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### DOES THE BALANCE-OF-PAYMENTS MATTER AT THE REGIONAL LEVEL?

**Pedro N. Ramos**, *Faculdade de Economia da Universidade de Coimbra* (Portugal)

[pnramos@fe.uc.pt](mailto:pnramos@fe.uc.pt)

#### ABSTRACT

The main focus of this paper is the importance of the balance-of-(international and interregional)-payments for the regional economies. Discussion centers on two points: 1) on one hand, we do believe that for regions, as a rule, at the overall balance-of-payments (BP) level, the size of imbalances is reduced; 2) on the other, we argue that even if relatively important imbalances arise their effect on regional economies is small. There are several reasons why regional BPs remain relatively well-balanced at overall level. The most important is that trade and current imbalances, that regions run very often with a considerable size, are easily financed by offsetting flows recorded as well in the BP. These trade and current imbalances, that do not pass into overall imbalances, are of benign kind. We present several reasons why that easy financing – allowing for trade and current imbalances – happens. As for the argument that a BP disequilibrium – if it arises – do not hit significantly a regional economy, that is the aftermath of a nationally integrated financial system, where the great majority of the regional units are only branches of national institutions operating all over the country. In this environment, a

variation in the regional money stock (that is the counterpart of an overall BP imbalance) is not magnified by a money multiplier. We then conclude that as regions do not face any significant BP constraint, exports do not have any peculiar role in the regional growth process, and therefore the regional competitiveness debate is misplaced.

**Key words:**

regional balance-of-payments; regional competitiveness; trade and current imbalances; regional money multiplier

## Does the balance-of-payments matter at the regional level?

### 1. Introduction: Regional competitiveness and the balance-of-payments

The concept of competitiveness (either of a national or a regional economy) has been attracting in a recent time an increasing attention of academic economists, opinion makers and policy rulers. It is difficult to say why such a concept is so appealing, but the reason may be that it matches the popular (and up to a point misleading) vision of modern capitalism, as a hyper-competitive place where people (and countries) struggle for surviving. In fact, organizations as the World Economic Forum, that produces a competitiveness index for ranking national economies, and documents as the “Lisbon growth strategy”, with its aim of closing the European competitiveness gap with the U.S., make their contribution as well for popularizing the focus on that notion. But competitiveness is not a sound unambiguous concept well-fitted on the ground of economic theory<sup>1</sup>. Budd and Hirmis (2004) accord that “the repetition of the term «competitiveness» sheds much heat but little light”. On the other hand, despite pure economic theory remains reluctant in adopting such a spurious term that do not belong to its lexicon<sup>2</sup>, the debate on competitive performance quickly went beyond the national macroeconomic discussion to the regional and the local level. However, some agreement on the meaning of the term competitiveness is need, whether we proceed with our analysis at the national level or at the regional or the local one. A minimum consensus is usually achieved if competitiveness is deemed to mean the same than productivity. For Porter (1990) the notion of competitiveness, however significant at firm and industry level, is a fuzzy and amorphous one at the national level. In our view the same argument

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<sup>1</sup> Kitson *et al.* (2004) discuss how elusive the competitiveness focus may be, or on the contrary whether it is a key concept. These authors recognize that economic thinking is far from a consensus on what is and on how to measure competitiveness. This paper introduces a special issue of the *Regional Studies* devoted to this debate on regional competitiveness.

<sup>2</sup> Krugman (1996a, 1996b) strongly challenged the misuse of the term competitiveness, although his criticism is not semantic but on the meaningfulness of the concept itself. For a different view, at least at the regional level, please see Camagni (2002)

may be extended to other spatial instances as the regional or the local ones<sup>3</sup>. Following Porter, the principal goal of a nation (or a region) is to produce a high and rising standard of living for its citizens and that depend exclusively on productivity. Even Krugman (1996a, 1996b) may agree that productivity really matters, and that the challenge of increasing it is what drives the living standard of countries (and of regions) in the long run. But in our opinion this minimum consensus is misleading because competitiveness and productivity are in fact different things. Competitiveness is a relative concept: different entities compete each other. On the contrary, the national productivity is important by itself for any individual country. A country ought to concern, even in autarky, with its productivity.

