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Large current account deficits in emerging Europe – more 'inflammability' but no repeat of Asian crisis

Current account deficits have reached very high levels in several central and eastern EU countries, prompting fears that a repeat of the Asian crisis could be in the making. Such concerns are aggravated by the countries' fixed or heavily managed exchange rates – usually a recipe for financial disaster. In this report we focus on the "+10" group of countries, that is the EU countries with a current account deficit equal to or higher than 10% of GDP. These are the three Baltic countries – Latvia, Lithuania and Estonia – and Romania and Bulgaria, which happen to be the poorest of the EU member states.

We believe that *the comparison with Asia 1997 is misleading*. It ignores the nature of EU integration, which lends support to a realistic real income convergence scenario and reduces considerably the risk of a sudden halt to external financing. This, combined with the balance sheet strength of most of these governments, explains Moody's sovereign investment grade ratings – which range from Baa3 to A1.

However, these countries are increasingly facing *dual risk scenarios, and "inflammability", while still low, is rising gradually.* First, a high probability of a rather benign scenario of economic stagnation "à la Portuguese"; or alternatively, an outside, but rising, chance of a much more virulent scenario, where balance sheet mismatches would be affected by interest rate – and in extremis by exchange rate – adjustments.

Perhaps more worringly, *economic policy dilemmas appear increasingly intractable*, with the "EMU criterion trap" and the impact of large net emigration, which, among other things, fuels wage inflation.

In conclusion, the Asian crisis is not the relevant reference for these countries, which are in fact more exposed to a "Portuguese syndrome". EMU accession, which may ironically be facilitated by the materialisation of such a deflationary scenario, will eventually remove any balance of payment risk. Finally, the risk scenario that ultimately materialises is something over which policymakers have only very limited influence.

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Current account deficits + fixed exchange rates = recipe for disaster?

The "+10" group of countries post extremely high deficits by any standards, and particularly given the current configuration of global imbalances. Indeed, most emerging market economies – which we define as fast converging middle-income countries – are net providers of savings to the rest of the world.

Only emerging Europe differs, prompting questions about the specific nature of the forces at play in this part of the world. Table 1 below shows the size of imbalances.

While not entirely without precedent – Ireland experienced a 14% current account deficit in 1981 and Portugal 9% in 2000 – these deficits are very high, and raise legitimate questions, especially as all these countries have fixed or stable exchange rates – a recipe for disaster in the recent past.

Comparison is not reason: this is not Asia 1997

While high current account deficits have been a source of concern in several new EU countries – explaining their low sovereign ratings relative to otherwise sound credit metrics – the comparison with Asia 1997 is not relevant. Understanding why sheds some light on the EU integration story.

In fact, EU membership reduces both the probability of a balance of payment crisis and, even more, its possible severity.

Four key factors show that "comparison is not reason":

EU accession has resulted in a realistic increase in the permanent income in these countries and a rapid trend of financial deepening

For the countries in question, EU accession has arguably constituted one of – if not the – most important economic development of their recent history. There are realistic grounds to believe that, like the other countries that joined the EU with a below-average GDP/capita, the future is bright. While nobody thinks convergence in real incomes will be a fast and linear process, the direction is pretty uncontroversial: upwards.

The reason is that EU accession represents a microeconomic revolution and gives access to a large market and robust public and private sources of financing (see below).

It follows that the availability of credit allows economic agents to overcome liquidity constraints and engage into consumption smoothing – consuming today on the basis of higher expected income. This results in higher debt – financial deepening – and current account deficits.

