FROM A CAPITAL ACCOUNT SURPLUS TO A CURRENT ACCOUNT DEFICIT

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How macroeconomic imbalances develop?

From Current account deficits to Capital account surplus

Overspending at home ("living beyond a country's means") leads to borrowing.

- The gap between private savings and investment falls due to increased private demand leading to current account deficits.
- The public deficit increases leading to current account deficits, also known as the "twin deficits".

Main channel

The supply of the domestic currency falls in the foreign currency market leading to an appreciation of the currency and a fall in net exports.

How macroeconomic imbalances develop?

From Capital account surplus to Current account deficit

Easy access to cheap international credit can lead to overborrowing, which leads to overspending.

Main channels

- Low world interest rates cause a capital inflow through the carry trade and momentum trading.
    - A stock market boom that increases consumption.
    - Increased domestic investment.

  Domestic demand is increased, which reduces the supply of domestic currency in the foreign currency market leading to an appreciation of the currency and a fall in net exports.

Financial crises

Several waves of financial crises in the post Bretton Woods period:

- Mexico and South America, early 1980s.
- Japan, 1990.
- Finland and Sweden, 1991.
- South-East Asia, 1997.
- The U.S., the U.K., Ireland, Spain, Portugal, Greece, Iceland in 2008.
- Argentina, Turkey,…….. 2018.

Common elements

- Capital flows.
- Unsustainable debt accumulation.

A perfect storm

Prelude

Asset price bubble, mostly stock market but also housing market.

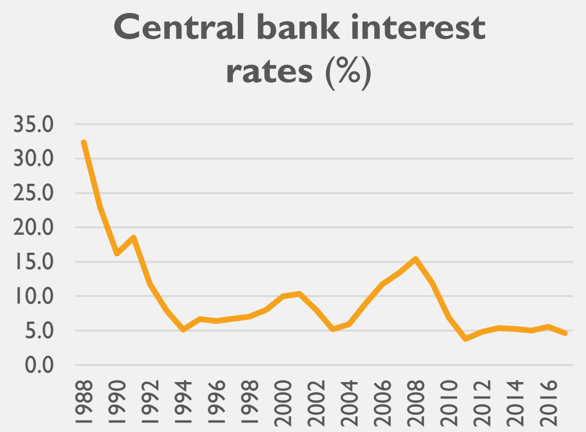
Rapidly expanding banking system from 2004 to 2008.

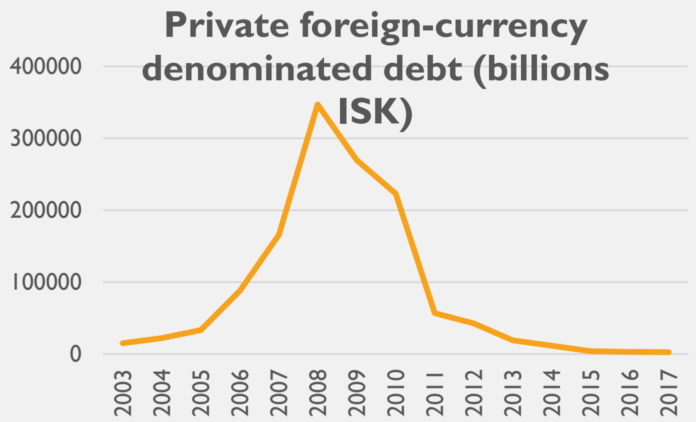
Foreign borrowing.

Carry trade.

Foreign investments.

Sudden stop of capital flows in spring and summer of 2008.