In fact, the concept of competitiveness, at the nations' level, implies that (rising) exports and (resisting) imports have a strategic interest for economic growth. National growth can be based on increasing productivity, but it may face concurrently a constraint on the balance-of-payments (BP). If exports lag behind imports, threatening that constraint, then growth can eventually be jeopardized. Exports (less imports) can count more than domestic demand on the growth process solely because of that constraint on countries BPs (if, of course, competitiveness is in fact an adequate concept for nations). The purpose of this paper is to look into the issue whether there is for regions, alike countries, a BP constraint, on interregional and international payments, hampering regional growth<sup>4</sup>. If such a constraint exists, then regional competitiveness matters beyond productivity. A BP constraint at the regional level, if it arises, may be particularly disrupting, because regions cannot dispose of an exchange rate mechanism for compelling that condition with a relatively reduced cost.

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<sup>3</sup> Camagni (2002) argues, against this extension, that regions act as the industries rather than as the nations in the Porter's contending. Regions compete (in a single currency area) on the basis of an absolute advantage principle, similarly to the Porter's industries.

<sup>4</sup> This idea that economic growth may be jeopardized by a BP constraint is the very essence of the Thirlwall's Law, that applies to regions as well in Thirlwall (1980). The suitability of this Law, however, depends on very strict assumptions, as the irrelevance of capital movements or the stability of the real exchange rate (the latter is stringent of course only at the national level). For a discussion on the working out and on the releasing of this assumptions, please address also McCombie (1982)

This paper proceeds to an appraisal of the importance of the regional BP in two steps. Firstly we raise the question of how frequent and sizable disequilibria in regional BPs are in real life. The importance of exploring this point is due to the non-existence of official statistics providing information on the regional BPs position. This lack of information may be seen, of course, as a signal that the significance of this indicator is residual. However, the opposite view may be deserving as well: that is, that information should in fact exist and regional leaders should take care with their regions' BPs. On the other hand, we shall stress that there is not any inconsistency at all in having, at one time, a relatively well balanced BP, at the overall level, and important disequilibria in the partial balances that are parts of BP, as the trade or the current balances. When this happens we shall wonder whether these partial imbalances, which do not convey into an overall disequilibrium in BP, are of the benign kind, or whether on the contrary they hit deeply on regional economies.

In a second step, on its turn, we will look after the issue of what happens if regions really run a significant overall imbalance in BP, however unlikely this scenario seems. This imbalance will be, as a rule, supposed to be temporary, although we devote a paragraph to the even least probable possibility of a structural BP imbalance. In this section we were driven back to classic references as Meade (1957), Ingram (1959, 1960) and Pfister (1960), inasmuch as we were not able to find recent contributions on this issue.

Our conclusion on the strategic relevance of the competitiveness concept for the regional analysis will depend therefore on the diagnosis we will make on the actual importance of the regional BP. If we conclude that the regional BP may fall at times into imbalance, and that the regional economies may be heavily beaten by these disequilibria, then regional authorities shall focus on their regions' competitiveness. Otherwise only productivity really matters.

## **2. How frequent are relevant disequilibria in the regional balance-of-payments?**

In a previous work (Ramos, 2005), concerning the trade and the current balances, we argued that at those levels regions can run more often wider imbalances than countries. Some empirical evidence on this assertion was there also provided. The idea, however, in that paper, was that regions can stand for those larger and more frequent imbalances, in the partial levels of BP, that are precluded to nations, because it is easier for them to finance those disequilibria. That financing usually proceeds from capital movements that are recorded in BP as well. Sometimes the trade balance is financed yet by other offsetting flows inside the current balance itself. Regardless of the precise way that that financing is met that phenomenon does not disturb the equilibrium on the overall BP level. When those partial imbalances arise surpluses are recorded somewhere, inside BP, offsetting deficits that emerge elsewhere.

