

Kiel Policy Brief

The Importance of Investment Income and Transfers in the Current Account: A New Look on Imbalances

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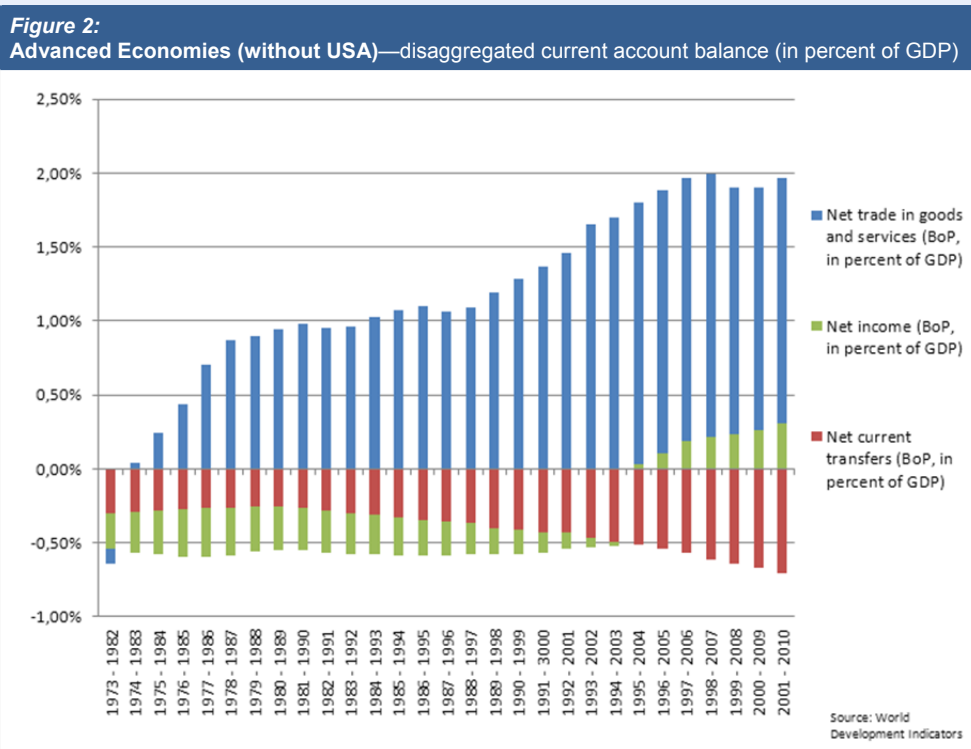
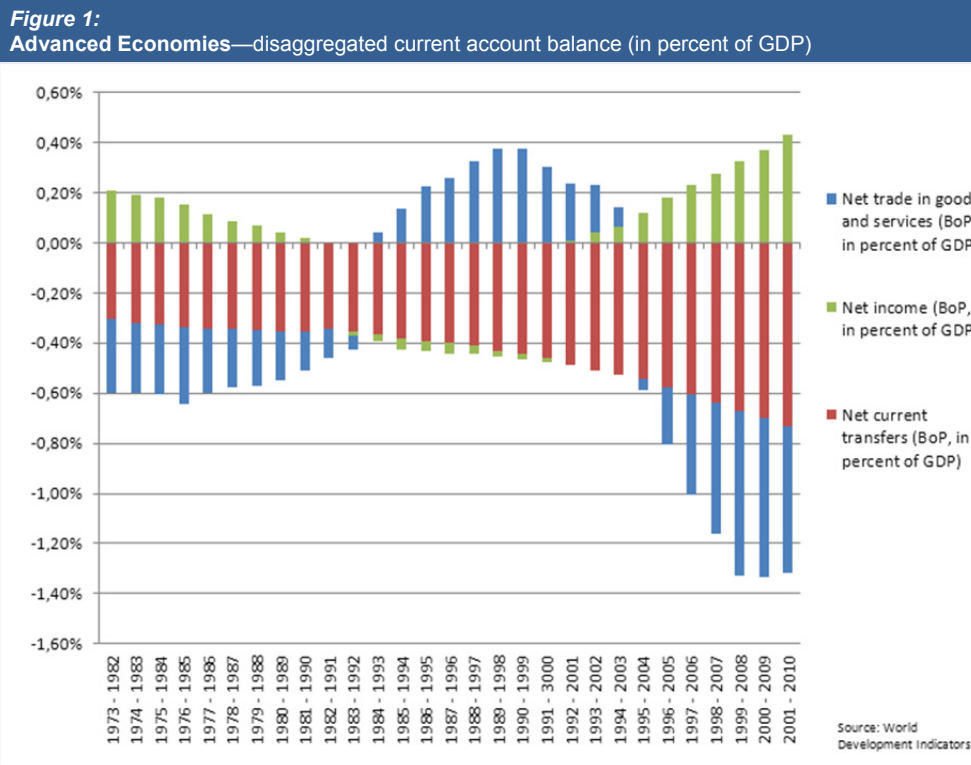
Over the last twenty five years, current account imbalances have been both rising over the trend and have become more volatile over the cycle. In boom times, imbalances expanded while in times of a cyclical downturn they shrank. A rising trend has been mainly explained with two developments: first, the increasing capacity and willingness of international financial markets to relax domestic savings constraints in financing domestic investment and consumption, and second constraints in domestic financial markets of some countries to efficiently absorb high domestic savings. The cyclical observation has often been derived from changes in trade flows and the “slicing up” of the value added chain. For a number of supply and demand reasons, cross-border value-added chains grow during an upswing and shrink during downturns. Hence, the ups and down in intermediate trade have been made widely responsible for cyclical variations in the current account.

However, the focus on only one of three components of the current account, the trade balance, hides the look on the two other components, net investment income (in the figures labeled as net income) and transfers. It will be shown in this Policy Brief that these two components have also been subject to important changes over the trend and cycle and that these changes vary substantially between six different groups of countries. In particular, both investment income flows and transfers are very likely to become more important as elements of inter-temporal consumption smoothing between emerging markets as the origin of payments to ageing economies as recipients or between emerging markets and advanced countries on the one hand and poor countries as recipients on the other hand (for instance, remittances).