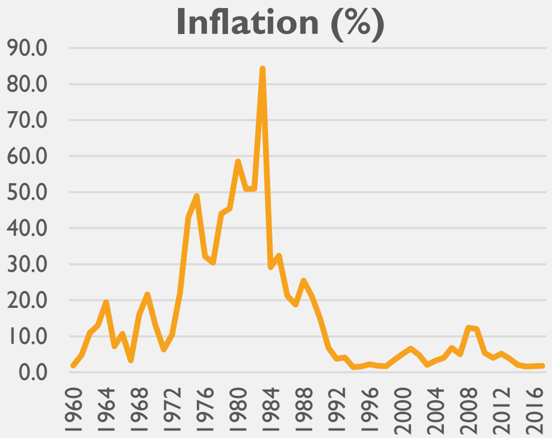


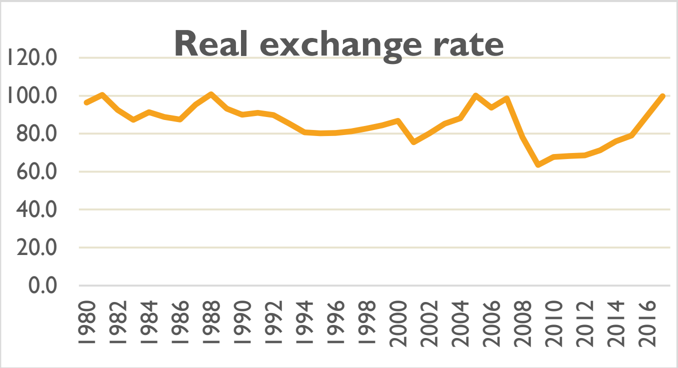
Collapse

Balance of payment problems.

Collapsed banking system.

Inflation and unemployment.





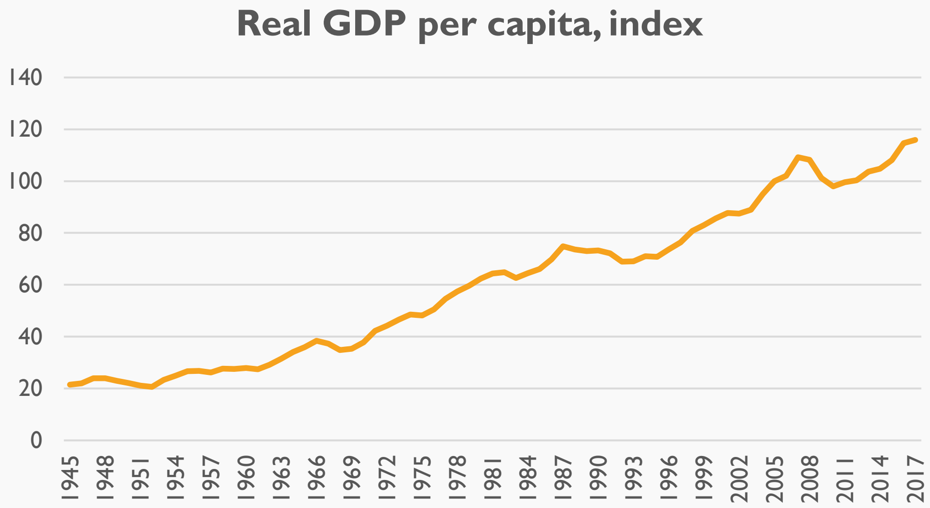
A successful IMF program

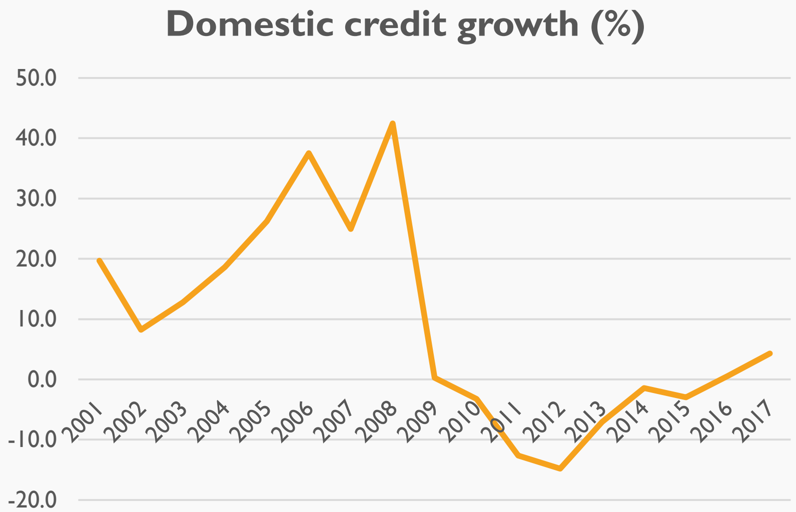
Capital controls from late 2008 to early 2017.

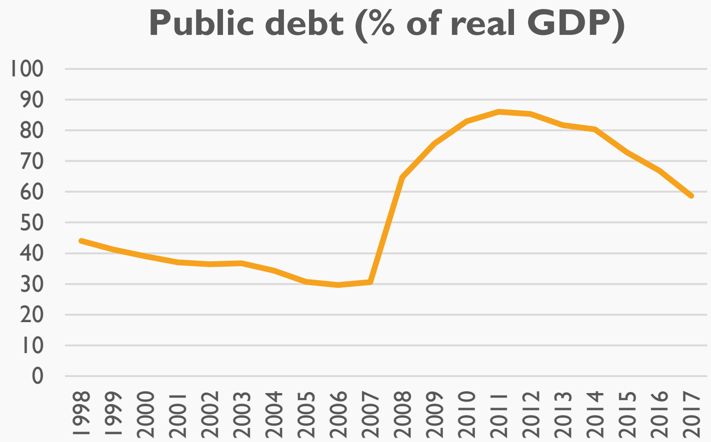
Monetary policy.

