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Euro Area Current Account Developments

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Abstract

After a decade-long period of surpluses, soaring energy prices sent the euro area current account into a deficit in 2022. This occurred against the backdrop of a lingering COVID-19 impact, and in parallel with gradual recovery of the tourism sector. After its strong fall, the euro area current account balance has been on an improving path this year, as energy prices have fallen from their 2022 highs, and assisted somewhat by a small but visible reduction in the volume of net energy imports. However, energy prices are expected to remain above their pre-pandemic levels exerting a continuous downward pressure on energy balances in the medium term. The asymmetric nature of these shocks caused current account balances to widen across the globe over the past three years, undoing the narrowing that had previously been underway. The fading of these shocks will affect the normalisation of current accounts worldwide and in the euro area and may result in a changed landscape going forward. This paper reviews recent developments in the euro area external position, discusses the main drivers and provides some insights into the likely determinants of the external position in the near term.

JEL Classification: F45, F62.

Keywords: Net International Investment Position, Balance of Payments, Current account, Energy Prices.

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ABBREVIATIONS

CA	Current account
ECB	European Central Bank
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
IMF	International Monetary Fund
NIIP	Net international investment position

CONTENTS

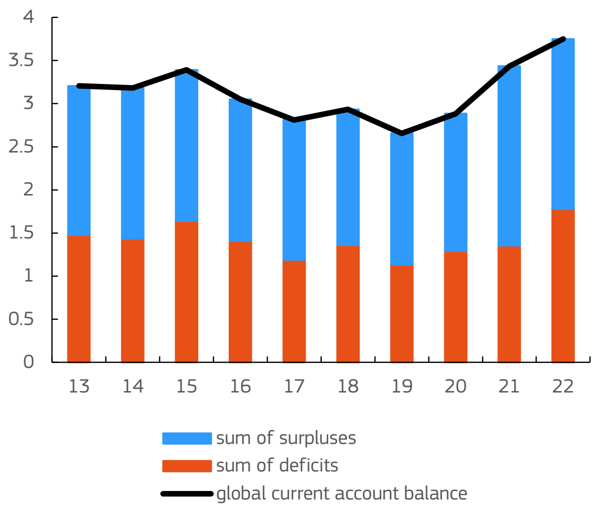
GRAPHS

1. SETTING THE SCENE

The energy and COVID-19 crises reversed the narrowing of global current account balances that had been underway[1], leading to sharp increases since 2020[2]. The uneven impact of the pandemic in 2020 started the reversal of a half-a-decade-long period of a gradual narrowing of global balances (see Graph 1). Global current account balances widened further in 2021, as a strong economic rebound took place while some sectors and regions around the globe remained strongly affected by the pandemic. A blow to the economic recovery inflicted by Russia's war of aggression against Ukraine, channelled mainly through a massive increase in commodity prices centred on energy, widened global current account balances even further last year.

With the fall in energy prices, global current account balances are coming down in 2023, but there is uncertainty in the future. In 2023, the fading of these shocks and ongoing monetary policy tightening are set to put an end to the three-year period of global current account balances widening. Energy prices have come down strongly from their peaks in 2022, and contributed strongly to the narrowing of current account balances that are underway. However, with energy prices likely to stay below their levels in recent years, it is unlikely that balances will return to their previous levels. Uncertainty remains high with persistent geopolitical tensions and the economic situation in China being key risk factors that could lead to further disruptions.

Graph 1: **Global current account balances, % of world GDP**



Source: IMF.

[1] The analysis was presented as a note for discussion in the Economic Policy Committee on external developments in the euro area on 12 December 2023, examining the euro area's external position since 2020 and providing insights on what might shape it in the near future.

