Box 4

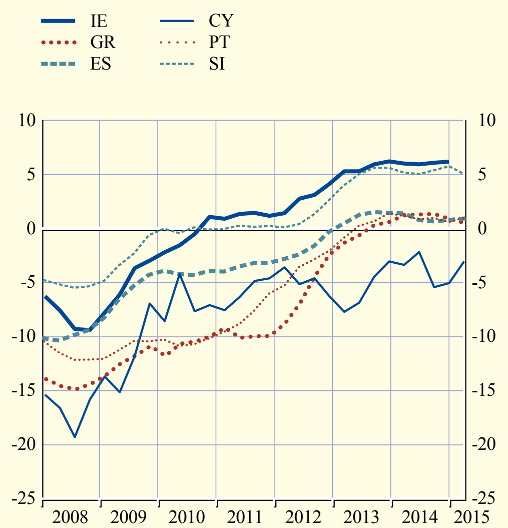
RECENT CURRENT ACCOUNT DEVELOPMENTS IN EURO AREA COUNTRIES WITH LARGE PRE-CRISIS DEFICITS

A number of euro area countries have been undergoing a process of external rebalancing. In the years leading up to the global financial crisis, particularly large current account deficits were recorded in Ireland, Greece, Spain, Cyprus, Portugal and Slovenia.[1] Between 2008 and 2013 the current account balances of these economies saw a significant correction and, in most cases, turned into surplus. This box takes a closer look at the more recent current account developments in this group of countries.[2]

In 2014 the current account correction in the euro area economies with large pre-crisis deficits came to a halt and even reversed slightly in some countries (see Chart A). In Ireland, Greece and Slovenia, the current account was broadly unchanged in 2014 compared with the previous year. In Spain and Portugal, it deteriorated slightly, by 0.6 and 0.8 percentage point of GDP respectively. A more pronounced deterioration of 2.0 percentage points was registered in Cyprus, although this was partly unwound in the first quarter of 2015. With the exception of Cyprus, all of the countries under consideration continued to record current account surpluses. Hence, the majority of the current account improvements recorded by the countries with large pre-crisis deficits between 2008 and 2013 remain in place.

Chart A Current account balance

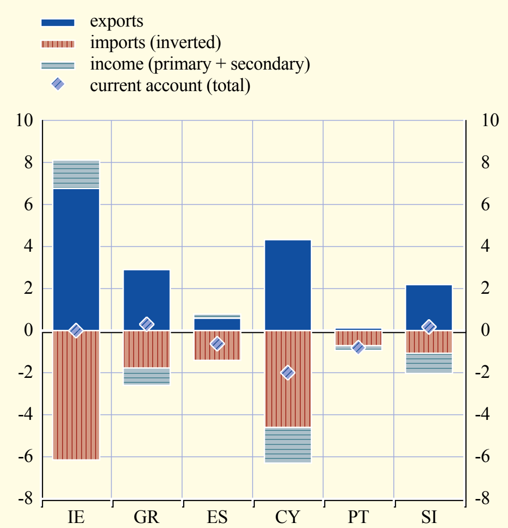
(as a percentage of GDP, four-quarter average)



Sources: ECB and Eurostat.
Note: The last observation is Q1 2015 except for Ireland (Q4 2014).

Chart B Decomposition of the change in the current account balance relative to GDP between 2013 and 2014

(percentage points)



Sources: ECB and Eurostat.
Note: A negative contribution from imports indicates an increase in imports relative to GDP.

1 This box focuses on countries that in 2008 recorded current account deficits in excess of 4% of GDP and adopted the euro before 2008. Cyprus is added to this group, as it received EU-IMF financial assistance.
2 For the earlier post-crisis period, see the boxes entitled "Progress in the current account adjustment in the euro area in 2012", *Monthly Bulletin*, ECB, July 2013, and "To what extent has the current account adjustment in the stressed euro area countries been cyclical or structural?", *Monthly Bulletin*, ECB, January 2014.

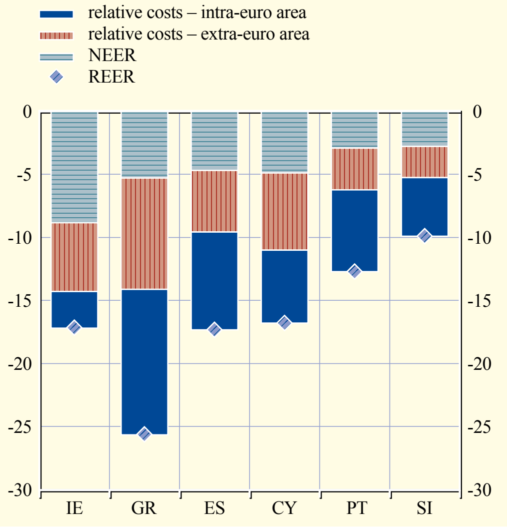
The recent current account developments mainly reflect a demand-driven recovery in imports, which counterbalanced the continued expansion in exports. In 2014 exports increased in most countries, particularly Ireland, against the backdrop of strengthening foreign demand (see Chart B). However, imports also recovered from their persistent weakness, which can be partly explained by a gradual pick-up in domestic demand growth. In Cyprus, Greece, Slovenia and, to a lesser extent, Portugal, a deterioration in the combined primary and secondary income account also played a role.[3] In Cyprus, this was mainly driven by an emerging deficit in the direct investment income account, in Greece by a deterioration in the secondary income account and in Slovenia by a broad-based widening of the deficit on investment income.