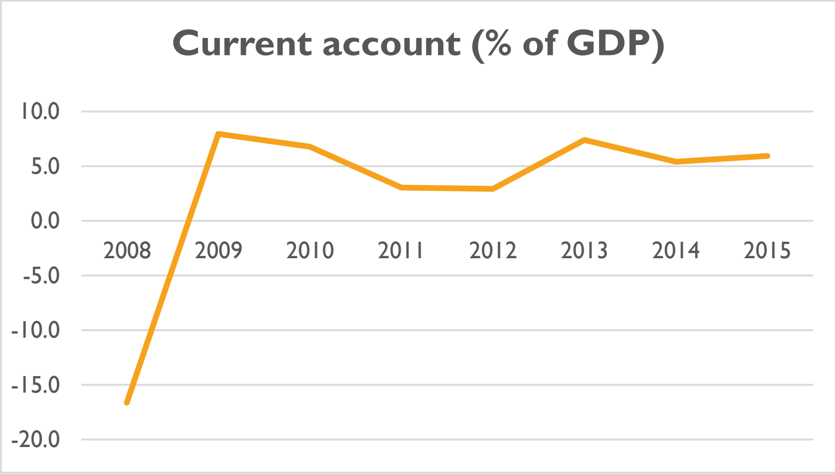
Fiscal policy.

Bank restructuring.