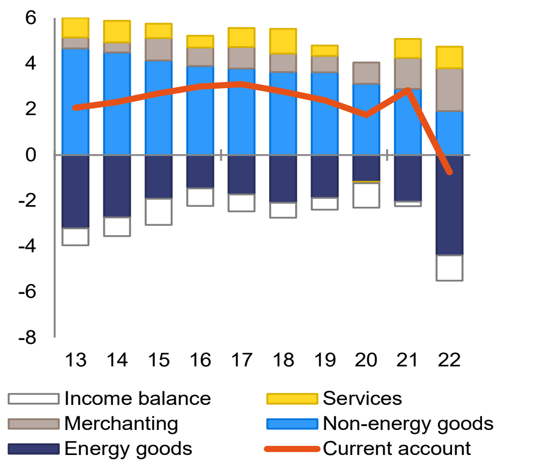
[2] The IMF (2023) defines global current account balances as the sum of absolute values of current account deficits and surpluses.

2. INCREASED CURRENT ACCOUNT VOLATILITY AMIDST LARGE SHOCKS

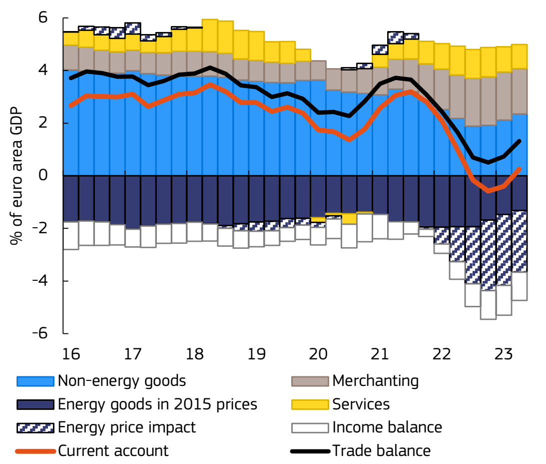
2.1 PRICE DEVELOPMETNS HAVE BEEN A CENTRAL FACTOR AFFECTING THE EURO AREA CURRENT ACCOUNT

Against this backdrop, energy prices played a key role in the external balance of the euro area falling from sizeable pre-pandemic surpluses to a deficit in 2022. The external balances of the euro area have been subject to considerable change since 2020. Despite a deep recession inflicted by the pandemic in 2020, the overall euro area current account deterioration that year was muted, with the surplus falling from 2.4% of GDP in 2019 to 1.8% in 2020 (see Graph 2). The tourism sector was particularly hit with scars remaining visible until last year. The current account recovery to 2.8% the following year, slightly above its pre-pandemic level, was short-lived. In 2022, the energy goods[3] balance plummeted, as energy prices skyrocketed pulling the current account to levels not seen in years. After a decade-long period of surpluses, the current account balance in the euro area fell to a deficit of 0.6% of GDP in 2022.

Graph 2: **Current account, euro area, % of GDP**



Graph 3: **Current account, euro area, quarterly**



Source: Eurostat.

In year data show a return to a current account surplus, driven primarily by the fall in energy prices and a reduction in the volume of energy imported. High-frequency data point to a bottoming out of the current account in 2023. On a four-quarter moving sum basis, the current account returned to a surplus in 2023Q2, 0.2% of GDP (see Graph 3). As shown in the graph, there is already a decrease in the (negative) impact of energy prices on the current account, and there is also a reduction in the extent to which the volume of energy imported weighs on the current account. Compared with the last decade, the contribution of the volume of energy in lowering the euro area current account is at its lowest level, having declined on a quarterly basis for the last year. More recently, surpluses in nominal terms continued to increase in all three months of the third quarter of 2023, driven by improving goods balances.