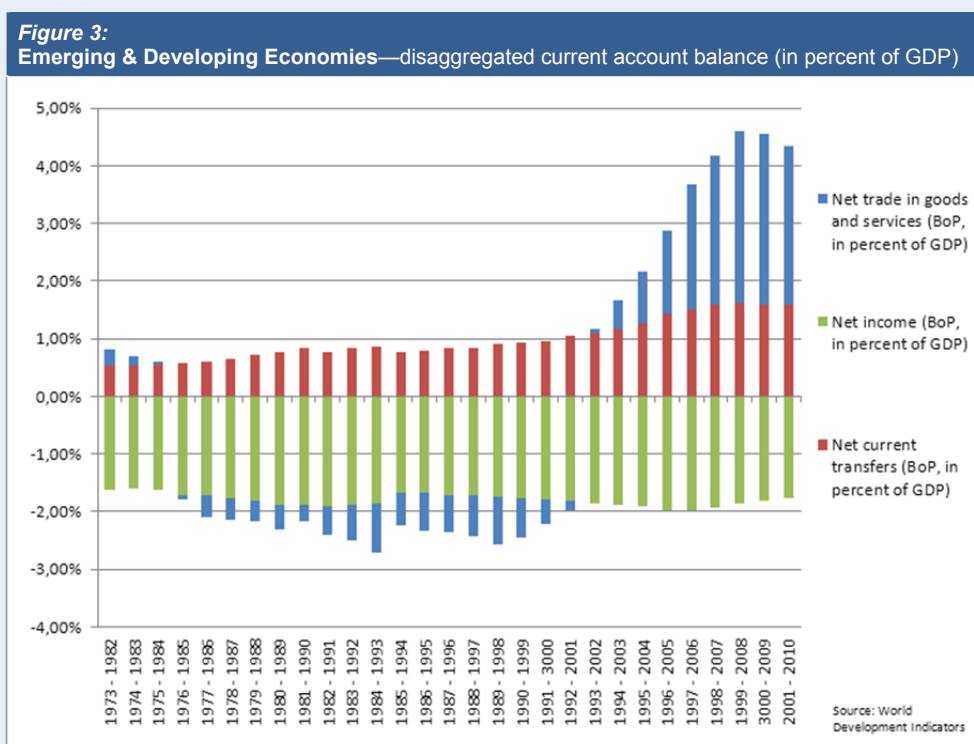
Stylized Facts

Since the year 2000, a positive net income /GDP ratio has grown over a ten year moving average for the **advanced economies** (Figure 1). This growth ran parallel to a growing outflow of net transfers driven both by public transfers (aid) and private transfers (remittances). Together with a growing negative net trade balance, this adds to a slightly negative current account for the advanced economies. It is the USA which determines this development. Even slightly rising net income inflows from US investment abroad, could not compensate for the growing trade deficit and also slowly rising net transfer outflows. Figure 1 includes the US. If the US is excluded (Figure 2), the composition of the current account changes as much as its development over time. Then, advanced economies still gain their current account surplus from positive net trade with a recently small but increasing part from net investment income earned abroad. The large discrepancy between the current account composition of advanced economies with and without the US displays the strong gap or dividing line between the US as a borrower and other countries as lender which has

become more distinct over time and finally led to a net borrower position of advanced economies (including the USA) which has been aggravated by rising outflows of public and private transfers.



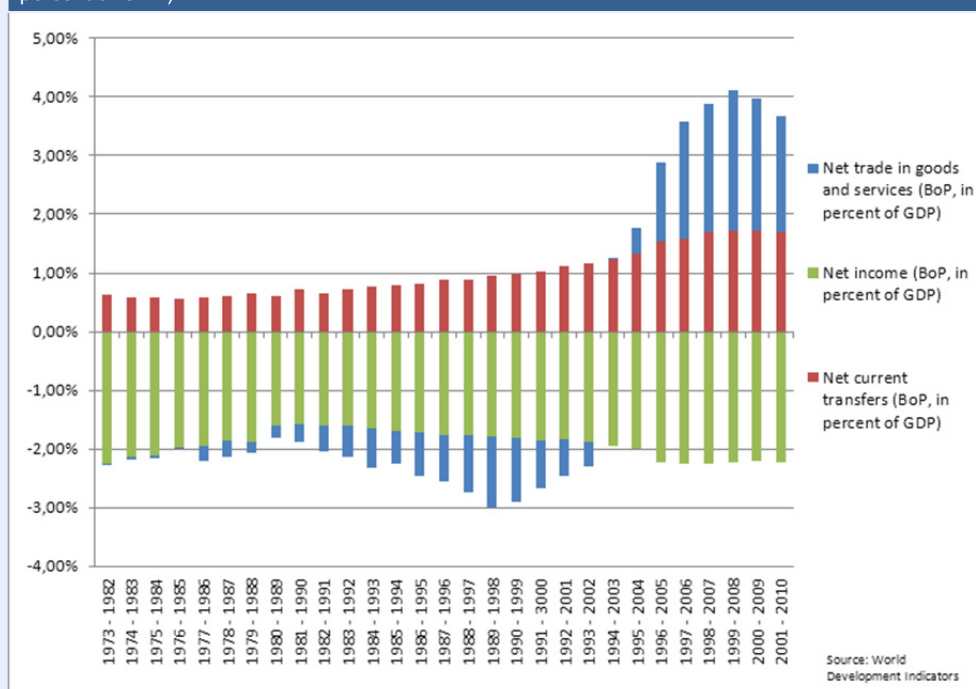
The counterpart to the advanced economies, the **emerging and developing economies**, experienced growing net positive trade balances together with rising net transfer inflows (Figure 3). In recent years, these inflows have outweighed the stable ratio of investment income outflows. Emerging and developing countries have become net lenders for the advanced economies. In other words, savings flow increasingly upstream from the poorer to the richer countries where theoretically financial resources should be most abundant. Again, as in the case of the USA, one could assume that given the economic weight of a single country, China, and its very strong trade position, differentiating between emerging and developing economies with and without China, would yield notable differences. Yet, this is not the case.



Without China, emerging and developing economies show an almost identical current account pattern as with China included but at lower levels (Figure 4). This reflects strong net exports of resource-rich economies (including fuel exporters) which add to the strong manufacturing export base of China. However, the current account pattern is by no means as homogenous as the aggregate picture of this country group suggests.

IMF data allow for disaggregating the heterogeneous group of developing and emerging economies by economic characteristics such as resource or energy export orientation, debtor status or by stage of industrialization (such as the **newly industrializing Asian economies (NIAE)**). Not surprisingly given the heterogeneity of the countries, such disaggregation reveals major differences in the current account composition between the groups.

Figure 4:
Emerging & Developing Economies (without China)—disaggregated current account balance (in percent of GDP)



In both the **NIAE** (Figure 5) also known as successful exporters of manufactures and the **fuel exporting countries** (Figure 6) the traditionally strong trade component in the current account even strengthened over time. While the fuel exporters experienced some outflows of investment income which, however, remained far below the trade component, the NIAE showed investment income inflows and outflows leveling out. Interestingly, in the fuel exporting countries, net transfer outflows (mostly remittances from guest workers, such as from South Asia working in the Gulf states) which in the mid-eighties and again a decade later had become somewhat relevant, declined to a negligible level relative to the trade component. This could indicate that either the flow of guest workers declined and/or that their savings were no longer as strongly repatriated as before.

A totally different picture emerges from **developing economies exporting non-fuel primary products** (Figure 7). These countries comprise, for instance, Chile and Peru and a number of Sub-Saharan African economies. The post-2000 price boom for the commodities exported by these countries helped them to shift the traditionally negative trade balance into a surplus but even more important was the continuously rising net outflow of investment income. Obviously, investors in the commodity sectors ceased to reinvest their incomes but increasingly repatriated them or invested them abroad.