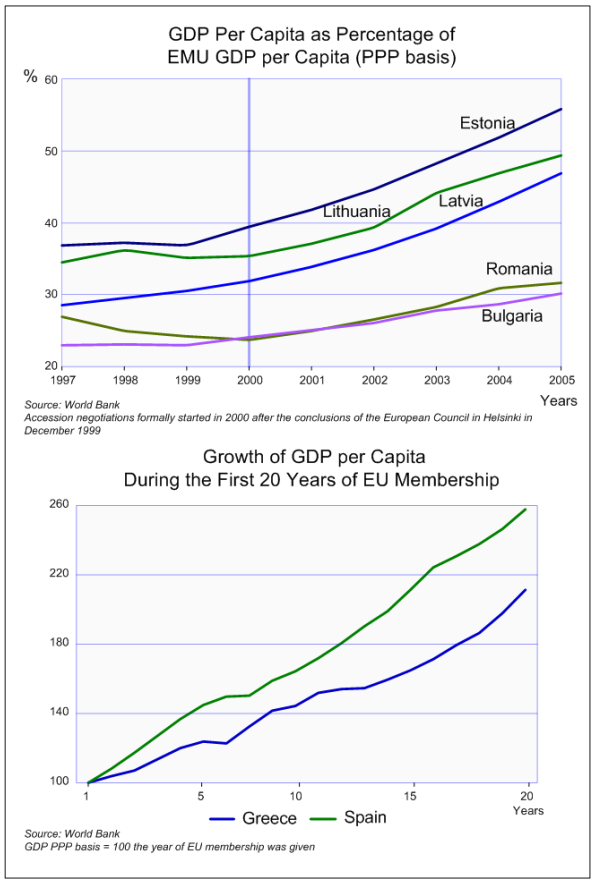
The graphs on page 3 show that assumptions regarding future income per capita growth and gradual convergence with the EU average level of prosperity are not unrealistic. The steep acceleration towards EU or EMU average levels in terms of income/capita is illustrated in the top graph. As regards further convergence prospects, the graph at the bottom shows that for those countries that joined the EU in the 1980s (Greece, Spain and Portugal), the 20 years that have followed accession have seen at least a doubling of their GDP/capita, with Greece posting the lowest score (X 2.1) and Spain the highest (X 2.6).

In conclusion, although convergence is neither linear nor assured, the rise in permanent income in these countries is a realistic assumption, especially given their very low starting point.

Table 1: The explosive pace of growth

2006 estimations	Current Account (% of GDP)	Domestic Credit Growth (%, Sept/Sept)	Domestic Credit (% of GDP)	Inflation average (%, Dec/Dec)	Real GDP Growth (%)	Gross Capital Formation (% of GDP)	National Savings (% of GDP)
ESTONIA	-14.3	35.0	76.2	5.1	10.9	38.5	27.2
LATVIA	-21.8	57.6	80.0	7.0	11.0	37.9	21.9
LITHUANIA	-12.0	56.6	46.9	4.5	7.8	26.0	17.2
BULGARIA	-16.3	13.9	40.9	6.5	6.0	30.2	16.2
ROMANIA	-10.7	51.3	24.5	4.9	8.0	24.5	14.1

Source:Moody's, Eurostat.



A productivity story underpins the strong recourse to external finance

A key issue for determining the extent to which current account deficits that primarily reflect private sector behaviour are a source of concern is to ascertain if credit is channelled to efficient productive purposes (investment rather than consumption). Relative price changes (in the tradable sector) and productivity growth are critical.

In fact, most of the "+10" countries post high relative productivity growth, which, to a large extent, mitigates concerns about losses of competitiveness. Indeed, while the real effective exchange rates deflated by consumer price inflation point to a worrying loss of competitiveness, the same measure deflated by unit labour costs suggests a more benign trend.

Another way to illustrate the differences to Asia pre-1997 is to look at the Incremental Capital-Output Ratio (ICOR). The ICOR measures the investment needed to generate an additional unit of output. A rising ICOR can be interpreted as indicating a declining output response to investment and, therefore, a falling efficiency of investment – which has been diagnosed as one of the causes of the Asian crisis. While this indicator is not without limitations, it is interesting to note that, except for Bulgaria where it has been stagnating, ICOR is declining in the countries analysed, in clear contrast with Asia pre-1997.

Combined with sounder economic and political "institutions" than Asian countries before 1997 – certainly for the three Baltic countries, but Romania and Bulgaria are progressing fast with adoption of the *acquis communautaire* – the risk of massive capital misallocation is diminished.

Table 2: Investment efficiency still high

ICOR	1998-2000	2001-2003	2004-2006
Bulgaria	4.3	5.2	5.3
Estonia	5.7	4.3	3.7
Latvia	5.2	3.8	3.6
Lithuania	8.7	3.6	4.4
Romania	-	4.6	4.3

ICOR	1987-1989	1990-1992	1993-1995
Indonesia	4.0	3.9	4.4
Malaysia	3.6	4.4	5.0
Korea	3.5	5.1	5.1
Thailand	2.9	4.6	5.2

Sources: Eurostat and United Nations.