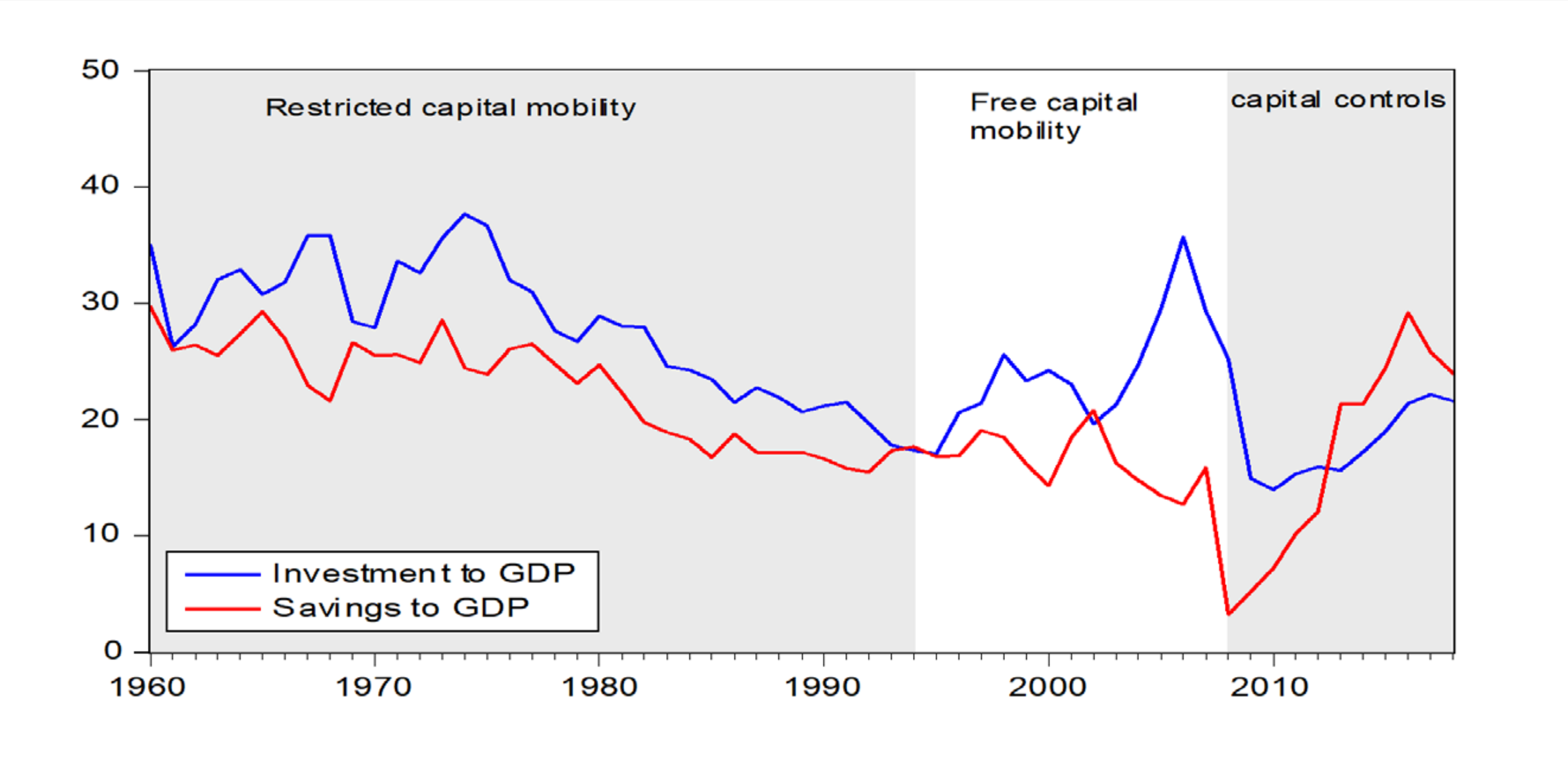






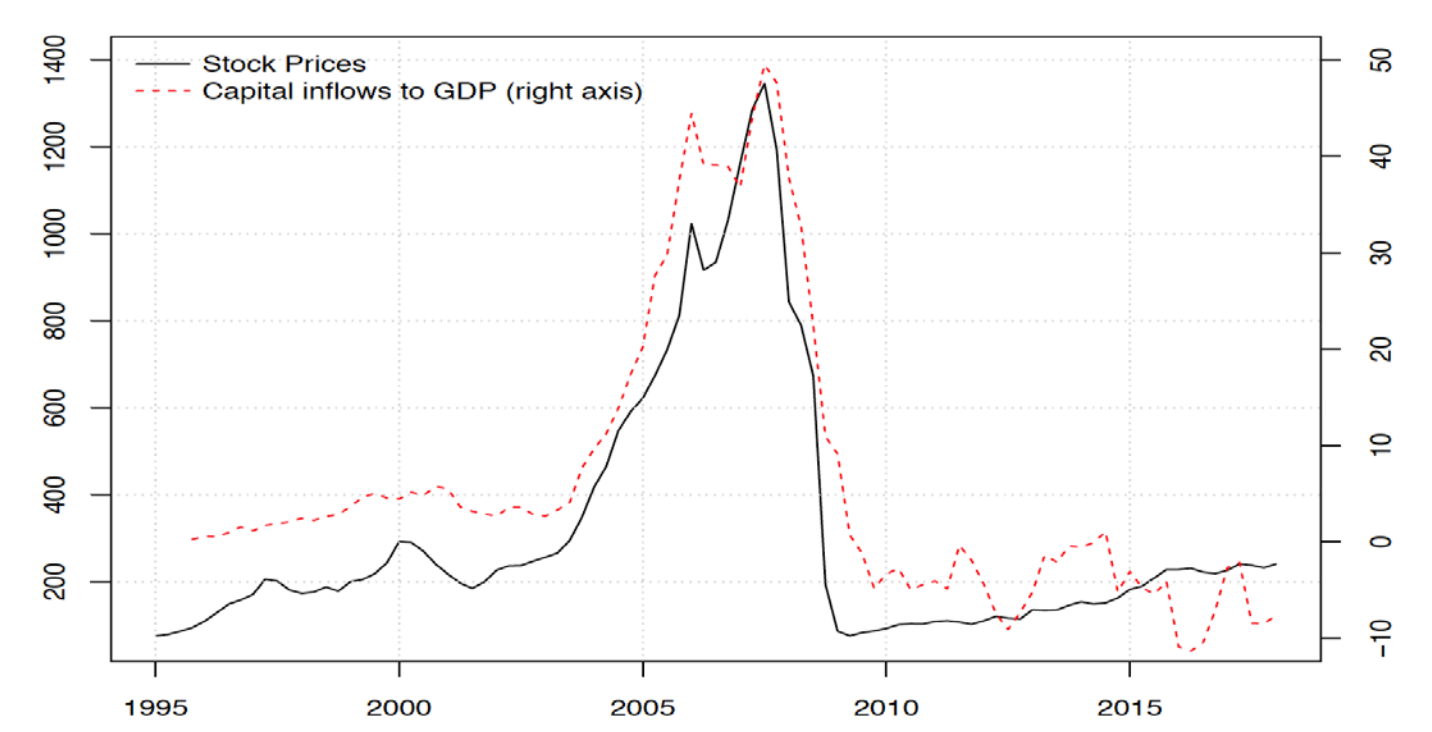


Main hypothesis: Where Iceland's story fit?