Finally, we have the **net debtor group of countries** (Figure 8). Their current account composition reflects the importance of a steady inflow of transfers, both public (aid) and private (remittances), to contain a rising negative net trade balance and a constant outflow of investment income of about 2% of the GDP.

Figure 5:
Newly Industrialized Asian Economies—disaggregated current account balance (in percent of GDP)

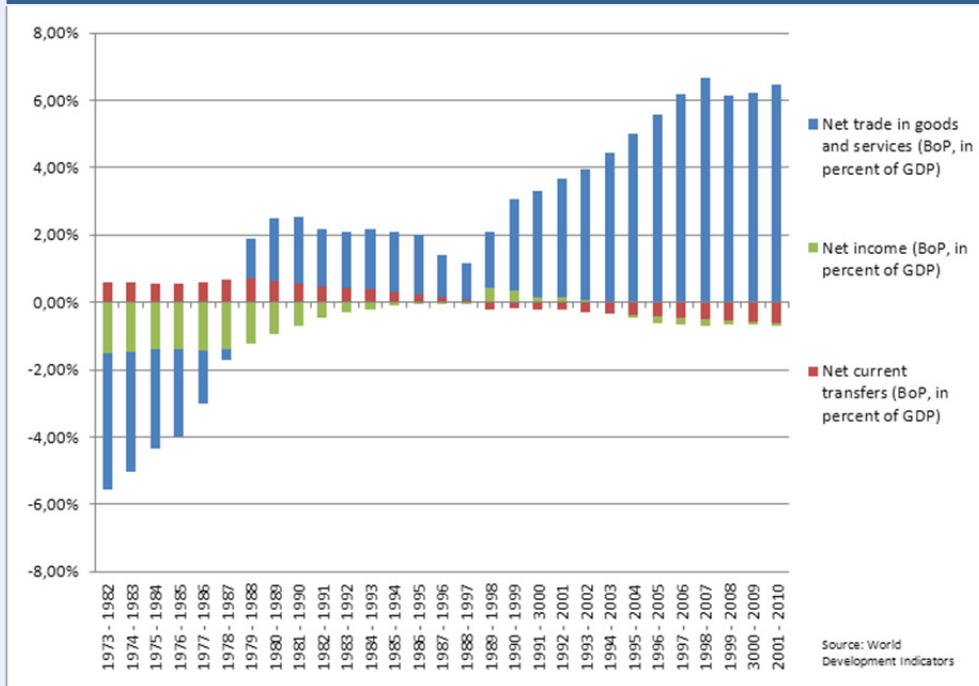


Figure 6:
Fuel Exporter—disaggregated current account balance (in percent of GDP)

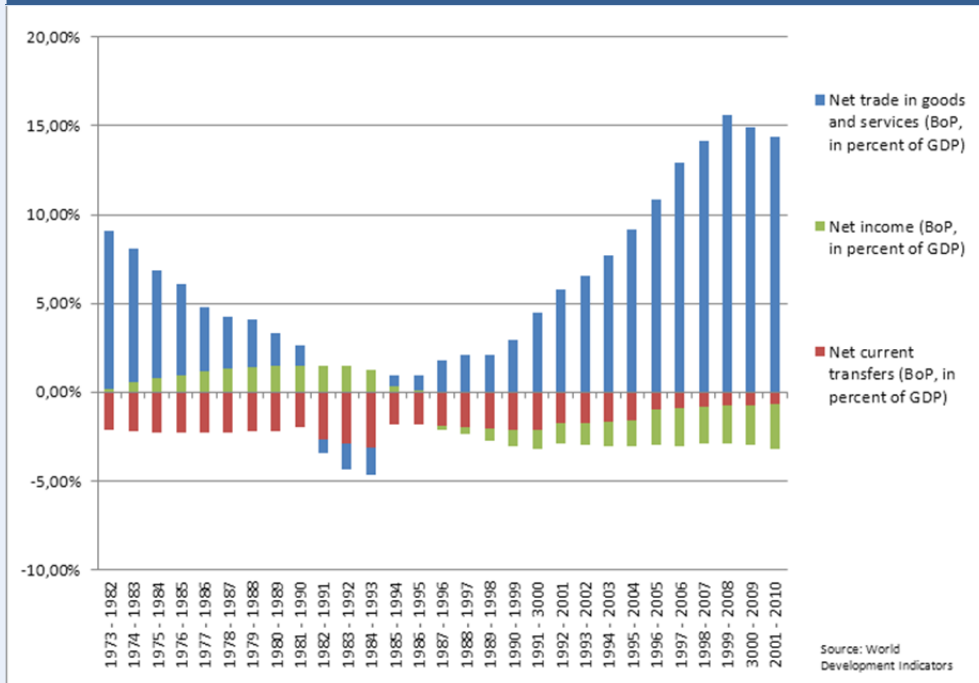


Figure 7:
Nonfuel Primary Product Producing Countries—disaggregated current account balance (in percent of GDP)