EU banking integration changes the dynamic of crises

A major development in recent years in CEE – which contrasts this region markedly with pre-crisis Asia – is that the financing of these economies has to a large extent been farmed out to reputable foreign EU banks. Between 65% and 85% of total banking assets in these countries are on the books of foreign-owned banks.

In the wake of the Asian crisis, and even more the Argentine crisis in 2001, concerns have been raised about over-reliance on foreign banks. The argument is that these banks may show "benign neglect" in times of crisis and "drop the keys" when the situation worsens.

In fact, the analogy with either Asia or Argentina is misplaced. Beyond the fact that evidence does not support this conjecture in Asia – foreign banks have curtailed lending by less than domestic banks, even though home-grown problems in Japan have created some degree of contagion – it is hard to believe that EU banks could walk away from their responsibilities in another EU country. The degree of cooperation amongst EU supervisors – as evidenced, for instance, by the December 2006 memorandum of understanding between the Baltic central banks and the central bank of Sweden – as well as reputation risk are such that having a banking system dominated by the same region's large and solid banks, far from being a crisis amplifier, is a crisis buffer.

A related point is that bank acquisition in fast-growing new EU countries has been a key strategic goal for large EU banks with mature – if not saturated – local markets. It is therefore quite probable that, should some CEE banks be on sale after a sharp weakening of their balance sheet, many large banks would be prepared to step in.

All this points to a critical conclusion: the countries in question are not vulnerable to the famous "sudden stop" of external financing that have plagued Asian and more generally emerging market economies over the recent years. There is no risk of credit-disruptive financing discontinuity for a EU country.

ERM2 provides a potential support mechanism

This last factor is more speculative, but some support from EU mechanisms should not be discounted.

Beyond the "medium-term financial assistance for member states' balance of payments", which can reach potentially €12 billion – about the GDP of Estonia – the Exchange Rate Mechanism 2, which replaced ERM1 in 1999, contains a solidarity mechanism.

Solidarity cannot be taken for granted though

ERM1 crises took place against a backdrop of doubts as to whether the Bundesbank would intervene in support of European currencies under attack. According to ERM (both 1 and 2) rules, there is an optional and limited solidarity mechanism called intra-marginal interventions before the attacked currency reaches the downward limit of its fluctuation band, and automatic and theoretically unlimited interventions at the limits of the fluctuation band ("very short-term financing facility").

In 1992 and 1995, the Bundesbank appeared hostile, or at least reluctant, to intervene. The German central bank, which had to combat the inflationary costs of German reunification, maintained that massive interventions (creating Deutsche marks) complicated its policy.

ERM2 is the antechamber to the Eurozone. The three Baltic countries are members of ERM2, and Bulgaria has indicated its willingness to adhere in the coming months.

Whether ERM2 countries could expect much external support if they were to experience serious tensions is largely uncertain. However, analysis of ERM1 crises is informative (see box above).

ERM2 comes at a different time and entails wider currency bands (±15% against a central parity vs ±2.25 under ERM1, at least before 1993). The institutional setting has also changed; the European Central Bank (ECB), as a pan-European institution, operates in a very different working environment to the Bundesbank. In addition, the ECB could, in principle, "suspend intervention if this were to conflict with its primary objective" of price stability.

Yet the mere risk that the ECB would intervene in support of an ERM2 currency in shallow markets has so far deterred speculative attacks.

In addition, it is inconceivable that the ECB could be exposed to an intervention in support of the Baltic currencies — effectively creating euros — massive enough to endanger price stability in the Eurozone.

The real reasons to be concerned

The most complex question with these countries is that after an often difficult transition from central planning two decades ago and, for Romania and Bulgaria, some costly episodes of policy incompetence in the 1990s, these countries have been engaged into a convergence process that has blurred the notion of the business cycle.

It is therefore difficult to say with any degree of certainty whether macroeconomic and financial indicators point to a significant misalignment with equilibrium values. The only thing that can be safely said is that speed limits seem to have been exceeded – and as a result inflammability has increased.

'Inflammability' is rising

Growing current account deficits raise a country's dependence on foreign funding and make it more "inflammable", i.e. more vulnerable to capital outflows and the associated output contraction and balance sheet adjustments.