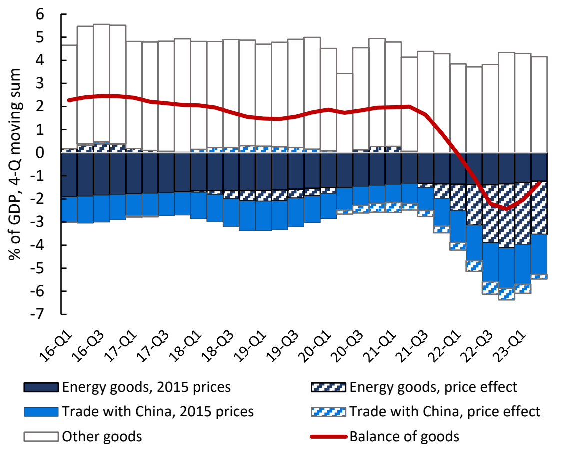
Energy prices have greatly deteriorated the trade balance since 2021, with a particularly strong impact in 2022. Trade in energy goods has been the single most important factor affecting the trade balance developments in the euro area in the past three years. As energy prices fell in 2020, the deficit of trade in energy goods narrowed from 1.9% of GDP in 2019Q4 to 1.1% in 2021Q1 (on a four-quarter moving

[3] The energy goods balance corresponds to the balance of trade in goods under item 3 “Mineral fuels, lubricants and related materials” of the Standard International Trade Classification (SITC).

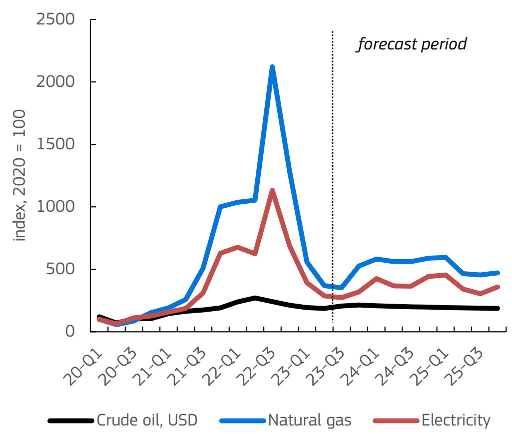
sum basis). With the subsequent pick-up in global demand and predominantly Russia's invasion of Ukraine, energy commodity prices skyrocketed and the deficit widened strongly, reaching 4.4% of GDP in 2022Q4 before improving to 3.7% in 2023Q2 (see Graph 4 and Graph 5). The deficit is set to improve further as energy commodity prices fell from their 2022 highs (see Graph 5). Still, the energy trade balance is set to remain below its pre-pandemic levels, as energy commodity prices are unlikely to return to their pre-pandemic levels in 2023. This impact is likely to be in the ballpark of -2/3 pp. in 2024, which compares with -2.5 pp. in 2022 and a neutral impact in the period 2016-2019 (see Graph 4), but is slightly offset by a reduction in the volume of energy imported.

Additionally, recent negative inflation in China has also contributed to the bottoming out of the euro area trade balance. The price of goods imports from China increased strongly between the second quarter of 2021 and the first quarter of 2022 (see Graph 4). In mid-2022, this increase is estimated to have worsened the euro area trade balance by about 0.6 pp. Since then, prices of goods imported from China have been on a falling trajectory. As a result, the negative price effect is gradually waning and is set to completely fade in the third quarter of 2023.

Graph 4: **Goods balance and contributions**



Graph 5: **Energy prices**

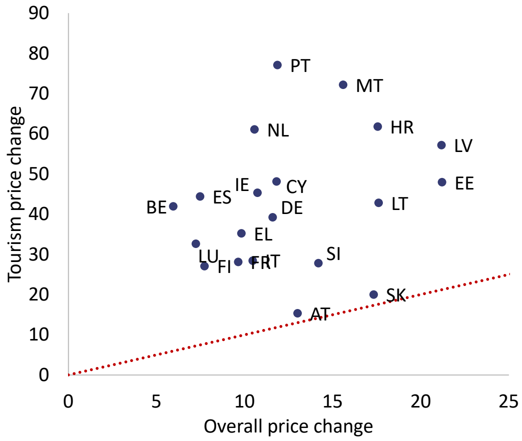


Source: Eurostat.

