FINANCIAL AND CURRENT ACCOUNT INTERRELATIONSHIP: AN EMPIRICAL TEST

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Abstract

Theoretically, financial account (FA) serves as a means of financing deficit in a country's current account (CA). With the outburst of the rapid globalization and the liberalization of the capital markets, the function of FA could be a major cause of CA instability. This study empirically investigates the interrelationship between CA and the components of FA for the four crisis-affected Asian countries of Indonesia, Korea, the Philippines and Thailand. Empirical results show that deficit in CA mirror the surplus in FA supporting the theoretical foundation of balance of payment (BOP). We observed CA Granger causes FA suggesting that CA can be used as the control policy variable for the flows of capital in these countries. Therefore, the innovation of CA (whether deficit or surplus) would be important information for the liberalization and globalization of FA.

Keywords: current account, financial account, Asian, causality

JEL Classification: F21, F32, F41, C32

1. Introduction

Imbalances of current account in both developed and developing countries are of great analytical and empirical interest to the policy front. According to Eichengreen (2006), large and persistent US current account deficit (CAD) would distort the capital inflows, sharp compression of the US current account and eventually the global imbalances. Makin and Narayan (2008) on the other hand, provoked that the rise of the CAD in the US are strongly coincided with the saving rates in East Asian, especially in the post 1997 era. Further, concern raise up by Obstefeld and Rogoff (2004) and Blanchard, Giavazzi, and Sa, (2005) that unless major policy actions are taken, these imbalances would generate global financial turbulence and possibly, a world economic crisis as the world experiences now.

When this scenario persists, the probing question to the policy forefront is what are the sources of the current account imbalances? Literature addresses several sources such as twin deficit theory (*see* for example, Rosensweig, and Tallman 1993, Vamvoukas 1999, Piersanti 2000, Leachman, and Francis 2002, Baharumshah, and Lau 2007, Acaravci, and Ozturk 2008, Hakro 2009) which supports that a worsening budget deficit stimulates an increase in current account deficit. Some resort to the 'savings glut' phenomenon as source of this imbalance (Bernanke 2005, Dooley Folkerts-Landau, and Garber 2005) while others examined the sustainability of the CAD (Cashin and McDermott 1998; Fountas, and Wu 1999, Irandoust, and Boo Sjoo 2000, Lau, and Baharumshah 2005, Lau, Baharumshah, and Chan 2006, Kim *et al.* 2009, Christopoulos, and Leon-Ledesma 2010).

Rather than relied on these sources, this paper venture from the perspectives of the balance of payment (BOP), a fundamental relation in open economy macroeconomics[1]. At the theoretical level, the interaction between the current account (CA) and financial account (FA) justified that capital flowing either in or out serves financially to fill the gap between domestic investments and savings or the CA. Experience from the developing countries especially the Latin America and Asian were at the receiving end of inflow of capital in the 1990s; however were allegedly not always used productively (Lahiri, and Mahbub-Morshed 2006)[2].

[1] The interrelationship between the component accounts in BOP would capture the reactions of the financial and real sectors to systemic disturbances and their interaction during the adjustment process (Fausten 1990).

[2] Since the late 1980s, the East Asian countries have been the largest recipients of capital inflows in the world (Grenville 2000). The investment boom during 1987–1997 was primarily led by foreign capital.