Looking at the 2009-14 period, the downward impact on the current account from the stabilisation of domestic demand was partly offset by sustained improvements in relative prices and costs, as well as the decline in oil prices. Compared with 2009 (when the nominal effective exchange rate of the euro reached its peak), the real effective exchange rates of the countries with large pre-crisis current account deficits, deflated by unit labour costs, have depreciated by 10%-30% (see Chart C). In the case of Ireland, most of the real depreciation since 2009 is accounted for by decreases in the nominal effective exchange rate, while for the other countries the depreciation mainly reflected adjustments in unit labour costs relative to the other euro area countries and the rest of the world. With the exception of Slovenia, the countries with large pre-crisis current account deficits have by now largely unwound the losses in cost competitiveness, as measured by the ULC-deflated real effective exchange rate recorded vis-à-vis the euro area between 1999 and the onset of the crisis. However, the pass-through from unit labour costs into both producer and export prices remains incomplete, reflecting factors such as continuing barriers to competition in product markets and increases in indirect taxes.

In 2014 the decline in oil prices also supported the current account balances of euro area countries with large pre-crisis deficits. Lower oil prices tend to reduce the oil bill and thus improve the structural deficit in trade in oil products. Between the last quarter of 2013 and the last quarter of 2014 the negative oil balances narrowed significantly in all countries except Greece (see Chart D), with price effects from lower oil prices being partly offset by stronger real imports of oil products owing to a pick-up in domestic demand.[4] The resulting improvements in the oil trade balance were particularly large in Cyprus and Slovenia (around 1.5-2.0 percentage points of GDP),

Chart C Breakdown of the change in the real effective exchange rate 2009-2014

(as a percentage, percentage points)



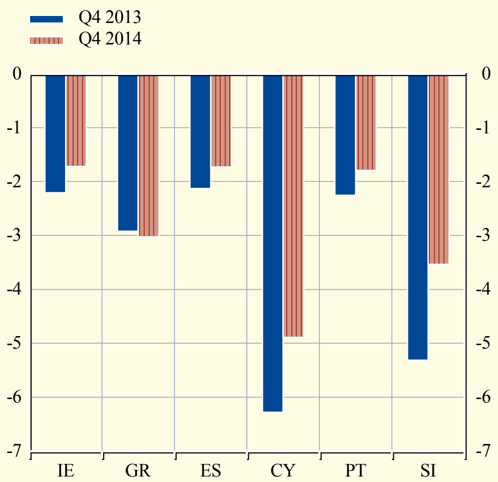
Source: ECB.
Note: The chart shows the real effective exchange rate (REER), deflated by unit labour costs, vis-à-vis the other euro area countries and the EER-20 group of currencies. A decline in the REER corresponds to an improvement in cost competitiveness.

3 The primary income account mainly captures investment income and the compensation of employees. The secondary income account shows current transfers, such as receipts from the EU community budget.

4 Greece – and, to a lesser extent, Portugal – hosts oil-refining industries and therefore simultaneously imports and exports oil and related products, such as light petroleum distillates.

Chart D Oil trade balance

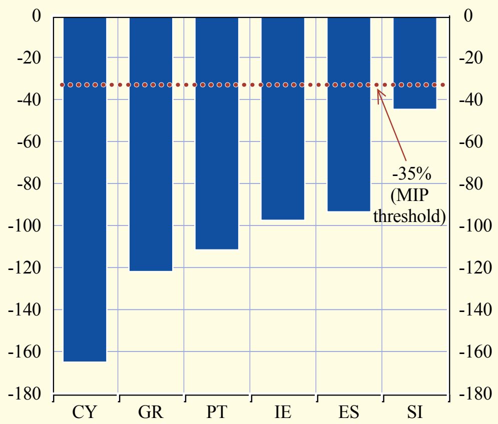
(as a percentage of GDP)



Source: Eurostat.
Note: Data refer to SITC category 33, i.e. petroleum, petroleum products and related materials.

Chart E Net international investment position in 2014

(as a percentage of GDP)



Source: Eurostat.
Note: The horizontal line corresponds to the indicative threshold of -35% of GDP used in the macroeconomic imbalance procedure (MIP).

but also noticeable in Ireland, Spain and Portugal (around 0.4-0.5 percentage point), where the positive effects of the decline in oil prices on the current account were partly offset by demand-driven increases in import volumes of oil and oil products.

Large and persistent stock imbalances call for sustained external rebalancing. Despite the flow adjustment seen over recent years, the countries with large pre-crisis current account deficits continue to record net foreign liabilities well in excess of 35% of GDP. This threshold is used in the context of the macroeconomic imbalance procedure to flag potential external stock imbalances that increase the vulnerability to future shocks. In most countries under consideration, net foreign liabilities are even above, or close to, 100% of GDP (see Chart E). Reducing these stock imbalances requires a combination of sustained current account improvements and robust nominal GDP growth over the medium term.