

Box 2

CURRENT ACCOUNT ADJUSTMENT IN THE EU MEMBER STATES OF CENTRAL AND EASTERN EUROPE

Since the start of the global financial crisis, the EU Member States of central and eastern Europe have witnessed a significant correction of the large current account deficits they recorded before the crisis.¹ This box examines the drivers of this external adjustment and the challenges that lie ahead.

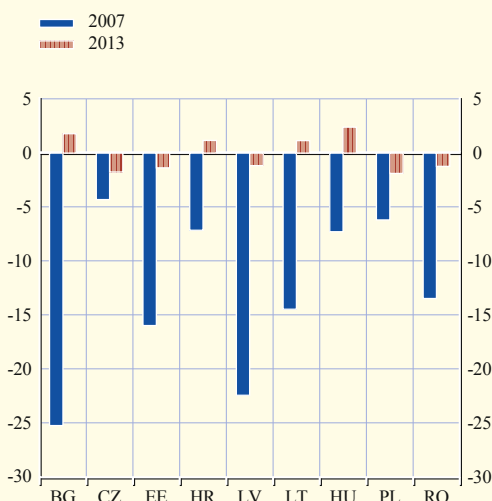
In the years leading up to the financial crisis, the EU Member States of central and eastern Europe embarked on a rapid process of catching up with the rest of the European Union. In several countries, particularly those with limited or no exchange rate flexibility, this was associated with strong domestic credit growth and other signs of economic overheating. External imbalances and vulnerabilities also built up, as illustrated by the current account deficits for 2007 (see Chart A). Particularly large deficits in excess of 10% of GDP were recorded in Bulgaria, Estonia, Latvia, Lithuania and Romania. While the current account deficits of these and the other EU Member States in the region have to be evaluated in the light of the convergence process, a number of them recorded deficits beyond levels justified by economic fundamentals and accumulated large net foreign liabilities.²

1 This box studies the non-euro area EU Member States of central and eastern Europe together with Estonia and Latvia, which adopted the euro in 2011 and 2014 respectively.

2 See the box entitled "External adjustment in central and eastern Europe", *Monthly Bulletin*, ECB, January 2010.

Chart A Current account balances

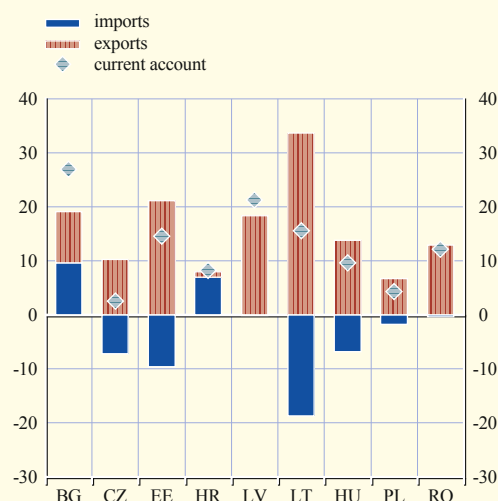
(as a percentage of GDP)



Sources: Eurostat and national statistical institutes.
Note: 2013 data refer to the four-quarter average for the period up to the end of the third quarter of 2013.

Chart B Contributions to the change in current account balances between 2007 and 2013

(percentage points of GDP)



Sources: Eurostat and national statistical institutes.
Note: 2013 data refer to the four-quarter average for the period up to the end of the third quarter of 2013.

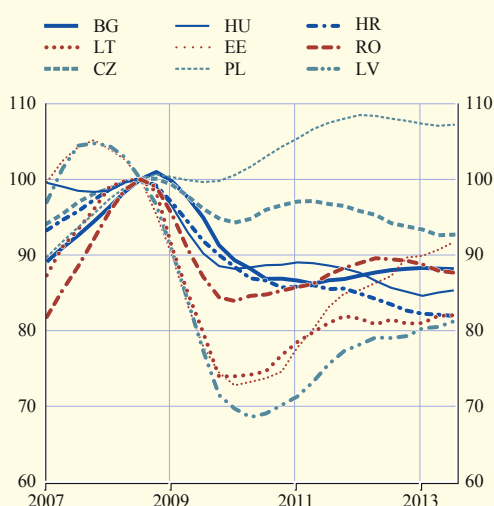
Following the intensification of the financial crisis in the period 2008-09, several of the central and eastern European EU Member States with external imbalances experienced a temporary withdrawal of foreign capital amid heightened global risk aversion and deleveraging by international investors. Against this backdrop, Latvia, Hungary and Romania received balance of payments assistance from the European Union and international financial institutions. In the wake of the crisis, the current account deficits of all EU Member States in the region either narrowed significantly or turned into surpluses, mainly on account of improvements in trade balances. In most countries, a substantial increase in exports relative to GDP was the dominant factor behind the adjustment when looking at the whole of the period 2007-13, except for Bulgaria and Croatia, where a decline in imports relative to GDP also contributed significantly to the external adjustment (see Chart B). This is remarkable, since the initial current account adjustment in the period 2007-09 had been characterised by a sharp decline in imports and a simultaneous drop in exports in all the countries under consideration. Over the period 2010-13, however, exports rose again, surpassing pre-crisis levels despite relatively weak foreign demand.³ At the same time, imports recovered in most countries, although at a more gradual pace.

The drivers of the adjustment in imports and exports vary significantly across countries. Most central and eastern European EU Member States – with the exception of Bulgaria and Poland – have witnessed a combination of a decline in domestic demand and a real depreciation in their currencies since 2008, when the real effective exchange rates reached their pre-crisis peaks. In the Baltic States, the decline in domestic demand was particularly severe (see Chart C). The Latvian lats and the Lithuanian litas, which were pegged to the euro during the period under consideration, remained stable in nominal effective terms. In real terms, however, the currencies gradually

³ Some countries, particularly Croatia and Hungary, have nevertheless lost export market shares, possibly due to developments in non-price competitiveness.

