetary Union (EMU) in Europe 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. that 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 (i) cannot grow indefinitely, (ii) must be repaid at some point, (iii) and that the higher they are, the more vulnerable the country's external position is.

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<sup>3</sup> See e.g. Ferguson (2004, pp. 186-193) who claims that the scale of globalization was bigger before WWI than now and who associates this historical phenomenon with the existence of the liberal British Empire ("Anglobalization" in the author's terminology).

**Table 1: Current account deficit in NMS, EU candidates and potential future EU candidates, % of GDP, 1998-2005**

	1998	1999	2000	2001	2002	2003	2004	2005
<b>Central and eastern Europe</b>	<b>-3.1</b>	<b>-4.4</b>	<b>-5.3</b>	<b>-2.7</b>	<b>-3.5</b>	<b>-4.3</b>	<b>-5.7</b>	<b>-5.2</b>
Albania	-3.6	2.3	-3.6	-2.8	-7.1	-5.5	-3.8	-5.6
Bosnia and Herzegovina	-8.4	-9.1	-17.5	-20.0	-26.5	-22.4	-24.4	-26.4
Bulgaria	-0.5	-5.0	-5.6	-7.3	-5.6	-9.2	-5.8	-11.8
Croatia	-6.7	-7.0	-2.6	-3.7	-8.4	-6.3	-5.6	-6.0
Czech Republic	-2.0	-2.5	-4.9	-5.4	-5.6	-6.3	-6.0	-2.1
Estonia	-8.7	-4.4	-5.5	-5.6	-10.2	-12.1	-12.7	-10.5
Hungary	-7.2	-7.9	-8.5	-6.2	-7.1	-8.7	-8.8	-7.9
Latvia	-9.0	-9.0	-4.8	-7.6	-6.6	-8.1	-12.9	-12.5
Lithuania	-11.7	-11.0	-5.9	-4.7	-5.2	-6.9	-7.7	-7.5
Macedonia, FYR	-7.5	-0.9	-2.0	-5.7	-8.4	-3.4	-7.6	-0.8
Malta	-6.2	-3.4	-12.6	-4.4	0.3	-5.8	-10.4	-6.7
Poland	-4.0	-7.4	-5.8	-2.8	-2.5	-2.1	-4.1	-1.6
Romania	-7.1	-4.1	-3.7	-5.5	-3.3	-5.8	-8.4	-8.7
Serbia and Montenegro	-4.8	-7.5	-3.9	-4.6	-8.9	-9.7	-12.5	-8.8
Slovak Republic	-9.6	-4.8	-3.5	-8.4	-8.0	-0.9	-3.5	-7.2
Slovenia	-0.5	-3.2	-2.8	0.2	1.4	-0.4	-2.1	-0.9
Turkey	1.0	-0.7	-5.0	2.4	-0.8	-3.3	-5.2	-6.3

Source: WEO, 2006, Table 31, p. 225

The actual attitude to the EU new member states (NMS) is the best example of this misconception. For many reasons, NMS offer a higher rate of return and, therefore, they attract a substantial amount of foreign investment. Most of them are about to join the EMU in the next few years, so the exchange rate risk is considered to be negligible by financial markets<sup>4</sup>, additionally stimulating capital inflow. The fastest-growing Baltic countries, which represent the most prudent monetary and fiscal fundamentals and most flexible and business-friendly microeconomic environment, attract the largest net capital inflows and run the highest current account deficits for many subsequent years (see Table 1). Paradoxically, they are considered as externally fragile and vulnerable in some policy analyzes, which use the traditional BoP analytical framework (see e.g. Deutsche Bundesbank, 2006; Lane and Milesi-Ferretti, 2006).

This kind of 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 analyzes of a country's external sustainability, the task of rethinking must start from identifying all explicit and implicit assumptions behind these concepts and understanding the analytical limitations imposed by these assumptions.

<sup>4</sup> Some of the NMS and EU candidate countries - Estonia from 1992, Bulgaria from 1997 and Lithuania from 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 the ERM-2 members (Slovenia, Latvia, Cyprus, Malta and Slovakia) where the risk of changing a central parity seems to be minimal.

