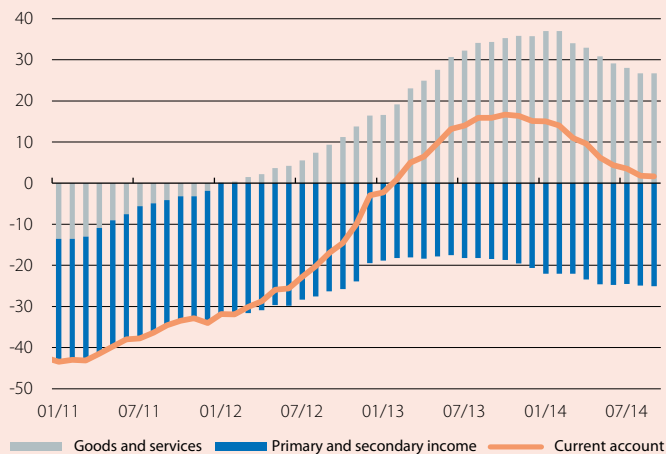


Correcting the external deficit: high and low points

One of the greatest achievements of the Spanish economy during the crisis has been the correction of one of its main macroeconomic imbalances: the external deficit. Whereas, in 2008, the current account deficit accounted for 10% of GDP, in 2013 it posted a modest surplus of 1.4% of GDP, the first in 25 years.¹ However, the current account has deteriorated again during 2014. Between January and September the current account balance accumulated a deficit of 4.2 billion, contrasting with a surplus of 9.3 billion over the same period in 2013. This situation has set alarm bells ringing: it seems as if the Spanish economy cannot (or doesn't know how to) grow without accumulating an external deficit. Nevertheless a more detailed analysis helps us to temper this conclusion, of the utmost importance given the Spanish economy's large external debt.

Current account balance

Cumulative over 12 months (billion euros)



Source: "la Caixa" Research, based on data from the Bank of Spain.

2014's deterioration in the current balance can essentially be explained by two factors. On the one hand, nominal imports of goods and services, which fell by 2.7% in 2013, grew by 5.1% during the first nine months of 2014 compared with the same period a year ago. This increase is due to the fact that the components of domestic demand that have grown the most during the recovery starting in 2013 Q3 have been the private consumption of durables, such as domestic appliances and automobiles, and investment in equipment, both with a strong import content.² On the other hand, nominal exports of goods and services performed badly, going from 3.5% growth in 2013 to 2.2% for the year to date up to September compared with the same period a year ago.

Although these trends are likely to change direction in the coming quarters as domestic demand shifts towards goods and services with less import content and European demand improves, the deterioration in 2014's balance of trade has highlighted the vulnerability of the adjustment taking place.

This has revived debate regarding the importance of

determining the relative weight of cyclical and structural factors in the current account deficit correction. A cyclical adjustment, which reflects weak domestic demand and a high output gap, means that the current balance will record a deficit again as soon as production picks up and GDP comes close to its potential figure. If, on the other hand, the adjustment is mostly structural in nature, i.e. a result of improving productivity and redirecting production resources towards the export sector, then it could grow without a deterioration of the external balance.

In practice, calculating the cycle-adjusted current balance will crucially depend on the estimate for potential GDP and the output gap. But there is one drawback: potential GDP is a theoretical construct and, as such, cannot be observed. Consequently the conclusions reached can be very different depending on the trend in potential GDP employed. For example, the EC estimates that most of the deficit correction between 2009 and 2013 would be structural.³ Specifically, it attributes 9.8 of the 11.1 points of correction to this; i.e. 88% of the adjustment. According to these estimates, the cycle-adjusted current account deficit stood at -0.2% of GDP in 2013 (the surplus recorded was 1.4%). This result comes from assuming a significant reduction in potential GDP, so the output gap would almost be closed. The IMF, however, assumes a smaller drop in potential GDP and, consequently, is less optimistic regarding the extent of structural correction. Specifically it estimates that around 30% of the adjustment can be put down to cyclical factors.⁴

Given the difficulty in discerning, with any reliability, what proportion of the adjustment has been structural due to the high degree of uncertainty surrounding such estimates, the Spanish economy should focus on bolstering a current surplus with a sufficiently wide margin to make sure it can reduce its external debt position. The latest data available, referring to 2014 Q2, show that the country's net international investment position (NIIP) rose to -999 billion euros; i.e. a debt position equivalent to 95% of GDP.⁵ This figure is far above the threshold of 35% set by the EC in its evaluation of the macroeconomic imbalances of EU countries, highlighting the importance of bringing this down to a more sustainable level.

1. The data used in this article correspond to the methodology employed in the new balance of payments manual (BPM6), except for the data from 2008, which correspond to the previous methodology.

2. Import content refers to the proportion of the value of production corresponding to the consumption of imported intermediate goods. This means that, when private consumption or investment increases, imports also increase.