Chart C Domestic demand at constant prices

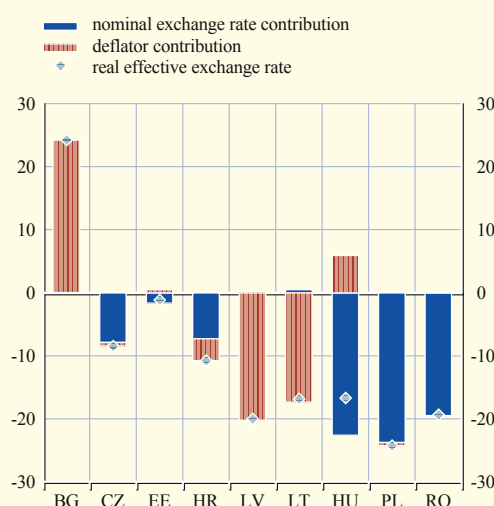
(four-quarter moving average; index: Q3 2008 = 100)



Sources: Eurostat and Haver Analytics.

Chart D Real effective exchange rates
(ULCT-deflated, vis-à-vis group
of 21 trading partners)

(percentage change between Q3 2008 and Q3 2013)



Source: ECB.

Notes: Negative values correspond to a depreciation of the real effective exchange rate. An equivalent harmonised competitiveness indicator is used for the Estonian kroon.

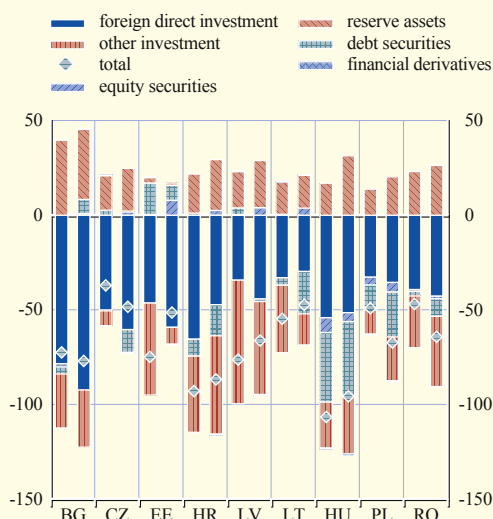
depreciated owing to an adjustment in unit labour costs (see Chart D). In Estonia, the real effective exchange rate also initially depreciated, although after 2012 it strengthened again due to rising unit labour costs. The Czech Republic, Croatia, Hungary, Poland and Romania also witnessed a depreciation of the real effective exchange rates, driven by a nominal depreciation of their floating currencies. At the same time, the decline in domestic demand curbed import demand in these countries, with the exception of Poland, where domestic demand grew robustly. In Bulgaria, the current account adjustment reflected a decline in domestic demand, while the real effective exchange rate of the Bulgarian lev, which is in a currency board with the euro, appreciated on the back of an increase in unit labour costs relative to the country's trading partners.⁴

Although current account balances have improved significantly, continued adjustment is needed in some EU Member States of central and eastern Europe to reduce the large stocks of net foreign liabilities (see Chart E). In 2013 the net international investment positions of all the countries stood at levels well below the threshold of -35% of GDP, which is seen as a sign of potential external imbalances in the context of the Macroeconomic Imbalance Procedure. A notable share of the foreign liabilities of the region's EU Member States is denominated in foreign currency, which may create vulnerabilities with respect to exchange rate changes. Net foreign liabilities also hamper the ongoing current account correction, since the corresponding payments, such as interest and dividend payments, give rise to sizeable deficits in the income account (see Chart F). The deficits in the income account constituted a drag on the current account balance in 2013, while most of the countries under consideration recorded surpluses in the trade balance and in current transfers, which cover EU structural funds and workers' remittances.

⁴ The appreciation of the Bulgarian currency's real effective exchange rate was less pronounced using other deflators, such as the consumer price index or the GDP deflator.

Chart E Net international investment positions

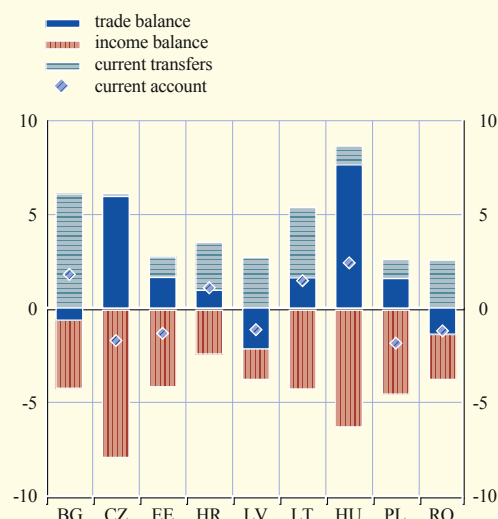
(as a percentage of GDP)



Sources: Eurostat and national statistical institutes.
Notes: For each country, the left and right bars correspond to 2007 and 2013 respectively. 2013 data refer to the four-quarter average for the period up to the end of the third quarter of 2013.

Chart F Main components of the current account balances in 2013

(as a percentage of GDP)



Sources: Eurostat and national statistical institutes.
Note: 2013 data refer to the four-quarter average for the period up to the end of the third quarter of 2013.

In summary, the current account balances of the EU Member States of central and eastern Europe have improved significantly since the start of the global financial crisis. For most of the countries, this reflects both a decline in domestic demand and a depreciation of the real effective exchange rate. However, in some of them, continued external adjustment is needed to reduce net foreign liabilities to more sustainable levels.