Box 4 Iceland's current account deficit in an international context

Broadly speaking, large and persistent current account deficits have originated from three sources: Firstly, fiscal mismanagement; secondly, external shocks; and thirdly, overheating in the private sector following the deregulation of the financial sector and international capital movements.

One of the most common causes of heavy current account deficits among the OECD countries in recent decades has been public sector deficits. Treasury deficits, for example, were the main cause of the large current account deficit in Greece from 1979-86, Ireland from 1976-85 and Portugal from 1980-83. A typical scenario then was burgeoning public sector outlays during an economic boom which the government failed to counter with a corresponding cut in spending when setbacks occurred. The consequence is a growing public sector deficit which fuels the current account deficit. When the situation gets out of hand, a hard landing is necessary, producing a contraction. This was by and large the sequence of events in the above cases.

External shocks have been another main cause of wide current account deficits in OECD countries in past decades. These, for example, were the root of New Zealand's large deficit from 1974-78, when its terms of trade deteriorated by more than 40% in the space of two years. The collapse of export markets in the Soviet Union and unfavourable terms of trade developments played a major role in Finland's large current account deficit over the period 1989-92, although overheating of the economy was also involved for the first part of the period. Both countries experienced deep depressions afterwards. External shocks were the simultaneous cause of both a current account deficit and an economic downswing, but in Finland the depression proved deeper than otherwise would have been the case, because significant imbalances had already developed before the shocks struck.

Recent heavy current account deficit periods are more difficult to analyse, since they have only originated in fiscal mismanagement and external shocks to a much lesser extent. Thus the sustained deficits in Mexico from 1991-94, Thailand from 1990-97 and the Czech Republic from 1996-97 were apparently largely sparked off by overheating of the domestic economy whose roots lay in large-scale investment and capital inflows prompted by strong investor confidence in these countries. In all three cases investors suddenly lost their faith in these economies and began withdrawing their capital. External conditions proved crucial, however, insofar as low interest rates in the industrialised countries first prompted large capital inflows which rebounded when interest rates rose again and conditions in the investment target countries became shakier. Weaknesses were present in economic policy management in these countries then, but hardly serious enough to merit such consequences. It should also be pointed out that in the cases of Mexico and Thailand their real exchange rates were seriously distorted before the currency crisis struck. The Thai baht, for example, was pegged to the US dollar, even though the country conducted most of its trade with Asia. Over the eighteen months before the currency crisis struck in Thailand the dollar strengthened by 50% against the yen, hitting the competitiveness of Thai companies hard. These countries' current account deficit periods came to an end with currency and bank crises accompanied by a sharp contraction in the economy.

In the instances described above, sustained current account deficits ended in a serious crisis or at least a contraction.[1] This is not absolute, however. One example of a benign current account deficit was in Norway from 1975-1978, equivalent to more than 7% of GDP then and peaking at 12% in 1978. The deficit was caused by large-scale capital formation in the oil industry. Once the oil industry had been developed the current account deficit narrowed very fast and since that time Norway has shown a surplus on average, since the investment has yielded substantial export revenues.

1. To show the scale of the difficulties they encountered, real income fell in Greece by 20%, unemployment rose by 10 percentage points in Ireland from 1980 to 1987, in the Czech Republic from just under 5% to almost 9% from 1997-1999 and in Finland from 3.5% to 18% within the space of a few years. The crisis struck Finland the hardest, cutting GDP by 15%. In Mexico economic growth shrank by almost 7% in 1995.