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Current Account Surpluses and Financial Crises in the Nordic Countries

Gylfi Zoega

University of Iceland

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How did the Nordic countries develop persistent current account surpluses?

Why do they run beggar-thy-neighbour policies?

Hypothesis: Financial crises bring about higher national saving and a positive current account, both in the short run and the medium run

Aliber (2010): Seven waves of financial crises since collapse of Bretton Woods

Common pattern:

Financial crises preceded by capital inflows,
the inflows generate higher stock prices and exchange rates,
consumption is increased due to a wealth effect,
current account deficits develop.

Reversal of capital flows causes stock market collapse and exchange rate depreciation.

Current account surpluses

Table 1. The current account as a share of GDP in 2007 and 2019

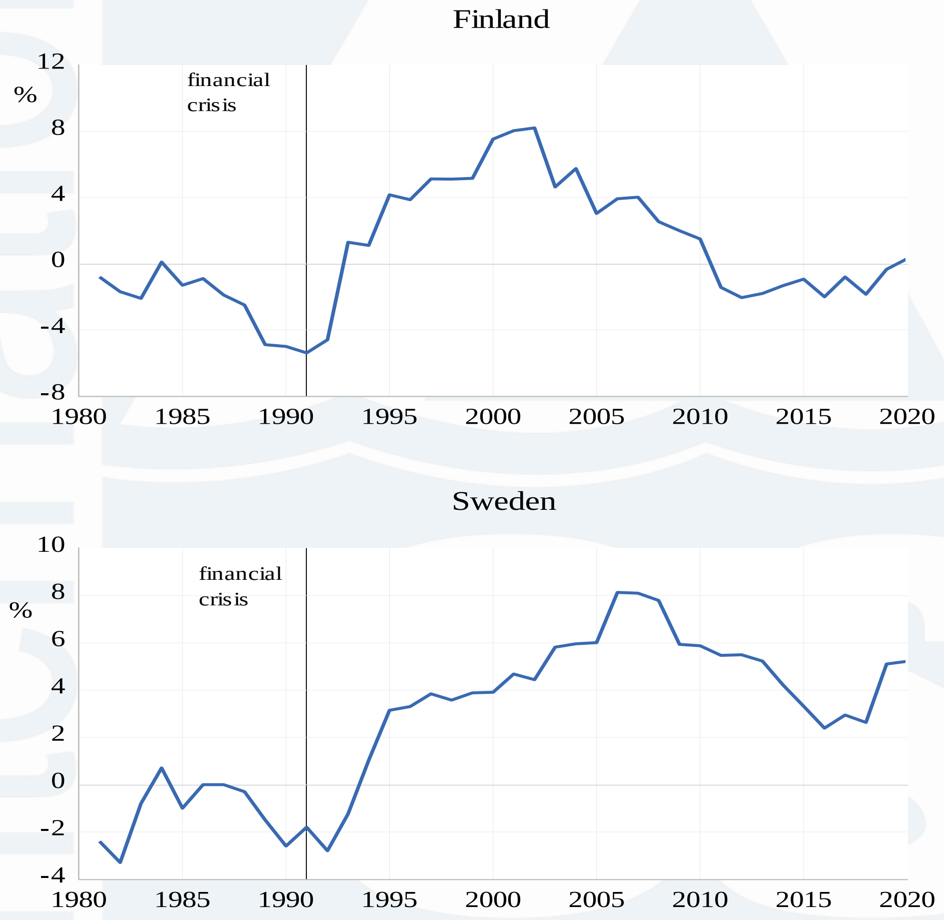
Current account surplus/deficit (% of GDP), 2007				Current account balance (% of GDP), 2019			
Surplus countries		Deficit countries		Surplus countries		Deficit countries	
Saudi Arabia	24.3	Latvia	-22.3	Netherlands	9.9	Ireland	-11.6
Norway	15.6	Iceland	-20.2	Denmark	8.8	Chile	-3.9
China	11	Estonia	-17.7	Germany	7.1	New Zealand	-3.3
Luxembourg	10	Lithuania	-14.6	Switzerland	7.0	United King.	-3.1
Switzerland	9.5	Greece	-14.3	Iceland	6.5	South Africa	-3.0
Netherlands	8.7	Spain	-10.1	Saudi Arabia	4.8	Brazil	-2.8
Sweden	8.6	Portugal	-9.5	Sweden	4.6	Indonesia	-2.7
Germany	7.9	New Zealand	-7.8	Luxembourg	4.4	Slovak Rep.	-2.7
Russian Fed.	5.9	South Africa	-7.3	Russian Fed.	3.8	United States	-2.2
Japan	4.8	Australia	-7.1	Japan	3.7	Canada	-2.1
Chile	4.4	Hungary	-6.8	Korea, Rep.	3.6	Greece	-1.5
Finland	4.3	Turkey	-5.8	Lithuania	3.3	India	-1.0
Austria	3.6	Ireland	-5.3	Italy	3.0	Argentina	-0.9
Argentina	2.8	United States	-5.3	Austria	2.8	France	-0.7
Indonesia	2.4	Slovak Rep.	-4.9	Norway	2.6	Latvia	-0.7
Canada	2.1	Poland	-4.8	Spain	2.1	Mexico	-0.3
Belgium	2.1	Czech Republic	-3.3	Estonia	2.0	Czech Rep.	-0.3
Denmark	1.5	United King.	-2.7	China	1.0	Hungary	-0.2
Korea, Rep.	0.6	Italy	-2.4	Turkey	0.9	Finland	-0.2
Brazil	0.1	France	-1	Australia	0.6	Portugal	-0.1
		India	-1	Poland	0.5		
		Mexico	-0.8	Belgium	0.3		