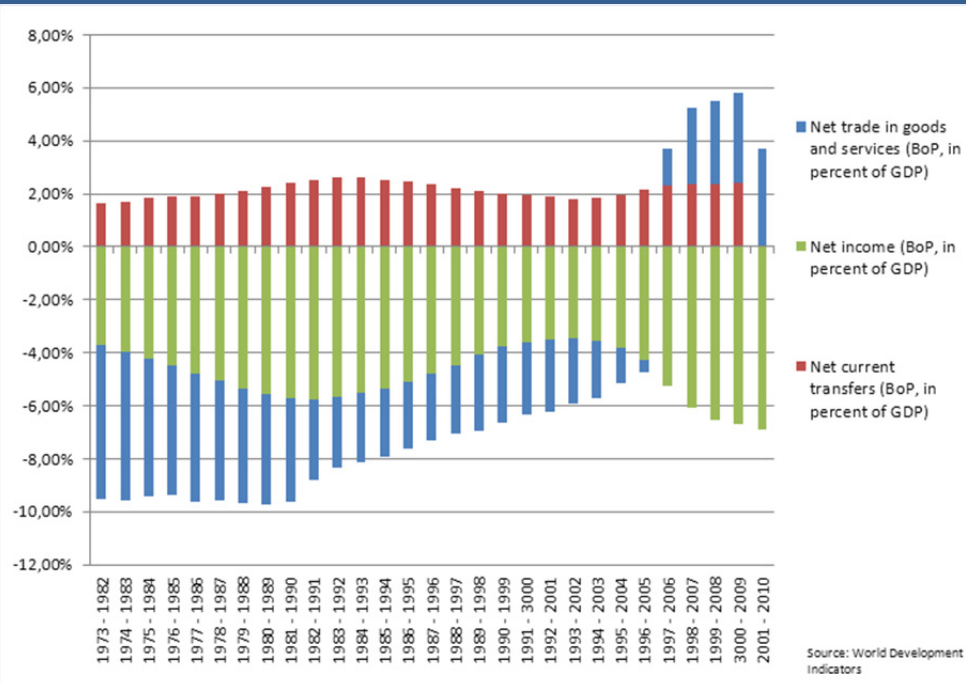
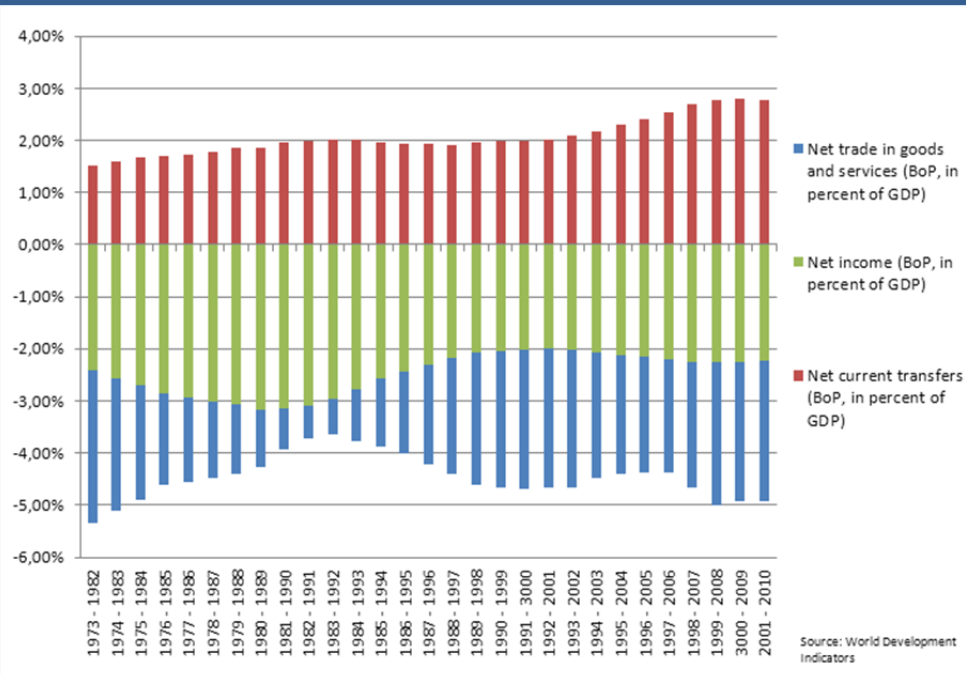
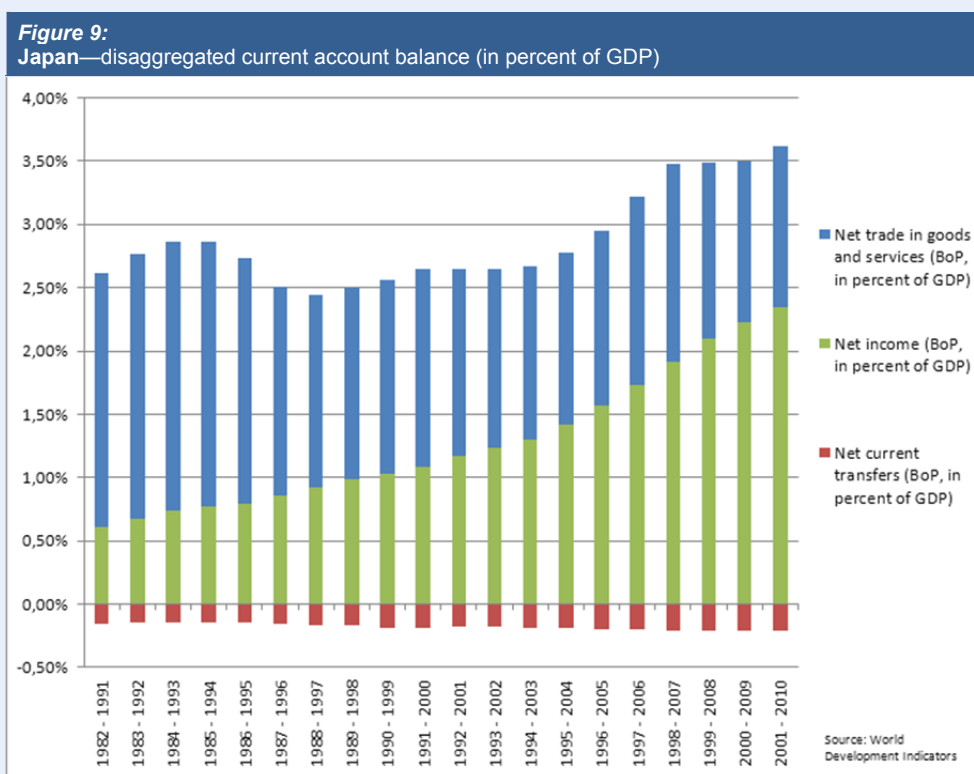


Figure 8:
Net Debtor Countries—disaggregated current account balance (in percent of GDP)



The current account patterns of all six country groupings show that cyclical volatility has been larger in the trade component than in the two other components with net transfers gaining in importance both on the outflow side (advanced economies) as well as on the inflow side (debtor countries).

Turning to individual countries, the outstanding case among those countries showing a rising importance of net investment income inflows is **Japan** (Figure 9). Since the 1995–2005 period, net investment income inflows into Japan have contributed more to the current account balance than net trade flows. In 2009/2010, Japan was the world’s largest creditor ahead of China, the Euro Area and the US as measured by its net foreign asset position as a share of GDP (IMF 2011¹). This strong position has been the backbone of income generated from foreign direct investment and portfolio investment abroad.



In contrast to Japan, the **US** (Figure 10) has not been able to relax a deteriorating trade balance plus a stable outflow of transfers by a sizable inflow of investment income. Its positive equity and FDI position was by far outweighed by its negative bond position of about 10 percent of GDP held primarily by countries like Japan. Nevertheless, trend figures for the last decade show a rising positive net income from US investment abroad depending very much on the development of stock markets. Both **Germany** (Figure 11) and **China** (Figure 12) share the outstanding and rising role of the trade part in the current

¹ IMF (2011). Japan: Spillover Report for the 2011 Article IV Consultation and Selected Issues. *IMF Country Report* 11/183 (July): 4.

account over the net investment income flow part which in China is still a “quantité négligeable” and which in Germany is only slowly rising in the recent past.