### **3. BoP and IIP concepts and their limitations**

BoP is a statistical concept aiming to provide a picture of a country's external transactions in a given period of time (usually quarter or year). While BoP illustrates external flows, a related concept of IIP deals with stocks – it provides a picture of a country's external assets and liabilities at a given time point. Obviously, the accuracy and analytical usefulness of both tools depends 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 and fit well the specifics of every country in every period of time. So, those who want to use these tools for analytical purposes must be fully aware of their limitations. Unfortunately, this is not always the case, even in the rigorous academic literature, nevermind less rigorous financial market or policy analyzes.

What are the most frequent simplifications with respect to BoP and IIP analyzes?

First, analyzes of external transactions may involve different concepts of what is "foreign" vs. "domestic": by residency, by currency or by jurisdiction. While in closed economies with inconvertible currencies these were practically almost identical, this is not the case in the highly integrated global economy<sup>5</sup>. Both BoP and IIP are concepts based on residency, so they do not necessarily provide a correct picture of currency mismatches and vulnerabilities. Transactions are conducted in various currencies, the same concerns denomination of assets and liabilities. As a result, exchange rate fluctuations may cause valuation differences in assets and liabilities, sometimes of a substantial amount (see e.g. Lane and Milesi-Ferretti, 2005 in relation to US in the first half of 2000s).

Second, in statistical and analytical practice BoP and IIP involve very often an additional implicit (not clearly articulated and not always well recognized) assumption that capital ownership residency has a fixed character (or, put more softly, that its change is highly unlikely). This means that investment in country A, financed by saving coming from country B<sup>6</sup>, will "belong" to the latter, including its right to repatriate a factor income (interest or dividend) and - eventually - the invested capital stock. In the subsequent parts of this paper we will challenge this implicit assumption.

Third, BoP summarizes all kinds of external transactions conducted by a country's residents and IIP covers all external assets and liabilities belonging to them. While both statistical tools allow for a far going disaggregation of the analyzed flows and stocks by various categories and subcategories, most analysts do not go so deeply. They just limit their efforts to observing and commenting on "crude" aggregates such as a country's current

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<sup>5</sup> I am very grateful to Christoph B. Rosenberg for drawing my attention to this distinction.

account balance or net investment position. This must lead inevitably to simplified judgments and conclusions.

For example, BoP covers both private and government transactions and IIP – both private and public assets and liabilities. If one analyzes only the “crude” aggregates she/he assumes implicitly their homogenous character and a kind of national-level 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 (see e.g. WEO, 2006, tables 37-41; pp. 238-245) is the best example here. Each loan obtained by a domestic agent from a foreign creditor is considered as 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. However, this cannot be accepted in the case of market economies fully integrated with the outside world and with a dominant role of private ownership and private transactions.

Fourth, the additional complication comes from simplified and sometimes confusing terminology used in many analyses<sup>7</sup>. For example, any current account deficit is considered as evidence of a country’s borrowing and any foreign liability - a country’s debt. Such an approach disregards various compositions of capital flows (credit, equity transactions, and transfers).

This may lead to serious mistakes in terms of proposed 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 which offer favourable business climate and bring a lot of foreign investments (which means usually large current account deficits) may be considered as macroeconomically vulnerable (as in the case of the Baltic states described in the previous section). On the other hand, countries with a poor business climate and resulting sustainable net capital outflow (the example of many CIS countries) will enjoy current account surpluses considered usually as a sign of macroeconomic health.

All the above mentioned analytical simplifications and implicit assumptions have far going consequences for understanding the nature of BoP constraints. Even if one accepts the existence of investment-saving imbalances (which is hard to avoid against the vast empirical evidence of such imbalances) they will be considered as temporary deviations from

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<sup>6</sup> For the purpose of this paper we assume a very simple model of the global economy consisting of two countries: A and B.

<sup>7</sup> For example, Lane and Milesi-Ferretti (2005) frequently use notions of “creditor countries/nations” and “debtor countries/nations” having in mind all kind 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.

the long-term equilibrium with a necessity to close this gap over the medium-to-long term perspective. Put differently, a country's IIP is expected to come back to balance over the medium-to long term.

#### **4. Looking for greater flexibility in analyzing BoP constraints**

The phenomenon of large current account imbalances could not go unnoticed by economic theory. The last two decades have brought several theoretical models of BoP, which analyze both causes and consequences of current account imbalances, particularly for countries that are capital importers. One must recognize the considerable progress and flexibility demonstrated both by the theory and by policy-oriented analytical methodology in response to these new circumstances.