Source: The World Bank (https://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS).

Financial crises in the Nordic countries in the 1990s: Finland 1991, Sweden 1991

- Financial deregulation set the stage for excessive credit expansion, asset price inflation and a rapid growth in consumption and investment.
- There followed a capital inflow and a loss of foreign competitiveness.
- The downturn started with speculation against the pegged exchange rates in both countries. This was met by interest rate increases, which caused asset prices to fall, which then made the banks fragile.
- The governments raised taxes and cut expenditures to reign in the budget deficits.
- The central banks were forced to abandon the pegged exchange rate regime and allow the markka and krona to float in the fall of 1992.
- The move to a floating exchange rate system then helped with the economic recovery.
- The economic recovery in Finland and Sweden was led by the rise of net exports.

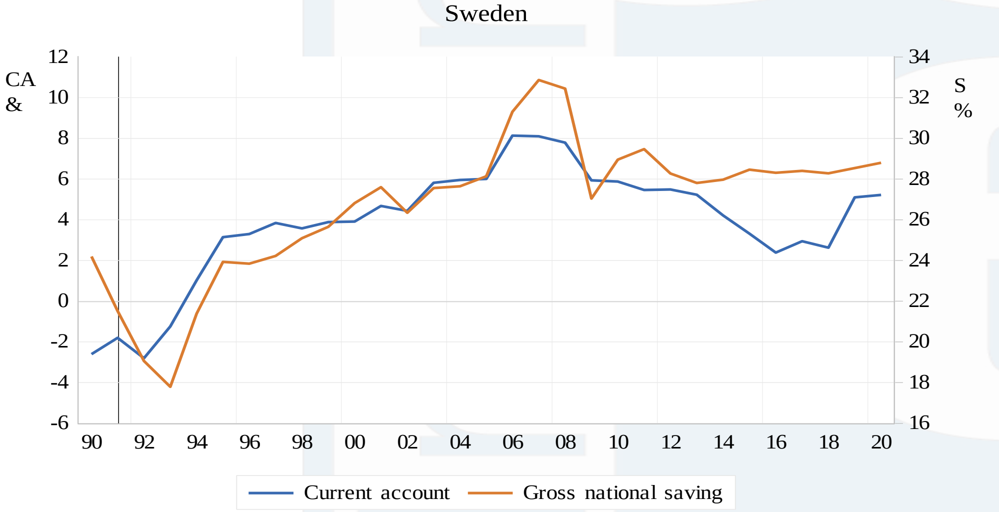
Figure 1. The current account in Finland and Sweden



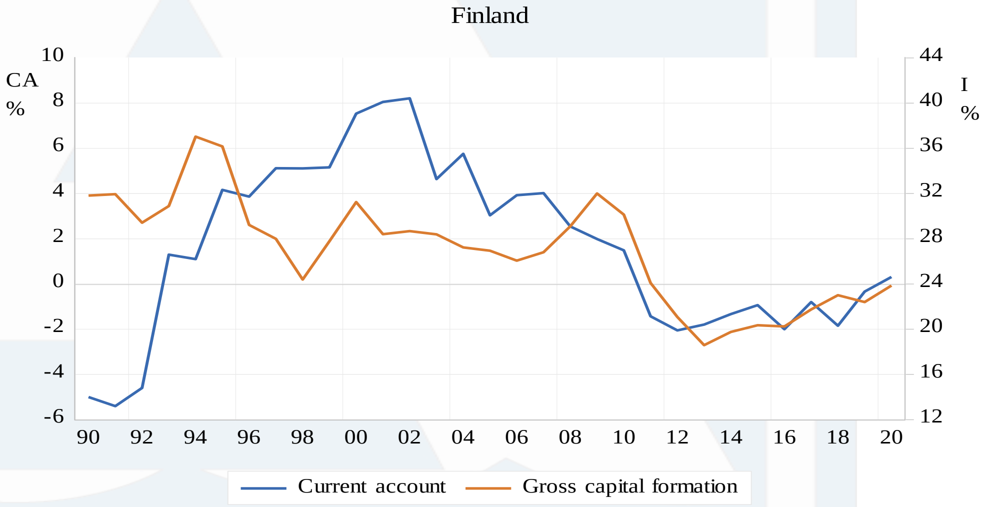
Persistent surpluses not explained by the initial depreciation.