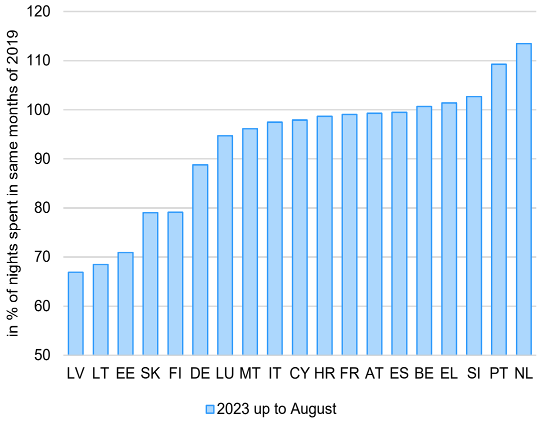
The balance of trade in services has stabilised at pre-pandemic levels, while the tourism sector is gradually recovering. The pandemic-induced deficit in trade in services proved short-lived, as the balance returned to surplus already in 2021 (see Graph 3 above). In 2021Q1, the service balance recorded 0.5% of GDP (on a four-quarter moving sum basis), up from the trough of -0.4% in 2020Q3 and continued growing to levels seen before the pandemic. After reaching 1.0% of GDP in 2022Q1, the service balance moderated to 0.9% in the second quarter of 2023. The current account balance reflects the digitalisation of cross border services: The net-export of telecommunication, computer, and information services contributed to its recovery, reaching 1.1% of GDP in 2021Q4 and remaining on that level. However, the balance of travel services has been improving only gradually, held back by a lingering impact of the pandemic. The pre-pandemic level of 0.4% of GDP was only reached in late 2022 and remained at this level in the first two quarters of 2023, though partly due to a price impact. It appears that inflation in the tourism sector climbed above the overall rate of inflation in the euro area but differing notably between the Member States (see Graph 6). The number of nights spent by international tourists has recovered in only some of them (see Graph 7)[4]. Netherlands and Portugal surpassed the 2019-benchmark despite high inflation in the respective tourism sector. However, the majority of Member States have yet to reach the 2019-level.

[4] Note that Graph 7 does not include only extra-euro area tourists, as it also includes tourists from other euro area Member States.

Graph 6: **HICP inflation in tourism sector and overall, 2022Q1-2023Q3**



Graph 7: **International tourism, nights spent**

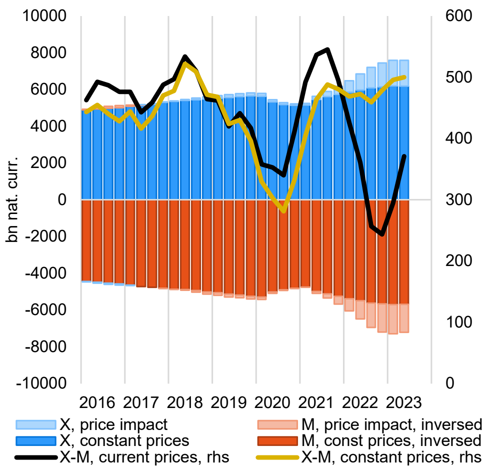


Source: Eurostat.

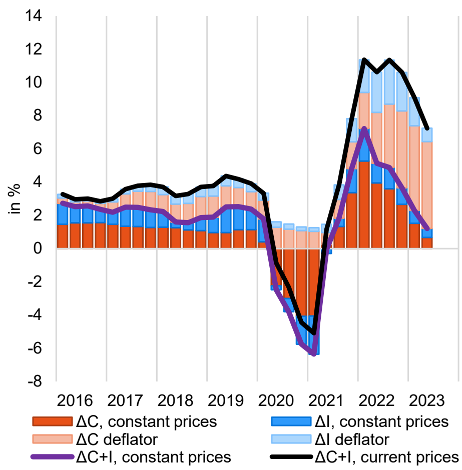
2.2 REAL DEMAND REMAINED RESILIENT IN THE WAKE OF HIGH INFLATION

Although price effects have been instrumental in recent current account developments, real demand has also played a role. A decisive policy action helped mitigate the impact of the pandemic on households' incomes. Still, real domestic demand fell sharply in 2020 while households' savings increased (see Graph 9 and Graph 13). Domestic production, however, took a bigger hit, as the pandemic shut down a large share of predominantly service activities. As a result, the trade balance in real terms[5] markedly declined (see Graph 8). The subsequent lifting of restrictions weighing on business activity helped the trade balance increase strongly in 2021. High inflation eroding real incomes and a tightening monetary policy cycle have gradually worked their way to decelerate real domestic demand growth since mid-2022 (Graph 9). The notable slowdown in the first half of 2023 thus contributed slightly to an increase in the trade balance.

