Box 1

EXTERNAL ADJUSTMENT IN CENTRAL AND EASTERN EUROPE

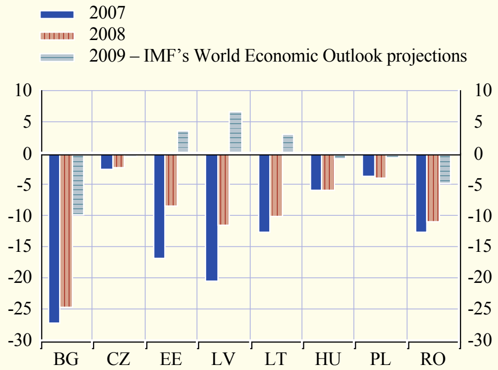
Since the end of 2007 several EU countries of central and eastern Europe have been experiencing an unwinding of domestic and external imbalances, a process which was exacerbated when the global financial turmoil intensified. Over the past two years most countries in the region have seen a significant fall in GDP and domestic demand, which has fostered a rapid contraction in the sizeable current account deficits that had prevailed in some of these countries in previous years. This box briefly examines the formation and subsequent unwinding of external imbalances in this region.

In the course of their increasing integration into the world economy, most central and eastern European countries have been going through a rapid catching-up process, accompanied by large current account deficits. While this is, to some extent, a normal feature of the catching-up process, several central and eastern European countries have recorded deficits much larger than that which could typically be explained from an intertemporal perspective.[1] In 2007 current account deficits amounted to more than 10% of GDP in Estonia, Lithuania and Romania and exceeded 20% of GDP in Bulgaria and Latvia, raising questions about their medium-term sustainability. These external imbalances were generally also a reflection of internal imbalances. In particular, in countries with no or limited exchange rate flexibility, relatively low interest rates fuelled domestic credit growth and economic overheating. Accordingly, current account deficits widened as a result of strong domestic demand fuelling import growth, while export competitiveness was negatively affected by rising unit labour costs.

Since the end of 2007 current and capital account deficits have narrowed in all of the countries under consideration. In the Baltic States, they even turned positive in 2009 (see Chart A).[2] The unwinding of current account deficits has occurred amid a significant decline in house prices and credit growth, especially in those countries that had previously shown strong signs of overheating. Although the correction of the imbalances had already started prior to the intensification of the financial turmoil in September 2008, heightened global risk aversion amplified the speed and magnitude of the adjustment and led to a sharp contraction in economic activity and domestic demand. The decline in activity was particularly pronounced in the Baltic States,

Chart A Current and capital account balances in central and eastern Europe

(percentages of GDP)



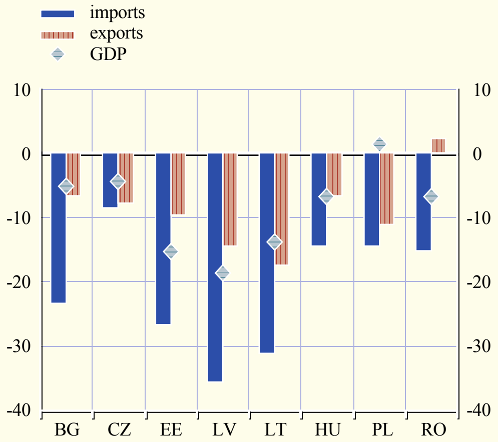
Sources: ECB and the IMF's World Economic Outlook projections.

1 For evidence relating to this, see M. Ca' Zorzi, A. Chudik and A. Dieppe, "Current account benchmarks for central and eastern Europe: a desperate search?", *Working Paper Series*, No 995, ECB, 2009.

2 Please note that, for some countries, income debits in the current account entail the provisioning by loss-making foreign-owned banks. Excluding this provisioning from the calculation would result in lower losses by foreign-owned banks, implying lower current account surpluses.

Chart B GDP, imports and exports

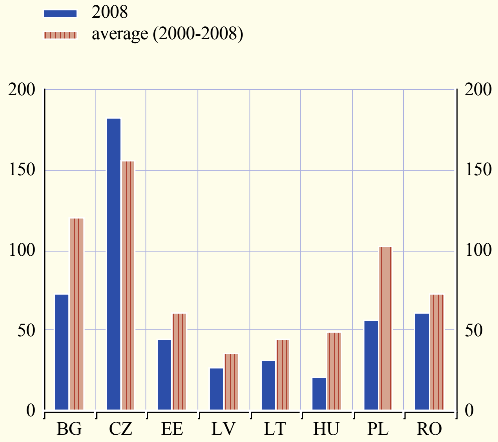
(annual percentage change in the third quarter of 2009, at constant prices)



Source: ECB staff calculations.

Chart C FDI coverage of the current and capital account

(net inflows of FDI as a percentage of the combined current and capital account)



Source: ECB staff calculations.

partially because the exchange rate could not depreciate and thereby mitigate the downturn in these countries. As the adjustment process was accompanied by a sharp contraction in global trade, both exports and imports fell sharply in each country in the region. However, in all of the countries under consideration, between the third quarter of 2008 and the third quarter of 2009 the decline in imports was stronger than that of exports, in both nominal and real terms, leading to a sharp correction of current account deficits (see Chart B).

The magnitude of the overall current account adjustment in each of these countries seems to have also been related to the financing of the current account deficit prior to the turmoil. In contrast to countries in which foreign direct investment (FDI) accounted for a large proportion of the financial account, such as the Czech Republic and Poland, countries that relied more heavily on "other investment" inflows, such as the Baltic States, have generally experienced a sharper contraction in their deficits (see Chart C). Heavy net outflows of "other investment" from these countries during the turmoil can be partly attributed to the global deleveraging that stemmed from the notable increase in investors' risk aversion and to a lower demand for credit, as some of these countries adjusted in response to previous credit-driven domestic demand booms. With respect to "other investment" flows, there are also differences between countries regarding cross-border flows between banks. In some countries, such as Estonia, Hungary and Poland, local subsidiaries received substantial liquidity support from their parent banks, which might have played a stabilising role.

To summarise, external imbalances in several central and eastern European countries have been undergoing strong and rapid adjustment, the speed and magnitude of which has been amplified by the effects of the turmoil. The strength of the unwinding in each country appears to have been partly related to the magnitude of the imbalances that had been built up before the crisis. In addition, the financing structure of the current account deficit also seems to have played a role in the adjustment dynamics, as countries with higher FDI coverage appear to have been relatively less vulnerable to the global turmoil.