Regarding the causes of current account imbalances, the emphasis has been gradually moved from an analysis of the demand factors (excessive spending due to lax monetary, fiscal or income policies leading to a current account deficit, which must be financed by external borrowing) towards the "push" or "supply side" factors (excessive saving in some countries or regions, which must be invested elsewhere).

Most recently, the role of demand vs. supply side factors has been discussed in the context of the so-called "global imbalances" (for an analytical overview see WEO, 2005, Chapter 2). On the one hand, an interesting concept of the "global saving glut" has been offered by Bernanke (2005) referring to a phenomenon of persistent current account surpluses in some countries and regions like East Asia or the Middle East. These surpluses must be accommodated by other economies like the US, other Anglo-Saxon developed countries or the EU NMS (see Macfarlane, 2005). On the other hand, Gros, Mayer & Ubide (2006; Chapter 4) confront hypotheses of "global saving glut" and "global liquidity glut," the latter caused by the lax monetary policies of the main industrialized countries.

The traditional analytical framework has considered a persistent current account deficit as an unsustainable phenomenon and a serious risk factor, which may provoke a speculative attack against a debtor's currency and cause a currency crisis<sup>8</sup>.

There is a large body of analytical literature on the so-called early warning indicators, trying to figure out what level of current account deficit and how long run may indicate the forthcoming danger of a currency crisis (see e.g. Kaminsky, Lizondo and Reinhard, 1998; Milesi-Feretti and Razin, 1998). This direction of analytical studies became particularly popular and appealing in the second half of 1990s after the Mexican and Asian crises. In its extreme version it led Summers (1996) to warn that any current account deficit in excess of 5% of GDP should be subject to attention. This gave birth to the "5% Doctrine", which was

adopted in the practice of both the IMF and private investors in the late 1990s (some other analysts used the threshold of 4%).

However, obvious empirical evidence - not every country running a persistent current account deficit becomes a victim of currency crisis and there are crises in countries running current account surpluses or having current account in balance - has called for a more flexible analytical approach and the latter has gone in at least two directions.

First, various kinds of inter-temporal BoP models accept the possibility to run current account deficits as long as imported savings generate a higher rate of investment and a high rate of return from these investments, allowing to repay the borrowed money in the future (see e.g. Obstfeld & Rogoff, 1996, Chapter 2). Second, FDI and other kinds of long-term investments are distinguished from pure borrowing or short-term portfolio flows. The former is considered as a more sustainable and less risky source of financing 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 the “home country bias,” i.e. the above described implicit assumption on fixed character of capital ownership residency. Most of them assume, in one way or another, that saving invested abroad will eventually return to the home country at some point in the future. Or at least the negative net investment position will generate an outflow of factor income, i.e. interest payments or dividends paid in favor of foreign residents whom the imported capital belongs to. In the next section we will try to challenge the key assumption of “home country bias.”

## **5. 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 & Horioka (1980). The authors presented a strong correlation between incremental investment and incremental saving in OECD member countries in the 1960s and the first half of the 1970s.

The Feldstein-Horioka puzzle needs a correct interpretation, however. The quoted authors analyzed investment and saving trends in a world of partly inconvertible currencies<sup>9</sup> and far going restrictions on capital movement, so their empirical results were unavoidable at

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<sup>8</sup> Disregarding a residency 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).

<sup>9</sup> In 1960s and 1970s most of currencies were not fully convertible with respect to capital account transactions and many countries also continued some form of current account restrictions.

that time<sup>10</sup>. The Feldstein-Horioka puzzle cannot be interpreted in the way that “home country bias” is unavoidable and determined forever.

Feldstein & Horioka’s (1980) findings were challenged in the subsequent debate on various grounds – see e.g. Roubini (1988) and Taylor (1994). On the other hand, other authors like Eichengreen (1992) and Jones & Obstfeld (1997) tried to confirm Feldstein & Horioka’s (1980) results in relation to the pre-WWII 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 - see e.g. Blanchard & Giavazzi (2002); Hericourt & Maurel, 2005. However, Feldstein (2005) himself tries to defend the contemporary relevance of his previous findings - at least in relation to large OECD countries.

