Box 3

ARE THE EXTERNAL POSITIONS OF THE NEW EU MEMBER STATES EXCESSIVE?

From a financial system stability perspective, among a broad set of economic and political indicators to be taken into account when assessing a country's vulnerability to a currency crisis, it is crucial to assess the evolution of the external imbalances of countries. By late 2006, with the major exception of the US, collectively the central and eastern European countries (CEEC) were the only region in the world recording sizeable and persistent current account deficits. By contrast, Asian and Latin American countries recorded either moderate deficit or surplus positions. Although the CEEC are economically relatively small, financial distress in these countries could entail more widespread financial stability risks. For instance, the Asian crisis in 1997-1998 demonstrated that financial distress in one country can affect a much larger economic area if investors simultaneously withdraw their funds from countries with similar characteristics. From a euro area perspective, the CEEC are particularly relevant given their geographic proximity and the participation of some of these countries in the Exchange Rate Mechanism (ERM) II.

Against this background, this Box examines from various perspectives the external positions of the new EU Member States (NMS) from the CEEC as one element in the analysis of these countries' vulnerability to financial stability risks. In more detail, it looks into developments in the current account balance, its financing as well as the net international investment position (i.i.p.) and level of external indebtedness.

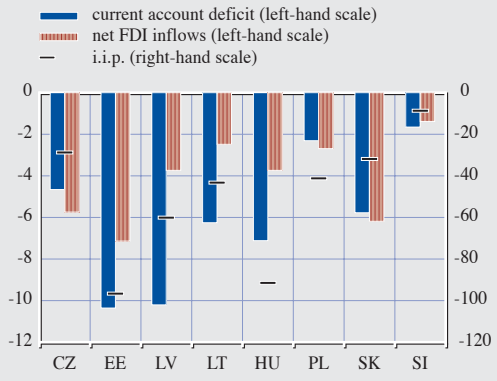
Current account positions remain rather diverse across the NMS. Estonia and Latvia recorded the highest current account deficits in recent years, reaching at times even double-digit levels if measured in terms of GDP (see Chart B3.1). The Hungarian current account deficit was also large, averaging about 7% of GDP between 2002 and 2006, which was partly related to the country's high fiscal deficit. On the other side of the spectrum, Slovenia and Poland have recorded smaller current account deficits in recent years. In the other NMS, average current account deficits in the range of 4-6% of GDP were recorded in the period 2002-2005. Among those countries, the patterns in Slovakia's current account balance represent a good example, whereby current account deficits were rather volatile without necessarily implying sharp exchange rate fluctuations: the Slovak deficit declined from 8% of GDP in 2002 to close to balance in 2003, followed by a strong reversal in the following years.

Overall, while deficits of such magnitudes could signal problems in terms of cost and price competitiveness, they may also reflect the catching-up processes taking place in these economies. One way of assessing whether these current account deficits can be considered "excessive" is to estimate a model that takes intertemporal aspects into account, and then to determine so-called equilibrium current account positions. Studies employing such an approach suggest that the deficits observed in the NMS have mostly stayed within sustainable ranges, although it must be kept in mind that such estimates are surrounded by significant uncertainty.[1] At the same

1 See M. Bussière, G. Müller and M. Fratzscher (2004), "Current Accounts Dynamics in OECD and EU Acceding Countries – An Intertemporal Approach", *ECB Working Paper,* No. 311; S. Herrmann and A. Jochem (2005), "Determinants of Current Account Developments in the Central and East European EU Member States – Consequences for the Enlargement of the Euro Area", *Deutsche Bundesbank Discussion Paper* No. 32; M. Doisy and A. Hervé (2003), "Les déficits courants des PECO: quelles implications pour leur entrée dans l'Union européenne et la zone euro?", *Economie Internationale,* 93, first trimester, pp. 59-88; and M. Rubaszek (2005), "Fundamental Equilibrium Exchange Rate for the Polish Zloty", *NBP Working Papers,* No. 35.

Chart B3.1 Current account, net FDI inflows and international investment position (i.i.p.)

(average 2002 - 2006, i.i.p.: 2005, % of GDP)



Source: ECB.
Note: Data for 2006 include the four-quarter moving average until the second quarter of 2006. The current account refers to the combined current and capital account balance.

time, these models also indicate that current account deficits that are significantly higher than 10% of GDP – as experienced at times in Estonia and Latvia – are likely to prove unsustainable from a medium-term perspective. According to these models, there are also signs of an excessive current account position in Hungary, particularly when the deficit rose above 8% of GDP.

Financial stability risks also depend on the structure of the financing of the current account deficits. If a significant share of the current account deficit is financed through longer-term and less volatile sources, a current account deficit may be considered more sustainable. Net FDI inflows constitute an important source of financing in almost all NMS (see Chart B3.1). They partly reflect re-invested earnings, which mechanistically increase the income deficit, and thus the current account deficit. Over the past four years, net FDI inflows have on average exceeded current account deficits in the Czech Republic, Poland and Slovakia. By contrast, in Hungary, Latvia and Lithuania over the same period, net FDI inflows only financed around half of their current account deficits, reflecting a combination of relatively subdued net FDI inflows and large current account deficits. In these cases, the financing gap was closed by higher inflows in portfolio investment and commercial bank borrowing.

By additionally taking into account the past evolution of a country's balance of payments, its net international investment or external debt position can be assessed. While the external debt situation varies between the NMS, it is noteworthy that the Czech Republic recorded a rather favourable external debt situation as a result of strong net FDI inflows which reduced debt-financing needs. In Hungary, gross external debt has risen strongly, and the i.i.p. is also strongly negative (see Chart B3.1), partly owing to the large fiscal deficit and the demand for foreign-denominated loans by the private sector. The boom in foreign currency-denominated mortgage lending has further increased balance sheet risks to the economy. In the Baltic countries, Estonia and Latvia experienced strongly negative and rising net i.i.p. and high levels of external debt-to-GDP ratios. In Estonia, the high level of gross external indebtedness seems to have been partly related to loans of commercial banks from their foreign parent banks, which appears to be less risky from a financial stability perspective. In Latvia, the high levels of gross external debt are mainly due to the special characteristics of the Latvian banking system, which attracts non-resident deposits and invests these funds in liquid assets abroad. Taking this aspect into account implies that Latvia's net i.i.p. is sizeably lower than its gross external debt position.

Summarising the examination of the external positions of NMS from all three dimensions does not suggest that external positions in this region are obviously excessive. For most countries, the current account position appears to be in line with the economic fundamentals of catching-up economies operating under the EU Single Market framework. Moreover, in many countries,

current account deficits are financed to a large extent by net FDI inflows, which are less prone to capital flow reversals. However, it is crucial that these countries maintain an investment-friendly macroeconomic environment so as to safeguard the positive market sentiment towards their economies. In addition, some closer monitoring of potential external vulnerabilities seems to be warranted in Estonia, Latvia and Hungary.