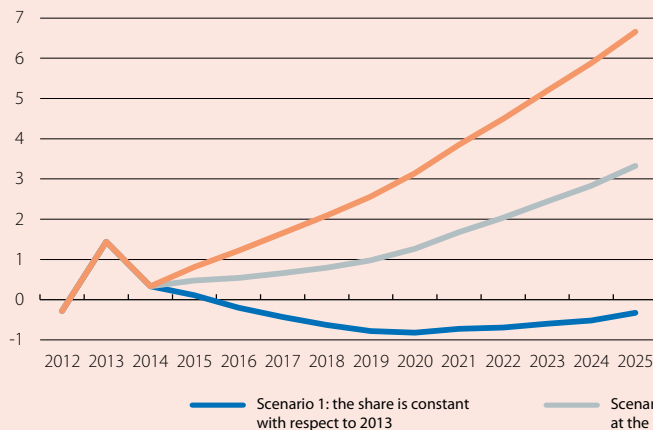
3. «The cyclical component of current-account balances», European Economic Forecast Winter 2014.

4. «Rebalancing in the euro area and cyclicity of current account adjustments», IMF WP 14/130, July 2014.

5. The NIIP is the difference between a country's investments abroad (assets) and investments from other countries (liabilities). If the balance is negative, it equals the net external debt.

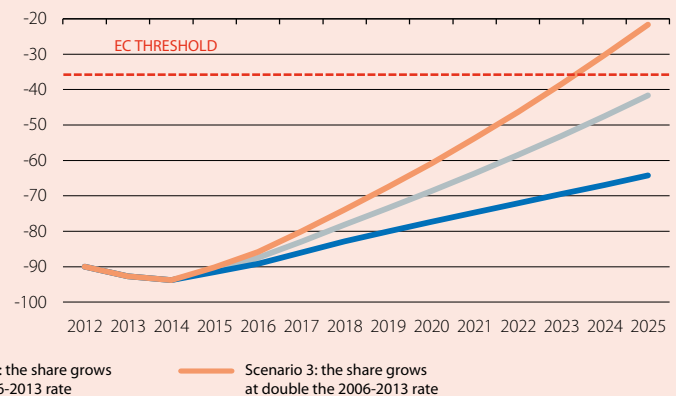
Trend in the current account balance

(% of GDP)



Trend in the net international investment position

(% of GDP)



Note: The share refers to the share of Spanish exports (Spanish exports to a country out of all of that country's imports).
Source: "la Caixa" Research, based on data from the Bank of Spain.

We will outline different scenarios to provide a more accurate analysis of the impact of the current account balance on the trend in the NIIP. In a first scenario, we assume that export shares (Spain's exports to a country out of the total imports carried out by the country in question) remain constant at the 2013 level and, therefore, exports only increase as foreign demand grows (we assume that each country's imports grow at a rate equal to their growth in GDP). In a second scenario, we apply the hypothesis that export shares increase every year at the same rate as the annualised increase in the period 2006-2013. Lastly, in the most optimistic scenario, we assume that export shares accelerate and grow twice as fast every year as in scenario 2.

The growth projections for domestic demand of "la Caixa" Research are used for all these scenarios. Specifically, imports are estimated based on the import content of the components of domestic demand and of exports. For each of the scenarios, the trend in exports and imports of goods and services is projected under the different assumptions described above and the balance of trade is calculated.⁶

In the first scenario, the most conservative, the average annual rise in nominal exports between 2015 and 2025 would be 2.6%, the same as for imports. This means that the current balance will remain slightly negative until 2025. In this case, the NIIP is only reduced thanks to the denominator effect; i.e. thanks to growth in nominal GDP. Consequently, the adjustment in the international debt position would be very gradual and it would not fall below 35% until 2035, in 20 years' time!

This scenario highlights the fact that it is not enough for Spain to maintain its competitive position achieved so far. Further gains need to be made in competitiveness. The second scenario aims to reflect this situation, where we assume that export shares grow at the same rate as in the period 2006-2013. In this scenario, nominal exports would increase by 4.3% per year on average and imports by 3.2%. Consequently, the current account surplus would increase gradually, reaching 3.3% of GDP in 2025 and this would lead to a substantial correction in the NIIP, passing the 35% threshold in 2027.

To illustrate what would happen in a more optimistic scenario, where far-reaching structural reforms are introduced to accelerate gains in competitiveness, we assume that the rate of growth for export shares is double the previous scenario. In this case nominal exports would grow at an average annual rate of 5.6% and imports by 3.7%. The current account balance would increase considerably, reaching 6.7% of GDP in 2025. The NIIP would fall below 35% in 2024.

In short, the correction of the current balance over the last few years has been the first step in stabilising the external position of the Spanish economy but further improvements need to be made to guarantee the sustainability of external debt in the long run. To achieve this, it is vital to continue implementing all those measures that help make gains in competitiveness. Only in this way will the Spanish economy's growth be sustainable and balanced.

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6. To calculate the current account balance, the "la Caixa" Research forecasts were used for the primary and secondary income accounts (the same ones in all three scenarios) and added to the balance of trade. The net borrowing/lending of the economy was calculated by adding together the current account and the capital account. For simplicity's sake, the latter is assumed to be equal to 0.6% of GDP in each period (in line with the historical average). Lastly, the NIIP of a period is equal to the NIIP of the previous period plus net borrowing/lending, assuming there is no valuation effect for the NIIP. Valuation effects correspond to changes in the value of stock of external assets held by residents and in the value of stock of external liabilities held by non-residents.