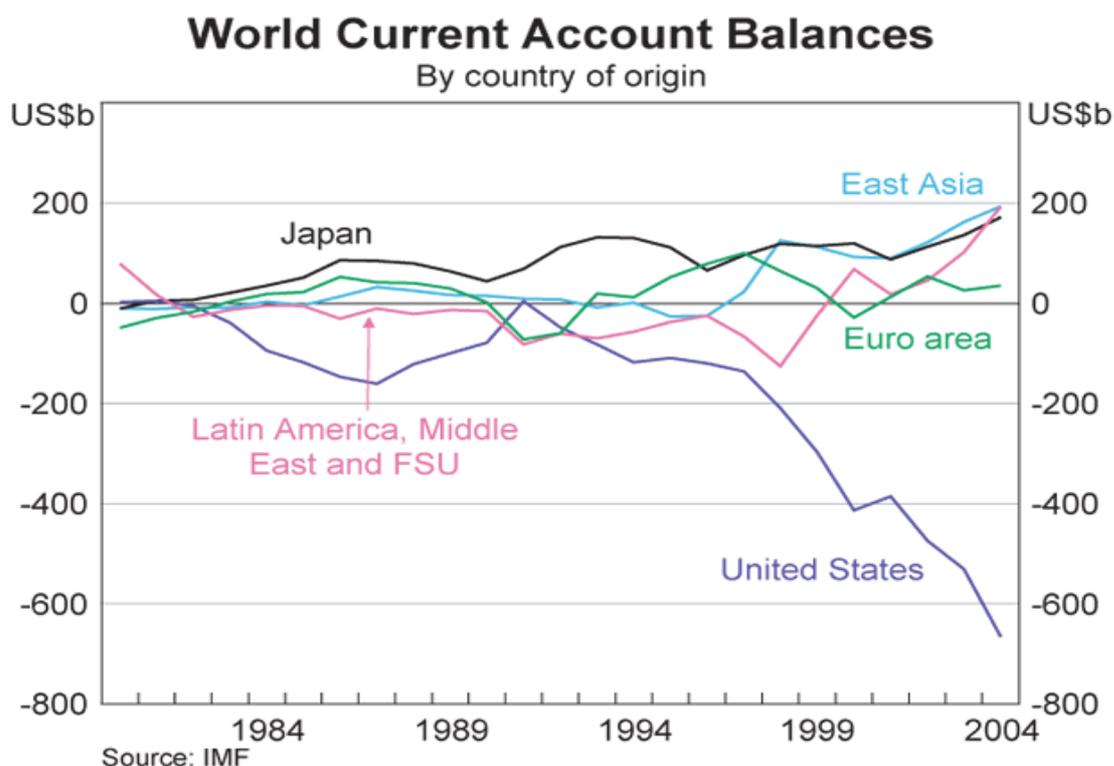
The world economy has changed radically and the globalization process has rapidly progressed from the time when Feldstein & Horioka’s (1980) paper was published. Without any doubt, we live now in a world of substantial and increasing saving-investment imbalances in respect to individual countries and their regional groups (see Figure 1).

The similar was also true in the distant past. Obstfeld & Rogoff (1995) give the example of Canada running a high (up to 10% 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 WWI. Ferguson (2004, pp. 188-189) gives evidence of the persistent character of large-scale capital export from the UK to British colonies at the end of the 19th and beginning of the 20th century.

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<sup>10</sup> Feldstein & Horioka (1980, p. 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”* (p. 328).

Figure 1



## 6. Alternative analytical framework

Let us think about an alternative analytical framework based on the following assumptions, which seem to reflect more accurately the contemporary world economy:

There is unrestricted international capital movement. This means the absence of serious administrative, tax or quasi-tax restrictions on moving savings from one country to other. This does not mean necessarily the same tax and regulatory regime in each country under consideration and 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, etc. contribute to the expected country risk premium and, consequently, they influence the expected rate of return (see Assumptions 3 and 4 below). The cross-border transaction costs may also be related to differences in legal and regulatory regimes (with respect to investment decisions, mergers, acquisitions, etc.), transportation and communication costs, usage of different languages and different currencies (including the exchange rate risk – see below). Generally, we do not substantially consider transaction costs other than those associated with exchange rate risk and, for the sake of simplicity, we will omit them in our further analysis.

Major sources of capital do not have a country of origin. This is connected with the transnational character of major corporations, financial institutions and investment funds,

even if they invest on behalf of residents of concrete countries. In addition, with free movement of people, physical persons (especially wealthy ones) may change easily their country of residence (domicile), moving together with their accumulated savings<sup>11</sup>.