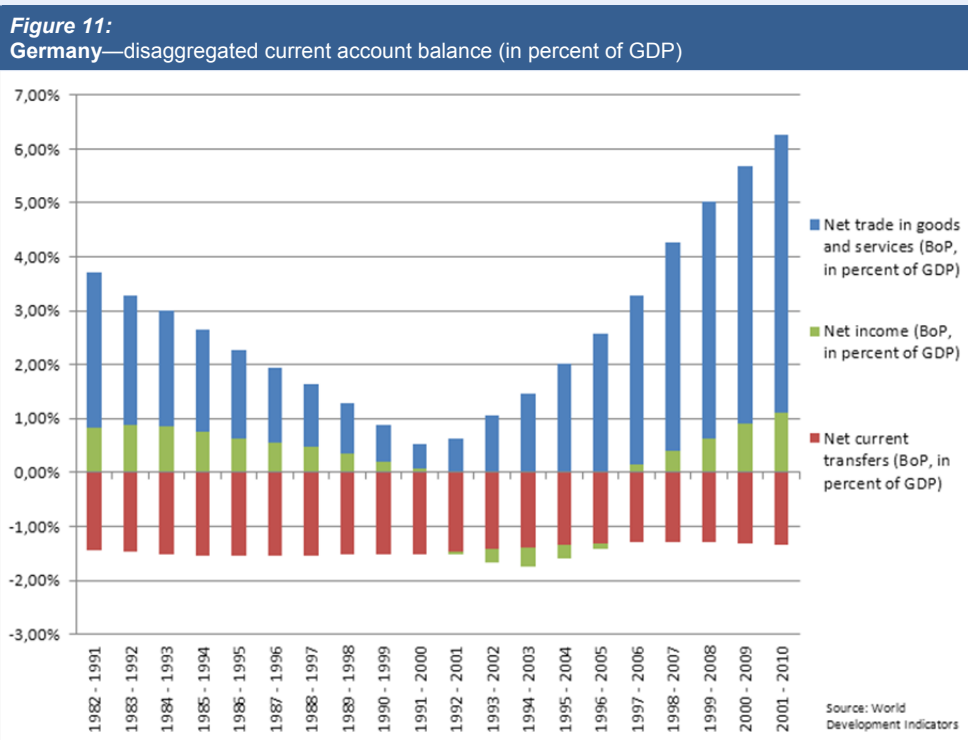
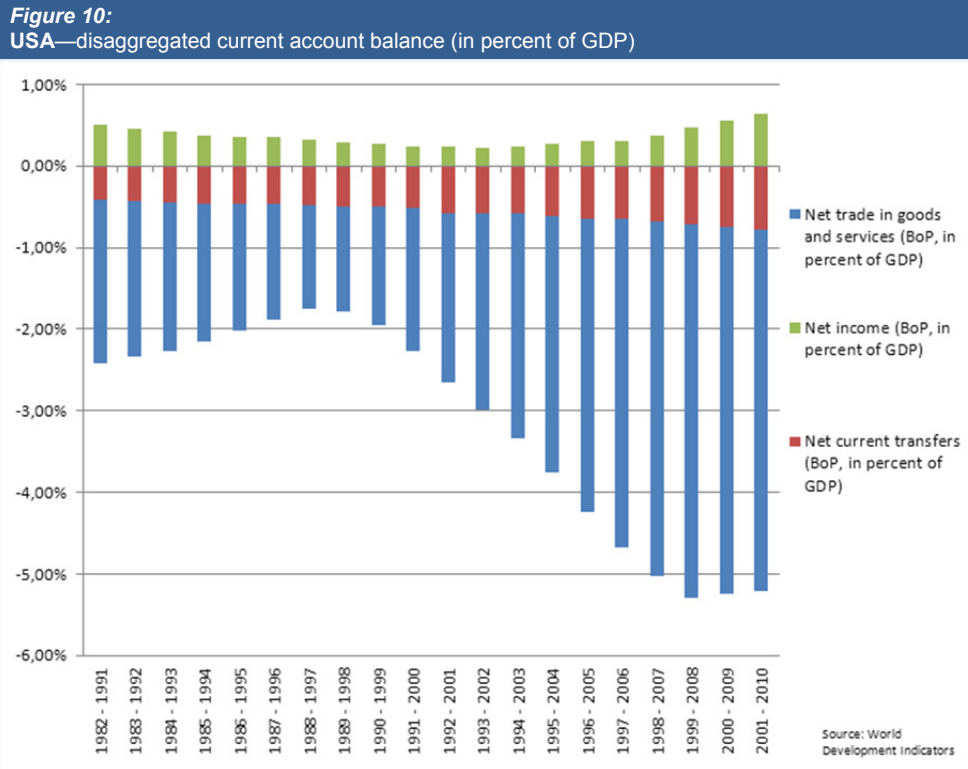
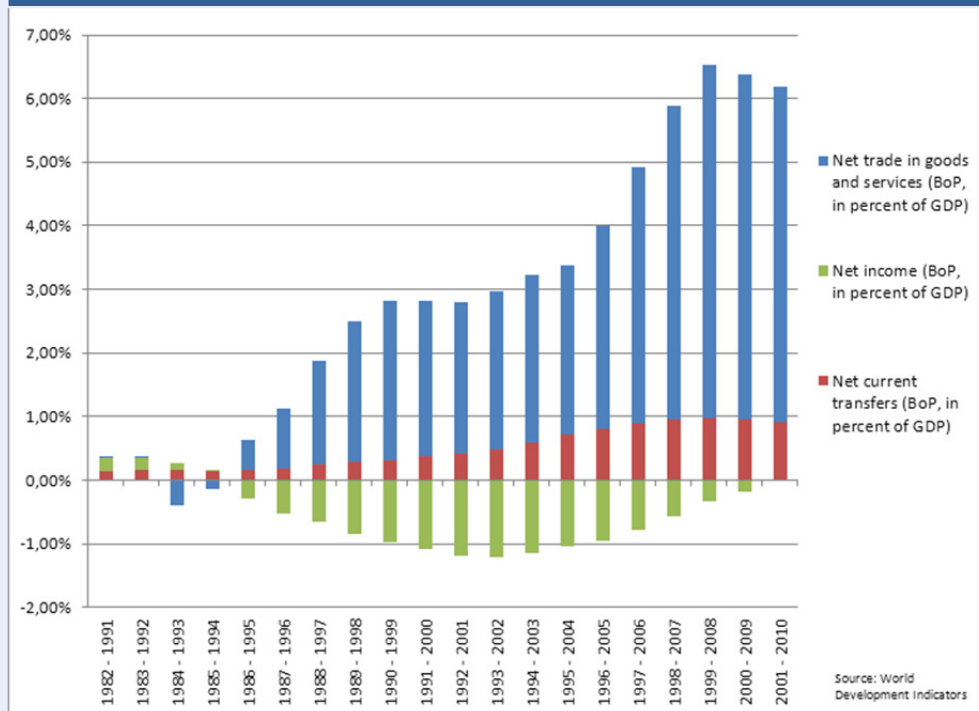


Figure 12:
China—disaggregated current account balance (in percent of GDP)



A number of other countries, both advanced ones (**France** (Figure 13), **Italy** (Figure 14), **Canada** (Figure 15), **Australia** (Figure 16), **the UK** (Figure 17), and **Spain** (Figure 18)) and emerging ones (**South Korea** (Figure 19), **Brazil** (Figure 20), and **India** (Figure 21)) mirror the heterogeneity of the economies. There are some extreme cases. In India, for instance, inflows of remittances and public transfers from abroad have been strongly rising over the trend and have widely compensated for rising trade deficits. A resource-rich economy like Australia owes the lion's share of its past large current account deficit to outflows of investment income. Another advanced resource-rich economy, Canada, however, displays, a different pattern of declining investment income outflows parallel to an improvement of the traditionally positive trade balance. A worrying example of rising outflows of transfers plus a steady outflow of investment income coupled with a massively deteriorating trade balance is Italy followed by Spain. The UK enjoys rising investment income inflows which, however, have been by far smaller than the rising trade deficit. Even with a ten years moving average, Brazil shows much volatility with sizable investment income outflows which are only partly compensated for by rising net exports in recent years. Finally, South Korea's current account position is still exclusively determined by trade. Net investment outflows came to a standstill there.