Thus, the very same argument that easy financing allows wider deficits in partial – trade and current – balances, implies likewise that regional overall BPs should easily balance. Of course, as we have already explained, we expect a relative equilibrium at that aggregated level because capital balance is taken into account as well when we compute the overall BP. The ultimate reason that lies behind that supposed easy financing of trade and current balances by capital movements is that for regions, unlike countries, global indebtedness is not pressingly limited by a sustainability constraint. In Ramos (2005) we set up different causes why the sustainability issue does not apply to regions. In short these causes are:

- the existence of multiregional firms, that account for a considerable share of the regional economies, whose plants operating inside the regions are not very often independent legal entities, and so are not liable (alone) by their debt;
- the multiregional nature of the financial system as well and of the great majority of the units belonging to it; in fact, in the international environment, households and corporations' foreign debt is seldom handled directly, but it is very often intermediated by the national financial system, that incurs the liability itself in the

- international markets; country risk is then to a great extent its financial system breakdown risk; for regions, however, the role of the financial system is quite different, as financial institutions usually operate all over the country, and they do not concentrate in their regional branches the risk deriving from their local customers;
- the lower legal capacity of regional and local governments that prevents the generation of a high sovereign-type risk at the regional level; regional and local governments are not immune from national laws and they have no capacity to protect private agents when they default;
  - the supposed non-existence of reputational externalities at the regional scale (at the countries level these externalities may determine the credit rationing of some borrowers, that otherwise would be considered sound, but that are affected by the “country risk” when other borrowers default); on the contrary, it may happen that some regions benefit from the national solidarity of other regions, through an investment bias towards the regions of the very same country that is preferred to investing abroad.

On the other hand, the trade balance financing inside the current account is also favored because:

- some regions benefit of huge interregional (explicit or implicit) governmental transfers that substitute exports financing the net imports;
- multiregional and sometimes even local corporations grant a large interregional income redistribution, paying dividends to their shareholders or interests to their lenders, sometimes residing outside of the region, or paying wages to employees living in neighboring regions.

For all these reasons it may happen – and it indeed happens very likely – that a region runs an important surplus or a wide deficit in its trade or current balance, and at the same time its overall BP remains well balanced. This type of partial imbalances that never convey in overall disequilibria on the external regional payments, and that hence do not

put the regional economies under stress, must be of a benign kind (it is important to emphasize that even among countries, when the current balance has a smooth financing through “autonomous” capital movements, the exchange rate remains in principle stable). These partial imbalances, that regions run very often, are in fact the outcome of a high interregional capital mobility, that allows capital to move towards the places where the investment opportunities arose. The capital inflows have the scope as well of sustaining the regional consumption, when regions are hit by idiosyncratic shocks that decrease transitorily their income. We must be aware that it is through these partial imbalances that regions were able to seize the efficiency gains that are generated into a financial integration process.

Besides the major capacity that regions reveal, comparing with countries, for the financing of the trade and the current imbalances, there are still further reasons supporting our conclusion of an overall well-balancing of the regional BPs endorsed in this paper. These reasons are:

- the non-existence of an exchange market (that produces for countries a lot of short-run exogenous instability on capital in- and out-flows on behalf of the speculative activity)
- the existence of a powerful long-run mechanism frustrating contingent BP imbalances: the labor mobility
- the relatively mitigated effect that real shocks are deemed to produce on regional trade balance

As for this softened effects of the real shocks that we believe do occur, our reasons are:

- the shocks on the real side of a regional economy, when they affect exports, they as a rule also hit imports in a offsetting and sizable way
- regions usually act as price-takers; thus, even a small neglecting price adjustment on tradable goods may restore a relative equilibrium in the trade balance;



- the regional non-tradable goods sector (where producers many times refuge when they face hard competition on tradables) is a small one and endowed with very porous boundaries; when the price of those goods fall they frequently become exportables.

### **3. And what is the impact on a regional economy of an overall imbalance in the payments with other regions or countries?**

Thus, as we argued in the previous section, we do believe that regions seldom meet sizable imbalances at the overall BP level<sup>5</sup>. But if these imbalances exceptionally happen what is their impact on regional economies? Indeed, we daze why this issue is so rarely raised in regional economics. The main problem on the regional ground is that the external payments adjustment, with the rest of the country and the rest of the world, cannot be provided by the exchange rate mechanism. That is what make regions peculiar and should be the reason for a greater interest by economic theorists. A discussion on the adjustment mechanism that prevails at the interregional level may be seen however in Meade (1957), Ingram (1959, 1960) and Pfister (1960).