Main hypothesis: Where does the Icelandic story fit?

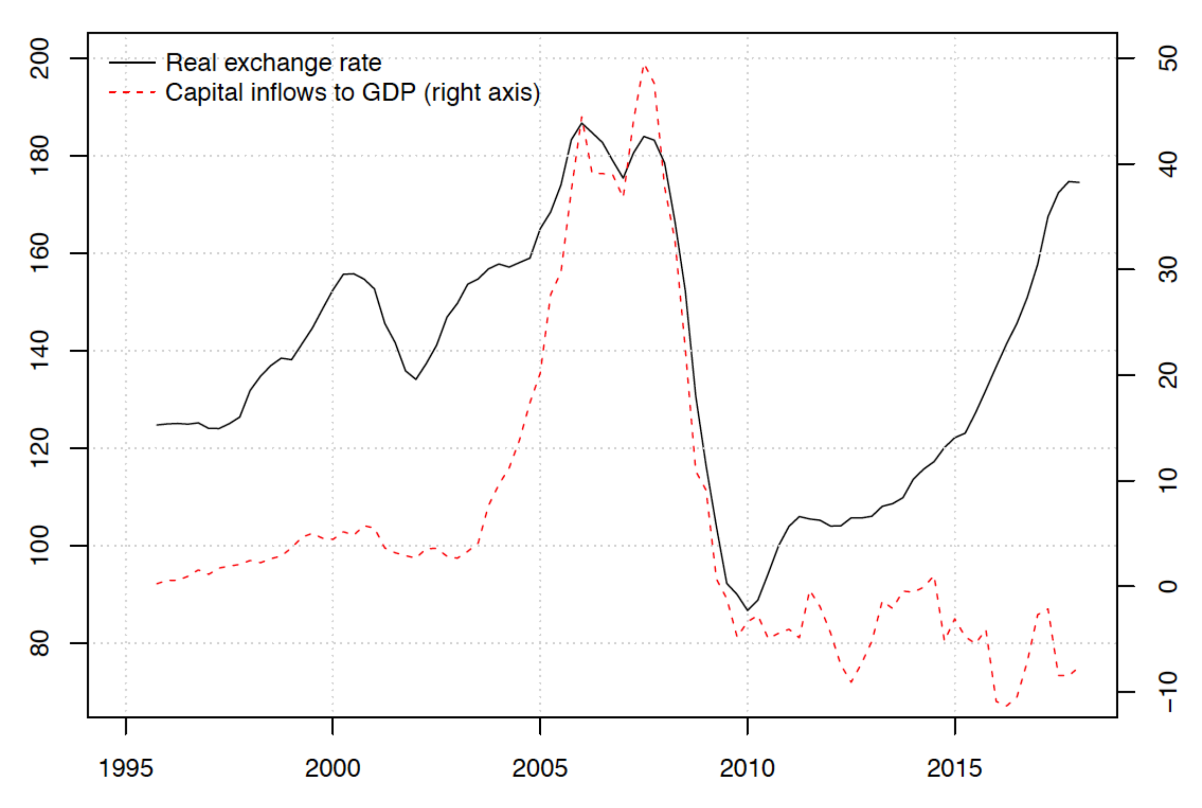
Gross capital flows and share price index