Figure 13:
France—disaggregated current account balance (in percent of GDP)



Figure 14:
Italy—disaggregated current account balance (in percent of GDP)

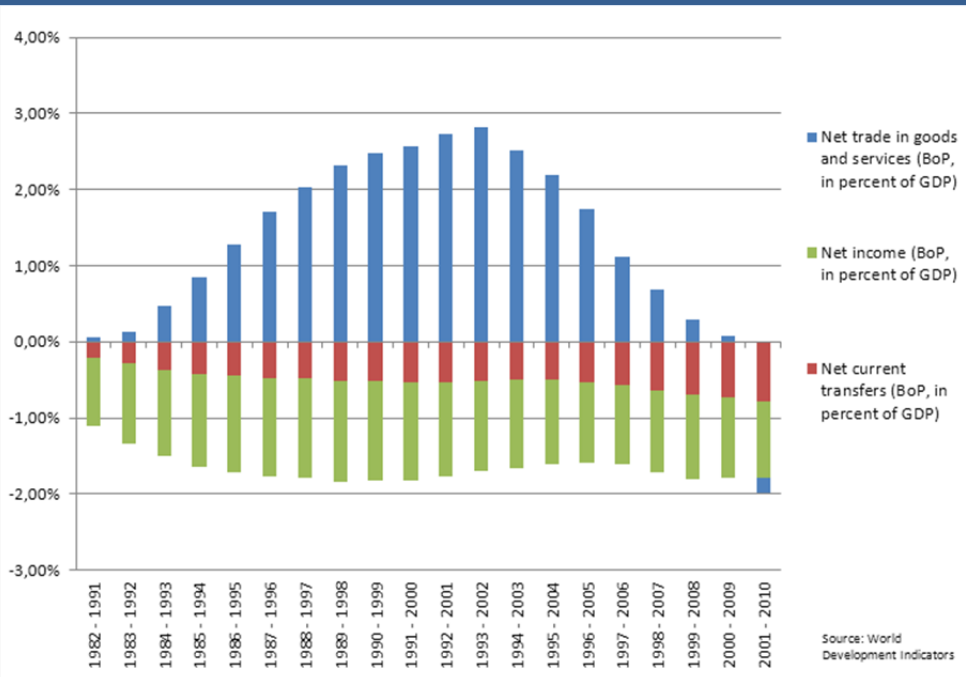


Figure 15:
Canada—disaggregated current account balance (in percent of GDP)

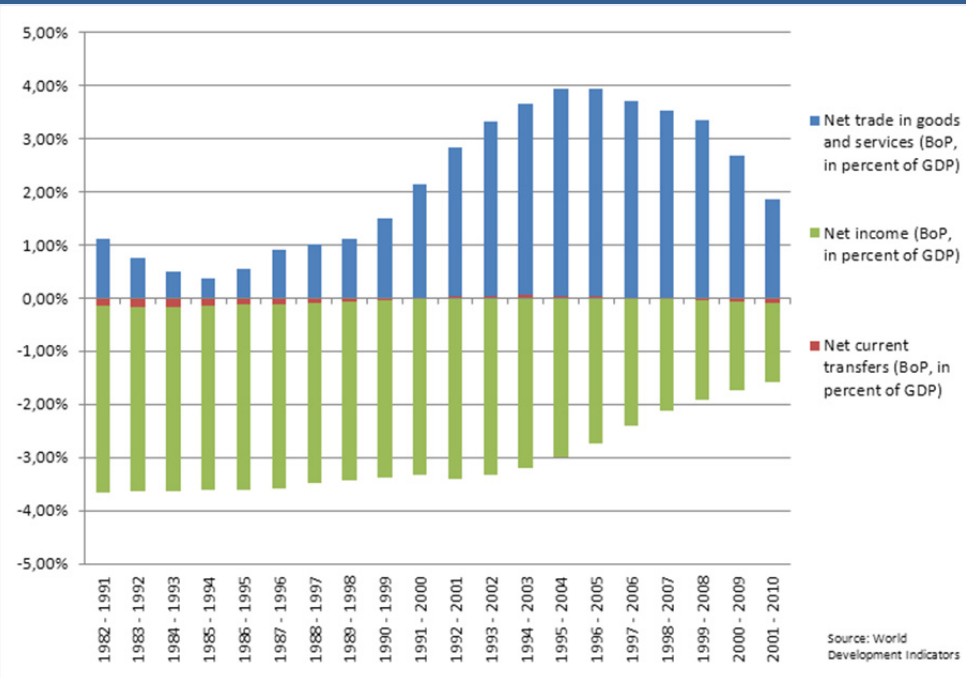


Figure 16:
Australia—disaggregated current account balance (in percent of GDP)

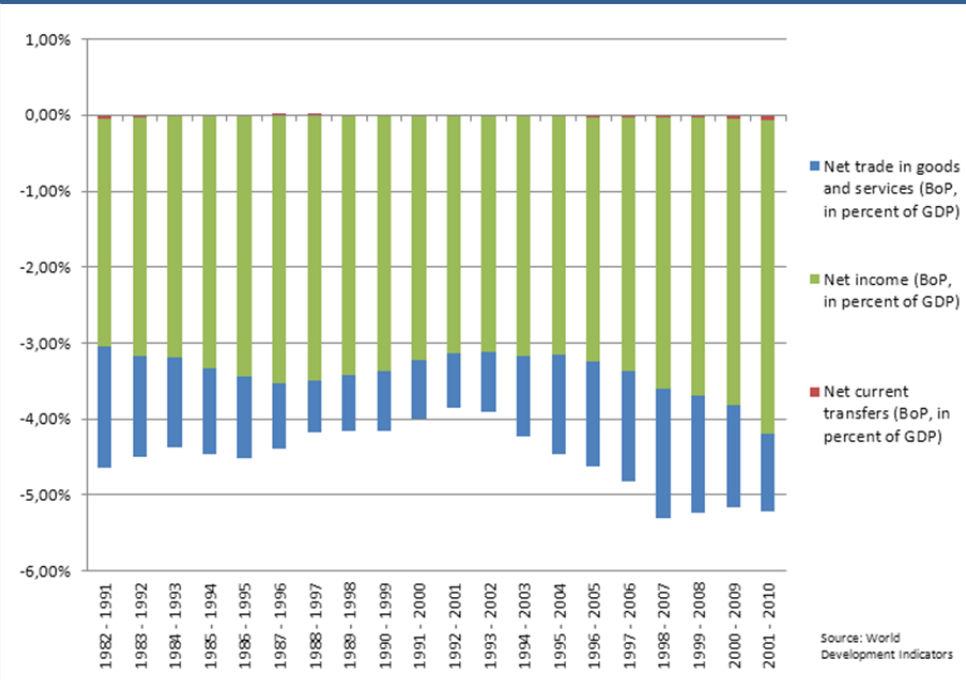


Figure 17:
United Kingdom—disaggregated current account balance (in percent of GDP)