Graph 8: **Trade balance**



Graph 9: **Domestic absorption, growth**

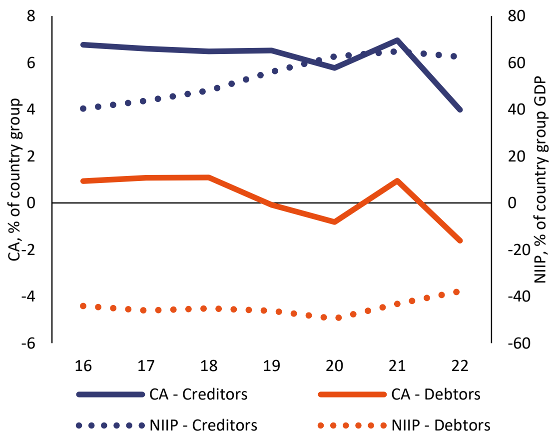


Source: Eurostat.

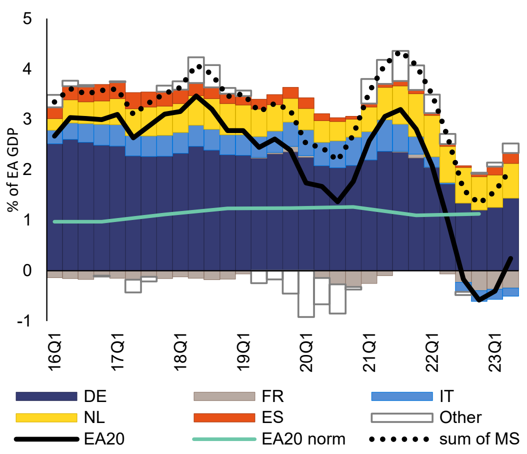
[5] The trade balance can be expressed as a difference between GDP and domestic absorption (the sum of final consumption expenditure and gross capital formation).

The shocks in the 2020-2022 period do not seem to have strongly affected rebalancing within the euro area. The current account gap between net-creditor and net-debtor countries temporarily increased in 2020 and 2021, but it returned slightly below the levels seen in several years before the pandemic in 2022 (see Graph 10)[6]. The gap was substantially affected by large changes in the current account balances in Ireland[7]. Without Ireland, the gap in the current account balances of the two groups of countries remained larger than it was before the pandemic in 2022. Despite a broad-based fall in current account balances across the euro area in 2022, it appears that domestic demand in net-debtor countries remained more resilient than domestic demand in net-creditor countries (see Graph 11)[8].

Graph 10: **Current account and NIIP, creditors and debtors**



Graph 11: **Current account, euro area, contributions**



Source: Eurostat.

3. THE EURO AREA REMAINED A NET LENDER

Despite the current account falling into deficit in 2022, the euro area remained a net lender due to an increase in the capital account balance. Following an extended period of rather negligible balances in previous years, the capital account balance saw a substantial increase in 2022. In particular, the Netherlands recorded a massive increase in income from marketing assets[9]. In addition, part of the increase is due to the funds from the European Commission, mainly the NGEU. Still, the net lending position in 2022 worsened considerably compared to earlier years (see Graph 12). After increasing to a multi-year high of 3.4% of GDP in 2021 from 1.8% in 2020, the net lending position of the euro area fell to 0.6% of GDP in 2022.