Investors represent the private sector and seek the highest rate of return in their investment/ reinvestment decisions, regardless of which concrete country their decisions concern. Each individual rate of return consists of two major components: (i) country-related component reflecting a country's tax and regulatory environment, provision of public goods, macroeconomic and political risk premium, etc., i.e. all factors which are popularly labeled a country's business or investment climate (see Assumption 1 above); (ii) project-related component.

There is not necessarily a diminishing rate of return in relation to a country-related component. This means that 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<sup>12</sup>.

The consequent adoption of these four assumptions leads us to definite questioning of a "home country bias" in investment decisions. The higher expected rate of return in the home country (as compared to others) can serve as the only rational explanation of any "home country bias" under the above assumptions.

The practical implications go as follow: the initial investment in country A done by 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, the form of investment financing (credit or equity) notwithstanding. The same concerns 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 becomes lower than that of country B for any reason (because of investment climate improvement in country B or its deterioration in country A) the direction of capital movement will change. Not only capital originated from country B will go back to this country but also residents of country A will move their capital and factor income from this country to country B.

The new set of assumptions proposed in this section does not mean that country A is immunized from the danger of capital outflow with all the associated negative economic and social consequences. However, the danger of such outflow comes from change in the

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<sup>11</sup> In fact, this is nothing uncommon in world economic history. In the 19<sup>th</sup> and early 20<sup>th</sup> centuries, emigration from Europe, to North America, Australia and some other colonies and dependent territories also involved capital export to these countries.

<sup>12</sup> This particular assumption seems to distinguish my proposal from the Blanchard & Giavazzi (2002) model, which generally is going in a similar direction as my thinking. However, Blanchard and Giavazzi (2002) argue that current account position depends on the level of a country's development. Less developed countries (the authors concentrate on the examples of 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 catching-up growth. Richer countries become capital exporters. This implies an assumption on a diminishing rate of return in relation to a country-related component.

country-related component of the expected rate of return (comparing to other countries) rather than from the non-resident origin of the invested capital.

Does the current account and country's net IIP still matter under the above assumptions? The answer is partly positive as far as countries A and B from our model have different currencies and run uncoordinated monetary and fiscal policies. If the current account deficit of country A is considered by investors as too high and the country's liabilities in foreign currency as unsustainable, it can lead to an increase in the exchange rate risk premium of country A<sup>13</sup> (the expected depreciation of A currency against that of B) and decline of the expected rate of return. In case of substantial changes in market perception of exchange rate risk premium it may trigger a sudden capital outflow (both "domestic" and "foreign") and currency crisis.

The above means that some elements of the traditional BoP analytical approach still hold although other assumptions specified above weaken somewhat the strength of 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 currency B in a durable and credible way.

Thus, inside the monetary union, BoP constraints between members disappear definitely and intra-union 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 consists of countries belonging to the Single European 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 continues to make any analytical sense is an open question for further debate. Continuing the analogy with inter-regional capital flows inside a national economy, one must notice that most countries do not even compute inter-regional current account/ financial flows statistics.

## **7. Policy implications of the alternative analytical framework**

The alternative analytical framework offered in the previous two sections has far going policy implications. Discussing these implications, we will distinguish two categories of

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<sup>13</sup> The earlier remarks related to the residency-based rather than currency-based character of BoP statistics hold true and this is the reason why we talk about the partial relevance of a current account imbalance only. However, we cannot ignore the dominant financial market sentiments (which consider current account imbalances as having some relevance). 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.

countries: (1) those running their own sovereign currencies; (2) those belonging to monetary unions with a particular emphasis put on the EMU case.

At the very beginning, we must underline, however, that both categories must involve countries, which are opened to capital movement and have effective access to international capital markets. We realize that there is still a substantial number of countries (especially less developed ones), which continue effective restrictions on capital movement or - if they are formally open - do not have, for various reasons (mostly reputational ones), access to international capital markets, i.e. they are neither able to borrow (this relates to both public authorities and private entities), nor to attract FDI and portfolio investment.