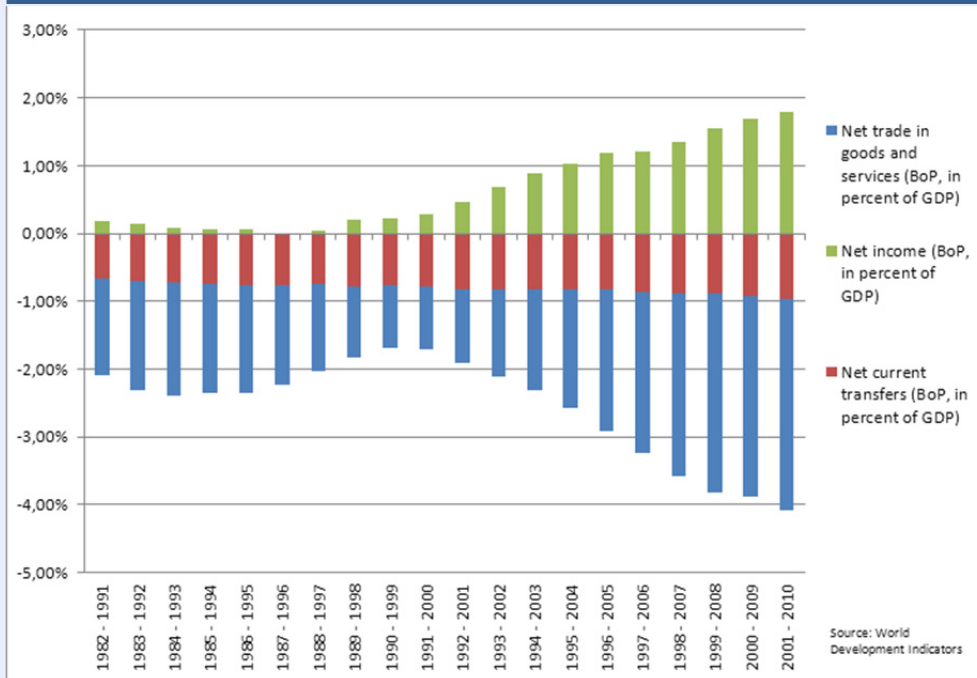


Figure 18:
Spain—disaggregated current account balance (in percent of GDP)

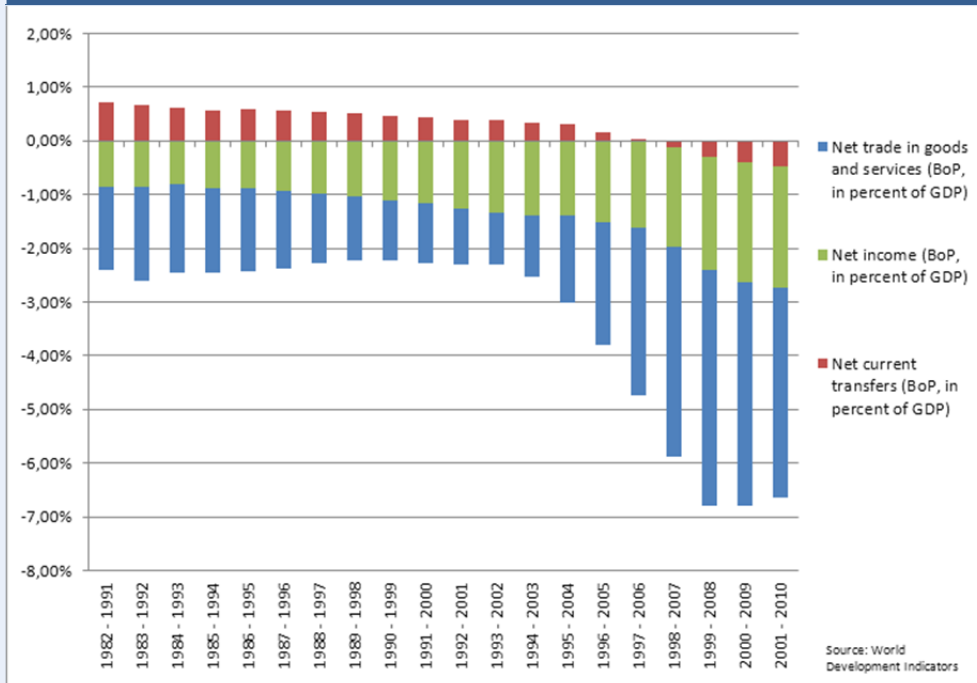


Figure 19:
Korea—disaggregated current account balance (in percent of GDP)

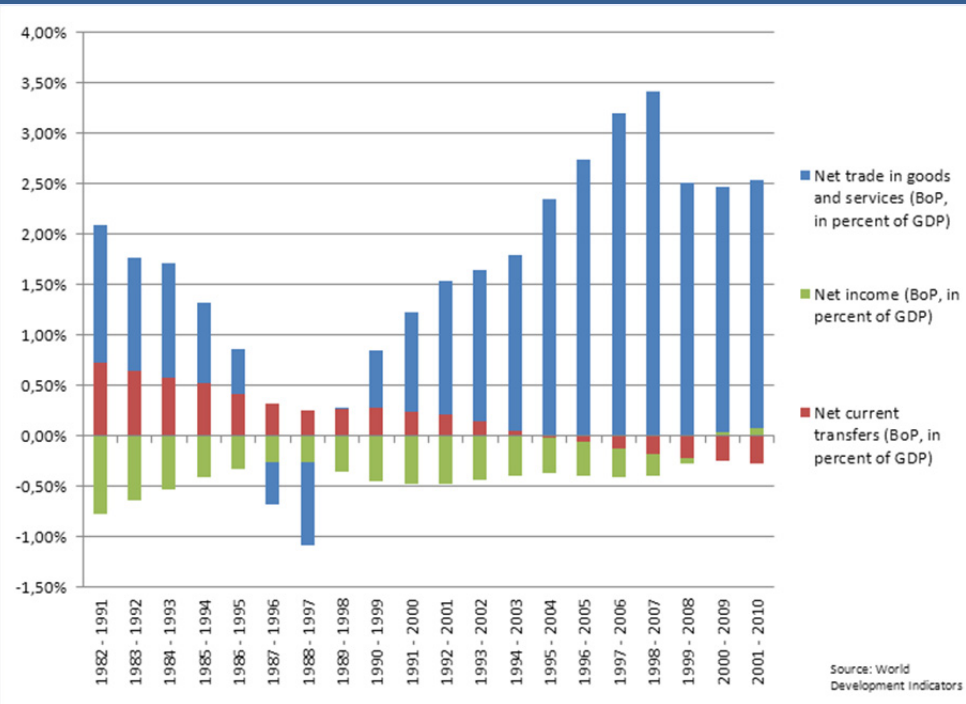


Figure 20:
Brazil—disaggregated current account balance (in percent of GDP)