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[6] The categorisation is based on Member State's average net international investment position in the past decade. Creditor Member States are BE, DE, LU, NL, AT, FI, MT. This group of countries represented 46% of euro area nominal GDP in 2022.

[7] The current account in Ireland recorded a balance of almost -20% of GDP in 2019 before improving to above -7% in 2020, almost 14% in 2021 and 11% in 2022.

[8] Note that significant discrepancies exist between the sum of balances of individual Member States and the euro area aggregate reported by Eurostat. In 2022, the combined balances of the euro area countries amounted to 0.8% compared to the -1% of the euro area aggregate. Notably, substantial differences were observed in the reporting of merchanting trade balances and investment income.

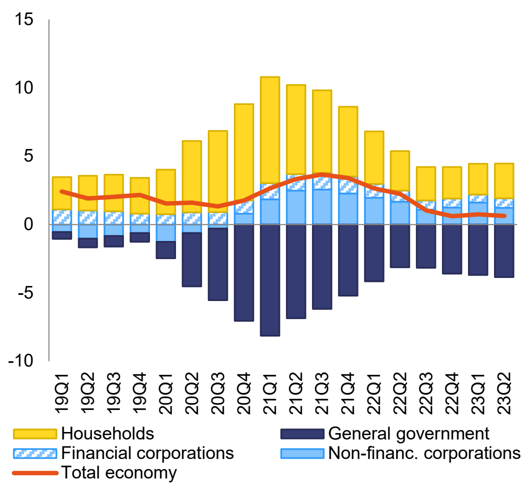
[9] See ECB (2023).

The massive shocks of the past three years have greatly affected savings of households, corporations as well as the government. Pandemic and energy-related fiscal support have heavily weighed on governments' gross savings, which fell into negative territory in 2020 before gradually increasing in 2021 and 2022 (see Graph 13). In the same period, households' gross savings were largely a reverse image of government savings, with a substantial increase initially, benefiting from fiscal support and a lack of spending opportunities during lockdowns. Afterwards, households gradually reduced their gross savings, with the decline particularly pronounced in early 2021, as the economies reopened, and then in 2022, as inflation started to accelerate. Gross savings of corporations, as a share of GDP, remained considerably stable when only 2021 saw a temporary uptick.

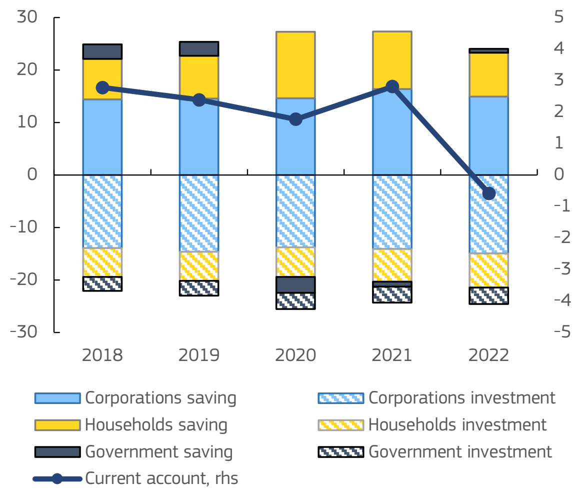
In the same period, investment in the euro area has been considerably resilient. Total investment, as a share in nominal GDP, increased markedly in 2019 and then again in 2021 and 2022 after a fall in 2020 (see Graph 13). Ireland contributed strongly in 2019 and 2020. Afterwards, its contribution fell closer to the pre-pandemic average while the contribution from a majority of other countries increased. Investment in construction proved particularly resilient, gradually increasing its share in nominal GDP in all three years, alongside strong demand for housing which drove property prices up across the euro area.

The solid performance of investment was strongly affected by developments in inventories. Gross capital formation, which increased by around 13% in nominal terms in 2021 and 2022, well above GDP growth, boosted domestic demand. This increase shows particularly in changes in inventories and net acquisition of valuables, which increased their share in gross capital formation from 4.7% in 2021 to 7% in 2022, with price effects strongly affecting the developments. In 2023, this impact seems to be fading.