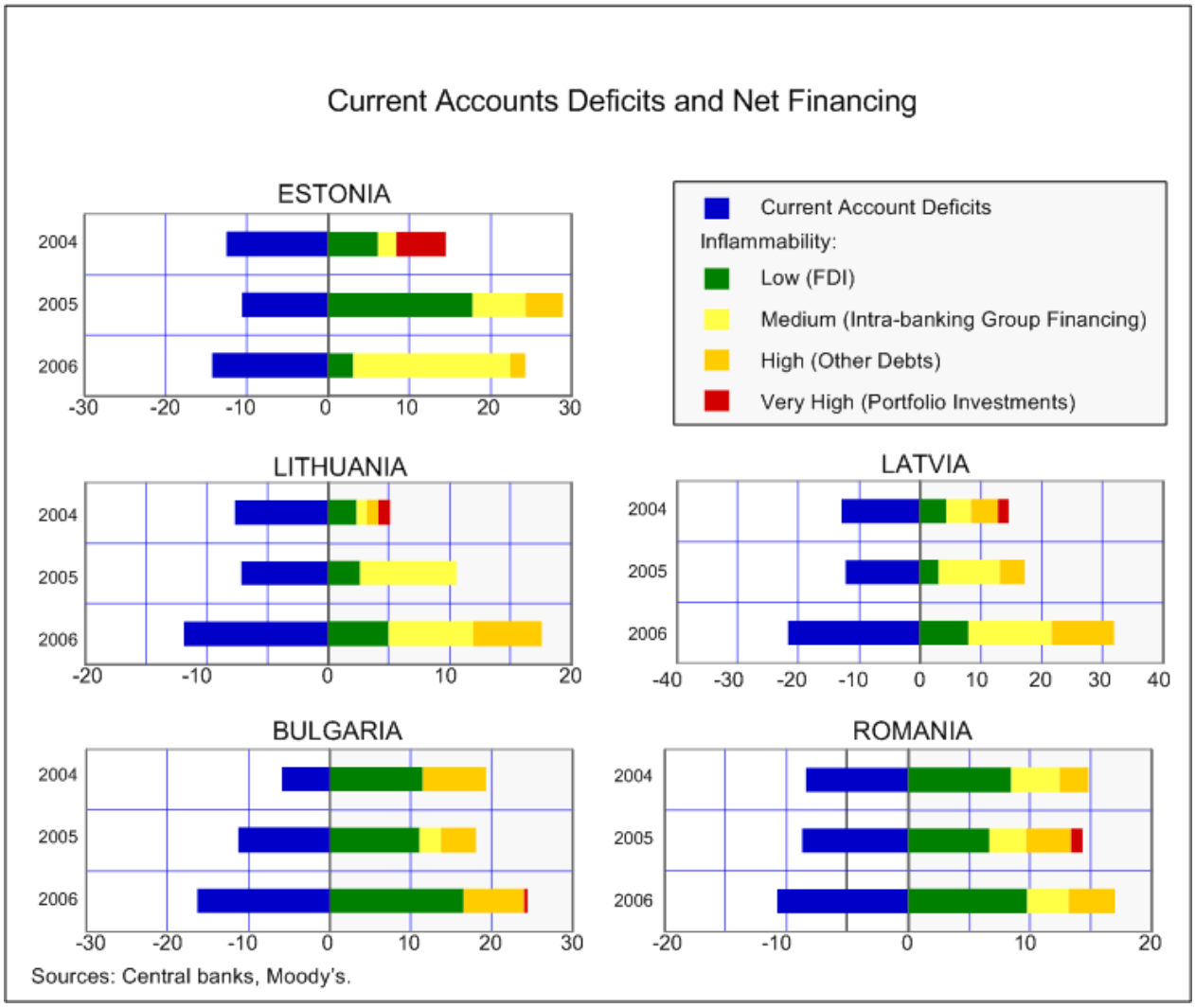
The extent of inflammability, however, depends on the nature of the financing.

Arguably, foreign direct investment is less subject to abrupt reversals than bank debt, which is itself more reliable than portfolio flows – that is tradable capital flows. Because most of the local banks are owned by other larger EU banks, a good deal of the external debt increase takes the form of loans from the parent to the local bank.