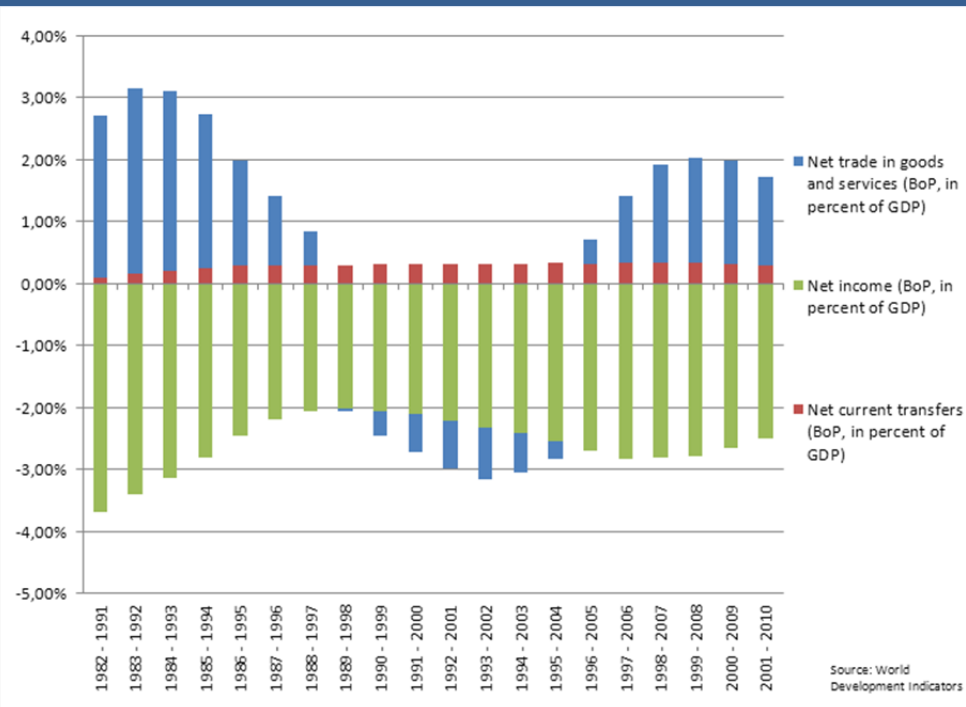
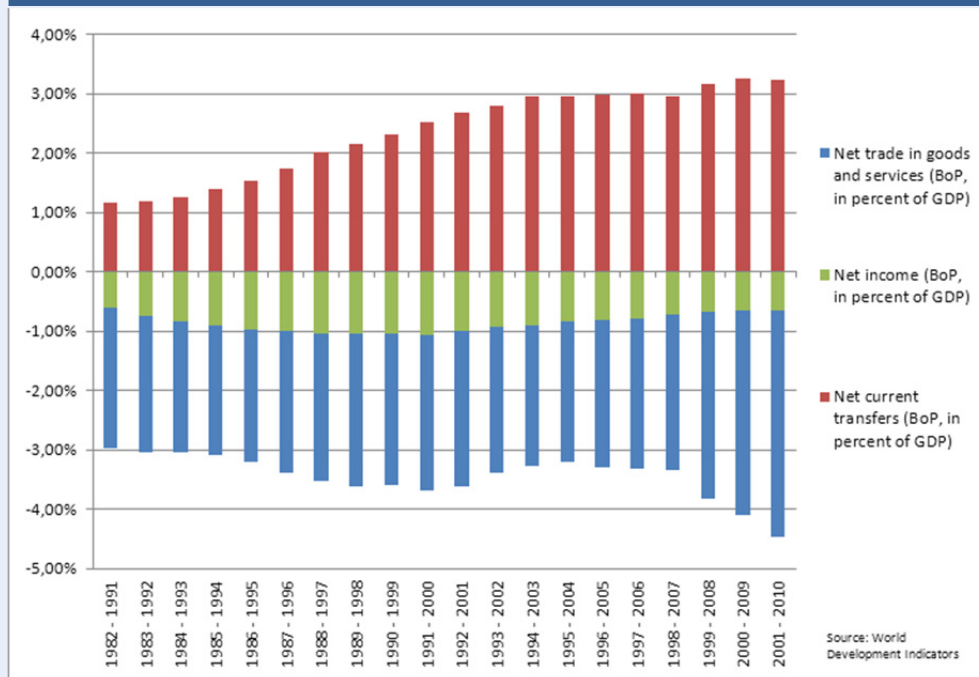


Figure 21:

India—disaggregated current account balance (in percent of GDP)



What does all that mean for the future?

Until today, the debate on current account imbalances has been large determined by the dichotomy between countries driving their import demand much beyond the availability of domestic savings like the US, the UK or Spain and countries offering unprofitable use for their high domestic savings like China and Germany. Such dichotomy materialized in growing trade deficits of the former group financed by savings of the latter group. However, looking only on the trade side obscures the rising importance of the two other components of the current account, transfers flows and the investment income flows. Extreme cases like India where remittances inflows from guest workers working abroad are vital to prevent the current account from derailing or Japan where it is investment income which helps the country to contain a trend of deteriorating international competitiveness, are only the peak of an iceberg. Other economies too see the importance of investment income and remittances rising. High growth of foreign investment and a rising cross-border mobility of labor are responsible for this development. Incomes from investing abroad and working abroad are not entirely consumed or saved in the host country or reinvested there but are partly returned to the home country. The motivation behind deciding between host and home country as the place for spending income follows a number of reasons rooted both in the relative macroeconomic and political conditions of host and home countries as well as in specifics at the firm and individual level. Furthermore, it is not clear whether the two components could contribute more to limiting the extent of current account imbalances than

via the trade account. Poorer countries will probably see the contribution of remittances to their current account at a higher level than richer countries and to the extent that labor migration is not seasonal but medium-term stable (because of high migration (sunk) costs), remittances could be less volatile than trade (see India). As concerns investment income from abroad, the decision to repatriate such income more than usual may be driven first by sudden events which signal the urgent need to invest at home (as the Fukushima tsunami of 2011) and second by abrupt exchange rate movements which shape the relative profitability of investment income reinvested or repatriated.

It can therefore not be excluded that among the three components of the current account, investment income will turn out to be the most volatile one while remittances become the most stable one. These could be good news for developing countries and somewhat uncomfortable news for those advanced countries whose current account sustainability becomes more dependent on investment income inflows.

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