Graph 12: **Net lending/borrowing, euro area, % of GDP**



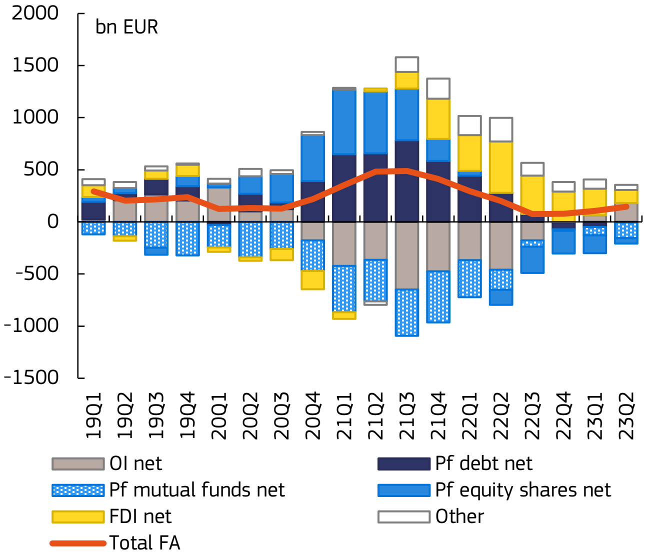
Graph 13: **Investment/saving, euro area**



Source: Eurostat.

On the financial account, the accumulation of portfolio investment reflects the increased current account surpluses in the pandemic period. Amid strongly increasing private savings and robust gains on financial markets, euro area residents markedly increased their holdings of portfolio equity and debt securities between late 2020 and early 2022 (see Graph 14). Holdings of direct investment assets also increased markedly. Concurrently, non-euro area residents increased investment in euro area portfolio equity and other investment, mainly deposits (including currency). The vigorous activity on the financial account swiftly cooled during 2022 and remained subdued in 2023. This moderation corresponded with the normalisation of high savings rates and the reduction of financial market gains due to a tightening monetary policy cycle. In net terms, foreign direct investment continues to contribute positively in 2023. However, in the last quarter of 2022, both FDI assets and liabilities saw a sizeable divestment, largely offsetting each other, resulting in a broadly unchanged positive net contribution[10].

Graph 14: **Financial account, euro area net position, 4q moving sum**

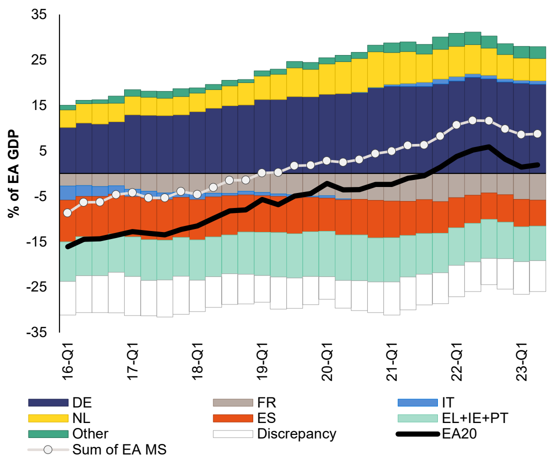


Source: Eurostat.