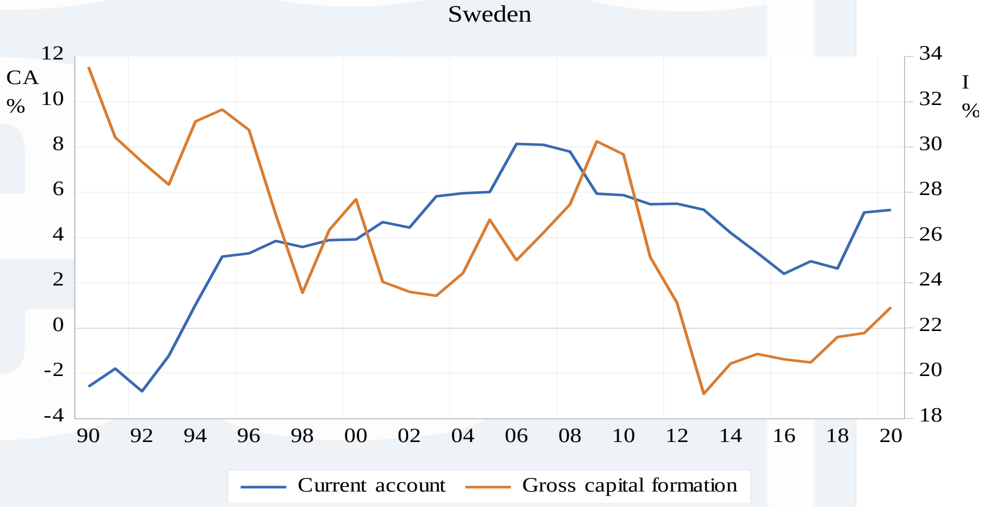
Finland and Sweden

Gross national saving and current account



Gross capital formation and current account





Crisis in Iceland in 2008

- Current account deficits every year until 2008.

- Bank privatisation in 2003 followed by a rapid expansion of the banking system.
  - Total assets amounted to one year's GDP in 2000, one and a half year's GDP in 2003, then rose to 193% of GDP in 2004, 303% in 2005, 390% in 2006 and 744% at the end of 2007.
  - Banks' direct ownership of shares when share prices were rising rapidly (because of the banks' credit expansion) increased capital but also the banks artificially inflating their capital by lending to buy own shares..

- Increase in country's balance sheet.
  - Foreign liabilities went from being 75% of GDP in 2003 to becoming 476% of GDP at the end of 2007.

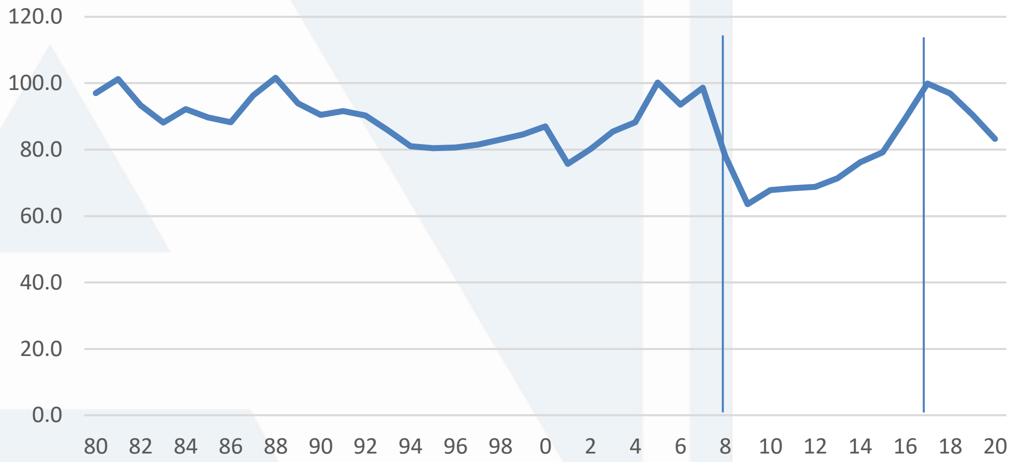
- Domestic credit expansion
  - Domestic liabilities rose from 60% to 268% of GDP.