Returning to the countries which are open to capital movement and belong to the first category, BoP constraints still hold in their case but their actual meaning differs from the “traditional” (or simplified) approach described in Section 3. If international capital markets consider the current account imbalance (especially deficit) of any country or group of countries as sustainable, it may be run for a very long period of time, almost indefinitely. Other countries may become, for various reasons, sustainable capital exporters<sup>14</sup>. The hypothesis on persistency of cross-country saving-investment imbalances in the well integrated global economy finds support in a vast empirical evidence – both contemporary (see Orsmond, 2005) and historical (of the second half of 19th century and beginning of 20th century).

The market perception of sustainability bases on a very individual country-specific assessment involving several economic and political variables, which 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 triggering a sudden capital outflow. However, it is worth remembering that (i) the increase in exchange rate risk premium and resulting capital outflow may not be necessarily determined by any particular size of a current account deficit or country’s IIP, or their change but by other factors (ii) if this happens it will affect the behavior of all capital owners, disregarding their country of residence.

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 current account or conduct any kind of current-account

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<sup>14</sup> The reasons why some countries or group of countries run permanently excessive saving rates (comparing to their investment rates) merit a separate discussion as they are outside this paper’s thematic agenda. Here we will limit ourselves only to suggesting a set of possible hypotheses: poor investment climate diminishing a 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 first half of the 2000s), systematic central bank interventions to keep exchange rate undervalued, etc.

motivated exchange rate engineering stay in conflict with the anti-inflation mission of a central bank (see Dabrowski, 2002). They contradict the direct inflation targeting framework adopted by an increasing number of countries running sovereign monetary policies (this strategy requires a free floating exchange rate).

The potential of fiscal policy to correct current account imbalances is also questionable. The concept of twin deficits (i.e. the 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 (see Rostowski, 2001). Successful fiscal adjustment is usually perceived by investors as a factor decreasing country risk (i.e. 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 inside a monetary union but there is still exchange rate risk with respect to other currencies. In the case of the Eurozone this concerns, for example, capital flows denominated in USD, GBP, CHF or JPY. This means that the BoP constraints hold with respect to the entire common currency area (for example, the Eurozone) but do not matter with respect to its individual member countries. For the latter, the entire analytical concept of BoP seems to lose its importance (see similar conclusion of Blanchard & Giavazzi, 2002). So blaming the Baltic countries, which are already part of the Eurozone (although not the EMU yet) for their supposedly excessive and unsustainable current account deficits (Deutsche Bundesbank, 2006), misses the point.

The above quite radical conclusion does not mean that entering a monetary union immunizes a country from any macroeconomic or financial risk. Hypothetically, the entire common currency area (like the Eurozone) may become a victim of a BoP/currency crisis. The 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 inside the national economic area without the participation of foreign investors. True, the impact of such a "regional" crisis may affect the entire common currency area depending on the scale of the shock and other circumstances (similarly to the impact of a "local" crisis inside 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 be reversed and the economy will have to adjust. However, this will affect both "foreign" and

“domestic” capital, which will seek other investment destinations. The geographic origin of capital and the previous BoP record will be irrelevant here. Again, this can also happen inside an individual country (among its regions) and must be addressed by means other than exchange rate adjustment.

## **8. 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. This is particularly true in the case of deeper regional integration like the EU and EMU.

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

In a world of free capital movement the geographic origin of capital has lost its importance (because of the ease with which one can change its domicile) and capital invested abroad does not need to return to the country of “residence”. There is no “home country bias” in investment decisions anymore; 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.

As far as 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, one must recognize that 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.

There are several issues which require further analysis and discussion. One concerns the rationale of our assumption of the absence of a diminishing rate of return at the country level and the role of the so-called systemic competition between countries in determining the expected rate of return.

Another question relates to sources and policy determinants of excessive savings in capital exporting countries and the sustainability of their saving-investment surpluses. This issue is closely linked with the ongoing debate on the role of demand vs. supply (“push”) factors in shaping the saving-investment imbalances.

One can also ask what are the possibilities (if any) to influence the current account position in a national economy fully open to international capital movement. If the answer is negative then the following question concerns the way in which a small open economy may insure itself against the danger of a BoP crisis.

Inside the monetary union one may continue discussion whether cross-country saving-investment imbalances have exactly the same nature as cross-regional imbalances inside the national economy and whether the way of financing these imbalances is similar or not.

The above list is far from being complete and it indicates that we are only at the beginning of a serious intellectual effort to rethink the traditional BoP analytical framework.

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