Note: Gross capital inflow is four quarter moving average

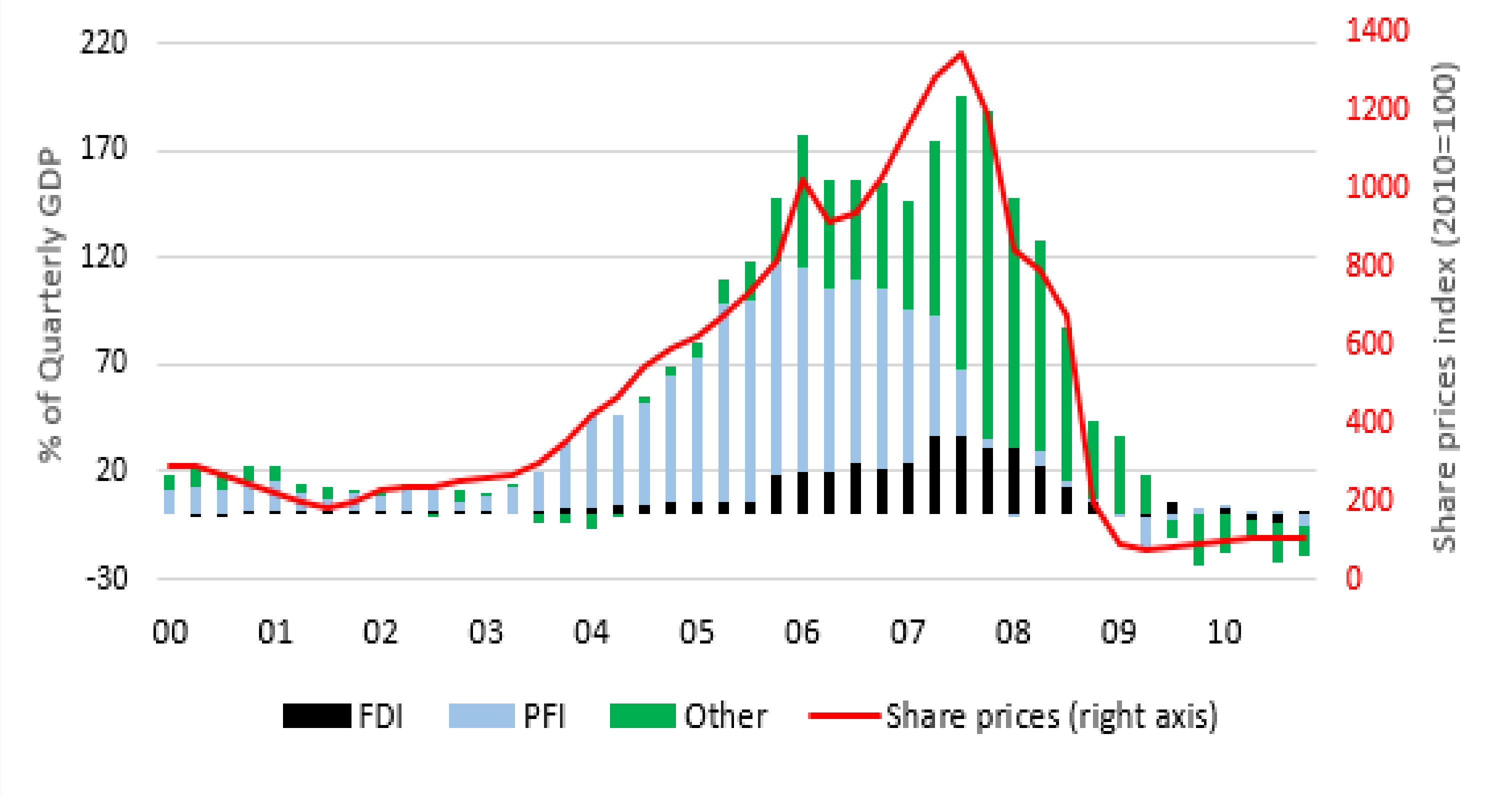
Main hypothesis: Where does the Icelandic story fit?

Gross capital flows and share price index



Main hypothesis: Where does the Icelandic story fit?

Which were the biggest inflows?



Main hypothesis: Where does the Icelandic story fit?

VAR model to investigate the interactions of:

Gross capital inflows (F)

Share prices (S)

Real exchange rate (REER)

For simplicity, the model is represented as:

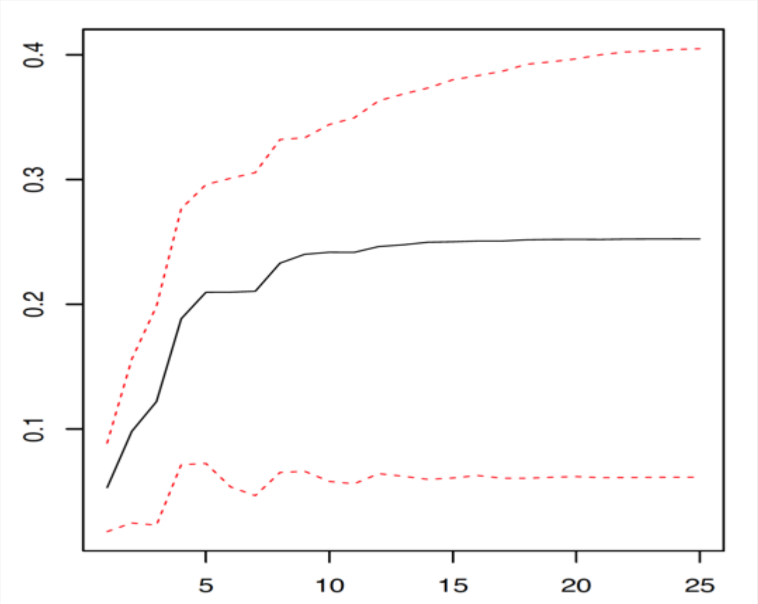
$$X = [\Delta F; \;\; ln\Delta S; \;\; ln\Delta REER]$$