- Stock market went up by a factor of ten.

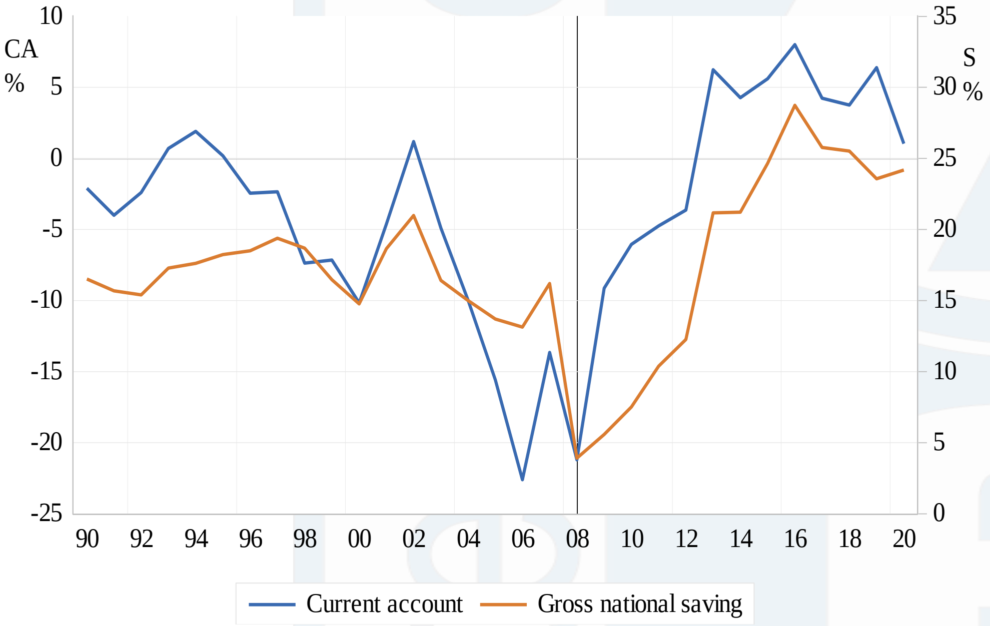
- The sudden stop of the inflow of capitals in 2007-2008 caused the krona collapsed, the current account deficit to disappear and become a large surplus, output to fall and unemployment to go up.

The price of foreign currency

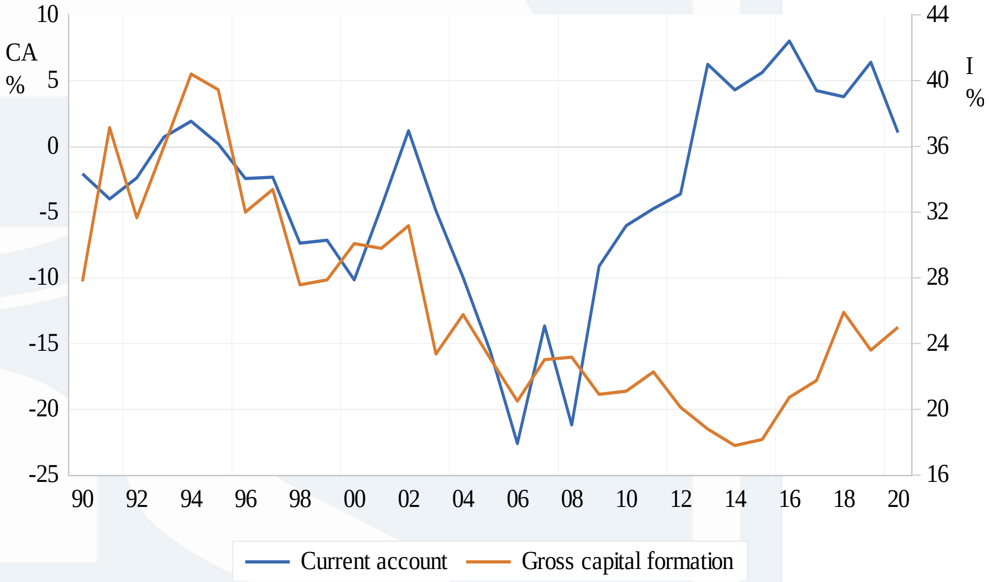
Real exchange rate



Current account and national saving in Iceland



Current account and gross capital formation in Iceland



Possible reasons for persistent current account surpluses in the wake of crises

In the short run

- Depreciation of currency,

Housing bubble in Sweden and Denmark and rising house prices in Iceland in recent years.

- wealth effect of falling asset prices on consumption

Finland and Sweden never lost access

- limited access to international credit markets
- Increased risk aversion raising saving
- Changed government policies aimed at limiting c.a. deficits and debt accumulation