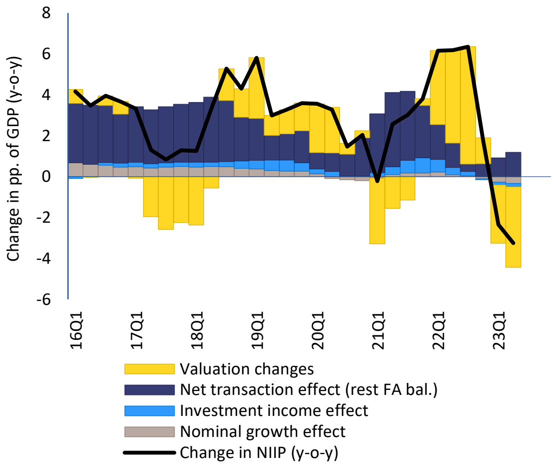
After moving into positive territory at the end of 2021, the net international investment position (NIIP) of the euro area decreased slightly. The euro area NIIP was on an upward trend in the past decade, moving from around 20% of GDP in 2013 to 3.2% in 2022. The increase was mainly driven by transaction effects resulting from the accumulation of large current account surpluses in creditor countries (see Graph 15 and Graph 16). With the current account balances falling, the role of transaction effects has diminished since early 2022. Valuation effects, partly owing to a depreciating euro, helped to strongly increase the NIIP around mid-2022, though this effect turned negative in 2023. In addition, the contribution from investment income vanished. As a result, the NIIP decreased to 2% in the second quarter of 2023. In terms of instruments, the share of portfolio debt securities has increased considerably in the 2020-2023 compared to earlier years. By contrast, the share of FDI slightly shrank in the same period. At a country level, the aggregate NIIP had grown largely due to increases in net positions of net-creditor countries until early 2021. Afterwards, net debtor-countries, benefiting from valuation effects and nominal growth, contributed to a continued increase in the NIIP.

[10] According to the World Investment Report 2023, foreign direct investment disinvestments in 2022 were also influenced by capital withdrawal of a multinational enterprise in Luxembourg, see United Nations (2023).

Graph 15: **NIIP, contributions**



Graph 16: **Change in NIIP, euro area**



Source: Eurostat.

4. CONCLUSION

The developments in the euro area external balances have narrowed the gap to the fundamental benchmarks, according to recent assessments. Based on the Commission's Autumn forecast[11], the cyclically adjusted current account balance is estimated to have coincided with its fundamental benchmark in 2020. The subsequent pick-up in the balance opened a positive gap of 0.8 pp. to its fundamental benchmark in 2021. The estimates suggest that the cyclically adjusted current account in 2022, at -0.4%, fell markedly below its norm of 1%. Acknowledging substantial uncertainty surrounding the estimates, the IMF assessed the euro area current account balance to be broadly in line with fundamentals in 2020 and 2022 while it was moderately stronger than implied by fundamentals in 2021[12].

Going forward, trade and current account balances are set to increase, but relatively high energy prices are likely to result in a lowering of balances compared to pre-2020. The confluence of structural factors, both temporary and cyclical, are markedly clouding the likely path for the euro area current account. In the short-term, the euro area current account balance is continue increasing. In particular, latest developments on the energy markets indicate a continued improvement in trade balances and the cyclical downturn also seems to be supporting the trade balance. Still, compared to pre-pandemic years, the energy balance is set to keep trade and current account balances lower. In addition, the asymmetry of the energy shock may lead to competitiveness losses, especially if the disinflationary process will be slow, which would further lower trade balances in the medium-term.

Supporting the energy transition and diversifying the sources of energy supply can increase the resilience of the euro area against external shocks and strengthen external positions over the medium-term[13]. Efforts to reduce energy consumption, and to accelerate the roll out of renewables have already effectively reduced energy imports of the euro area. Yet the overall vulnerability to energy price shocks and its impact on external balances and the competitiveness of European industries underlines the importance of coordinated European action to accelerate the roll out of renewable energy production, to shift

[11] See European Commission (2023).

[12] See International Monetary Fund (2023).

[13] Based on the Commission note on developments of energy pricesa in the euro area and policy responses for the the Eurogroup, 15 January 2024: https://www.consilium.europa.eu/media/69388/eg_energy-prices-and-competitiveness-note_final-to-eg-for-publication.pdf.

to less energy intensive production models, to diversify energy supply and to make further progress with the integration of the European energy markets. These efforts require considerable investment, which may initially worsen trade balances of EU countries, before yielding longer term dividends. The Members with persistent current account deficits and large external debt will thus need to carefuly navigate through the transition period to avoid a deterioration in their external sustainability in the short-term.

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