Main hypothesis: Where does the Icelandic story fit?

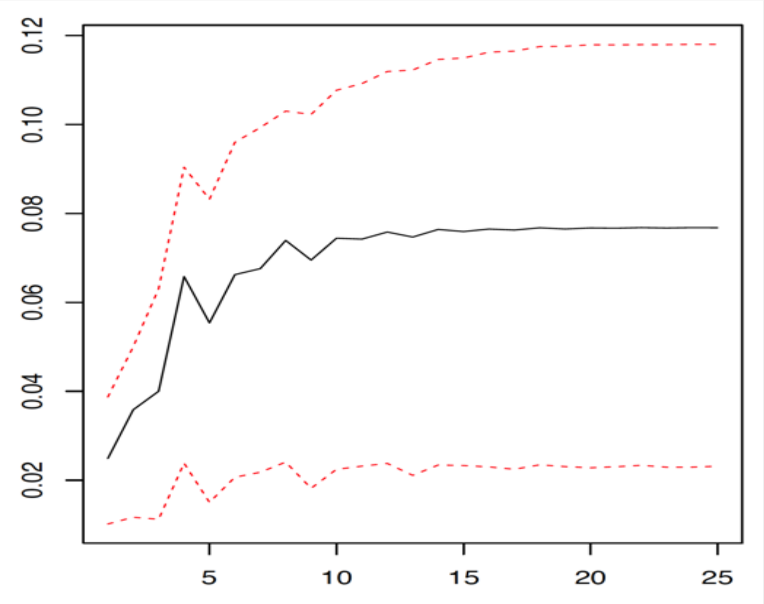
Main results:

1. Effects of inflows shocks (1995Q1-2017Q4)

Share prices



Real ex. rate



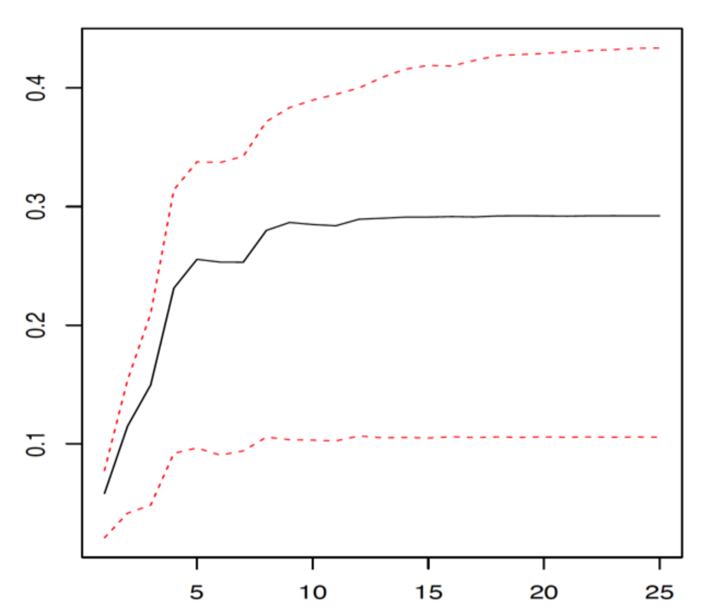
Note: The cumulative impulse responses are obtained for a reduced VAR but they do not change if we use a structural VAR with Cholesky decomposition

Main hypothesis: Where does the Icelandic story fit?