When a surplus on the overall regional BP occurs then the quantity of money circulating inside the region shall rise, and on the contrary, if a deficit arises that quantity of money will lessen. Such a consequence is nearly the same that we meet, for a country, when we assume a fixed exchange rate system without sterilization, by the central bank, of the external imbalance impact on the money stock. This is, in international economics, the well-known David Hume's mechanism. The rise in the quantity of money is the counterpart of the sales of goods and services out of the region, in excess over purchases, or of the capital inflows, exceeding outflows, from the rest of the country or from other countries. When on the contrary the region registers a deficit, then payments to the rest of

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<sup>5</sup> Though some authors believe that this may have not been true once a time. In the United States, namely, regional BP crisis may be detected at least until the First World War (Ingram, 1959, Pfister, 1960 and more recently Rockoff, 2000). However the U.S.A. were not until very lately a financial integrated economy, as we assumed national economies are. Buch (2002) provides some insight on the historical segmentation and on the ensuing financial integration process of the U.S.

the world, beyond receivables, are only feasible as the region hand out a parcel of its money stock.

Quite obviously, those movements on the money stock, following the regional BP imbalances, result then into deposits variations inward the regional bank system. Thereafter, however, the process takes a different course for regions than usual mechanisms admit for countries. The point is that at the regional level the inflow of deposits moving into the bank system does not give rise to an increasing credit supply in the very same region where the deposits settle. In the same manner, when deposits reduce, the regional credit is not affected as well for certain. This happens because the regional banking system where the deposits gather is not based on independent banks, but mainly consists of regional branches of national banks. By this reason, the bank deposits variation accruing from the BP disequilibrium in a specific region is offset by smooth capital movements, fleeing within the national banks themselves, which stabilize the regional credit and money supplies. We cannot even say that the risk concentrate in a regional system that at the local level loses ample bank reserves, as the branches of the national banks are not independent legal entities. By all these reasons we conclude that the variation in the regional money stock, that is the counterpart of an overall BP imbalance, is not magnified by a money multiplier. Therefore, we expect at the regional level, that the impact of BP disequilibrium and of the associated money stock variation, in the real economy, is much softened, comparing with the crude effect that is foreseen for a country by the Hume's mechanism.

Nevertheless, we can only assume in a reasonable way that the money stock variation is so innocuous to the real economy, when we presume that the BP imbalance is a transitory shock. A permanent imbalance at BP would impose a continuous variation on the money stock that would gap forever from the money demand, which must be assumed to depend on the usual variables. If that permanent shock happens – consisting of a BP fundamental deficit – we cannot exclude absolutely a real effect on the regional economy. This real effect should lead, in principle, to labor migrations to other regions or countries. An important feature of the interregional labor migration is that it may come only in the form

of commuting. In this case, the BP returns to equilibrium through an increase on factor income balance. Commuting is a particularly benign kind of labor migration, which is very unlikely to produce any induced trend of capital outflows. The catastrophic scenario of depopulation and decapitalization, that some authors fear (for example, Camagni, 2002), appears not to apply. Indeed, we do believe that a permanent imbalance in the regional overall BP, leading to massive labor and capital outflows, is very unlikely, by the very reason that any sizable imbalance is improbably, as we argued in the previous section, so it is even more a permanent one. Furthermore, unless the money stock drastically shrinks, a continuous capital outflow imposes, as an inescapable counterpart, that the region runs a surplus in its external current balance.

#### **4. Conclusion**

The main conclusion of this paper is definitely that the BP is not as important for regions as it is for countries. On the one hand, our argument is that at the regional level sizable overall imbalances are very likely rare events. The main reason for that irrelevance is that trade and current imbalances, that we admit regions run very often with considerable size, are easily financed by offsetting flows recorded as well in the BP. Because those partial imbalances do not pass, as a rule, into overall BP disequilibria, burdening on the real side of the economy, we conclude that they are of benign kind. But even when an overall BP imbalance arises, its effects on regional economy are deemed to be reduced, as the corresponding variation on the regional money stock is not magnified by a money multiplier. This result relies critically on the assumption of a nationally integrated financial system.

When regions do not face any significant BP constraint, as we argued, then exports (less imports) do not play any peculiar role in the regional growth process. Even assuming that that process is demand driven, the external and the domestic demand are both parts, in an equivalent way, of the same global demand, having a symmetric effect on product. Although productivity certainly matters, regions need not therefore to obsess with

competing each other. The final outcome of this argument is then that the debate on regional competitiveness, as this concept is distinguished from the productivity, is misplaced.

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