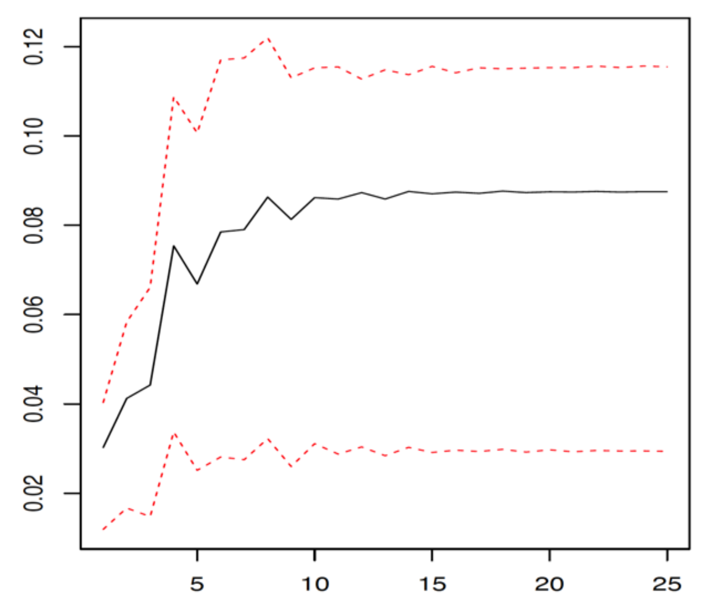
Main results:

2. Effects of inflows shocks in free capital mobility (1995Q1-2007Q4)

Share prices



Real ex. rate



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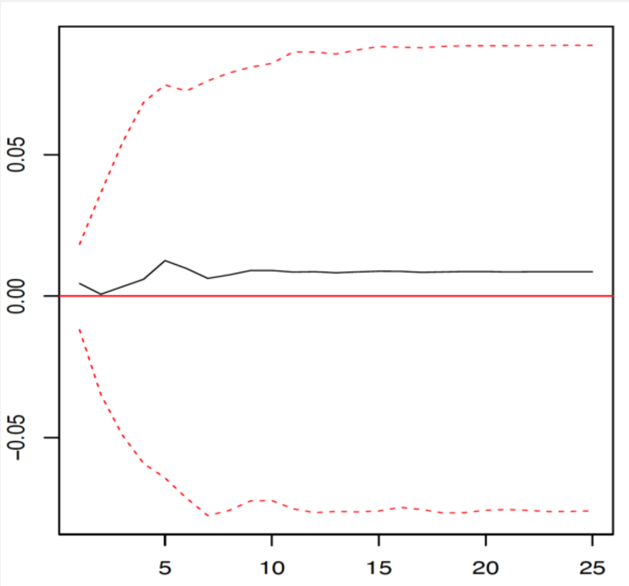
Main hypothesis: Where does the Icelandic story fit?

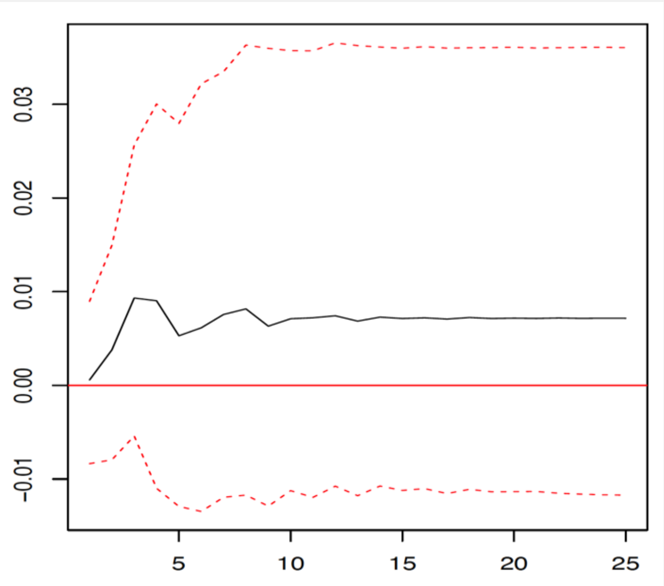
Main results:

3. Effects of inflows shocks in capital controls (2009Q1-2017Q4)

Share prices



Real ex. rate



Note: The cumulative impulse responses are obtained for a reduced VAR but they do not change if we use a structural VAR with cholesky decomposition

Main hypothesis: Where does the Icelandic story fit?

Additional results: Causality

- Capital inflows Granger cause Stock prices and Real exchange rate
- No causality from Real exchange rate to Capital inflows and Share prices
- No causality from Stock prices to Capital inflows and Real exchange rate

Overall, all the evidence points to the conclusion that financial account surpluses led to current account deficits.

Main hypothesis: Where does the Icelandic story fit?

Conclusions

Capital inflows make stock prices increase and the real exchange rate appreciate.

Capital inflows Granger cause current account deficits.

Need for a monetary policy tool that reduces capital inflows.