We consider this as more inflammable than FDI but less so than conventional debt.

Figure 2 shows that inflammability is rising, albeit from low levels. The main reason why inflammability remains moderate is the quasi-absence of portfolio inflows.

Figure 2: Inflammability, while still low, is rising



A 'Portuguese syndrome' is the most plausible threat

These countries are increasingly faced with dual risk scenarios (illustrated by the schematic on the front page): a highly probable but not devastating one or a very unlikely severe one.

These scenarios are only to a limited extent influenced by the possibility of joining EMU in the near future. Eurozone participation would make most external debt denominated in euros disappear at one strike, effectively eliminating the risk of external financial crisis.

However, it would not eliminate the need to get through the painful unwinding of financial excesses:

- A high probability of a scenario of economic stagnation or at least sluggishness "à la Portuguese", brought about by the slow adjustment of overextended balance sheets in the private sector.

Portugal, in the run-up to EMU and in a context of falling interest rates, experienced a boom: high growth rates, a large current account deficit, elevated credit growth, wage settings based on naively optimistic expectations…. By the turn of the century, when the international cycle started to reverse, a weakened competitiveness eroded Portugal's performance and led to a period of prolonged stagnation that has still not fully ended. As a result, convergence in terms of income per capita has been interrupted.

While this experience can be described as fairly benign in terms of economic and financial severity, it illustrates the

challenges of macroeconomic stabilisation in a single monetary zone – which is essentially the situation of the "+10 group" given their strong commitment to exchange rate stability if not fixity.

Therefore, this "Portuguese scenario" is not contingent on whether the countries do join the Eurozone or not, because they already operate in a fixed exchange. Only the risk of a very severe external financial crisis (see below) would disappear with euro adoption.

- An outside, but somewhat rising, probability of a much more virulent scenario, where private sector balance sheet mismatches would be affected by interest rate and, *in extremis*, exchange rate adjustments.

In this regard, the explosion of un-hedged foreign currency borrowing by households is raising the stakes. Even though the level of financial depth (credit/GDP) remains moderate in these countries – and certainly much lower than in more advanced EU countries – the pace of credit growth has been explosive (see table 1). A significant reason for this has been an increase in households' leverage, which in turn fuels property prices. It is possible that stable exchange rate regimes have contributed to the expansion of credit in these countries as borrowing in euros has appeared cheap. In Latvia, for instance, household indebtedness increased from 3% of GDP in 2003 to 29% in 2005, and 70% of the loans are in foreign currency.

There is therefore a small risk that the cooling down of these economies may be much more severe than our central risk scenario. Given the structure of external financing, the most likely cause would be a risk reappraisal by foreign banks, leading indirectly to a precipitate slowdown of credit growth. Note that the likelihood of a complete attrition of funds by parent banks is very low. A rapid deleveraging would have painful macroeconomic implications.

In extreme circumstances, an exchange rate de-pegging could be possible. For the reasons explained earlier, this is a rather implausible scenario, as governments would always have the last resort option of euro-isation, which would not please the European Central Bank but would avoid a traumatic balance sheet adjustment.

The absence of practical and effective policy options

Against a background of elevated risks, the "+10%" group shares to a large extent a situation characterised by the absence of macroeconomic policy options.

Monetary and exchange rate policies are tied, and a monetary tightening generally has adverse consequences through capital inflows. While most of these countries post fiscal surpluses, fiscal policies may perhaps be too lax given the strength of the boom. Yet it is hard to find much further room for manoeuvre given the legitimate needs to build infrastructure in relatively poor countries. Their ability to curb credit growth is also weakened by integration into the EU and the ability to source credit from non-resident banks; recourse to quantitative restrictive measures quickly reaches its limits.

This policy conundrum is aggravated by two factors:

The 'EMU criterion trap'

To enter the Eurozone, countries must, amongst other things, have a track record of two years of exchange rate stability within ERM2 and comply with the inflation criterion. According to the Maastricht Treaty, their inflation rate must not exceed by more than 1½ percentage points that of the three best-performing EU member states in terms of price stability during the year preceding the examination.

Beyond the oddity that the criterion is based on EU *and not EMU* best performers – which prevented Lithuania from entering in January 2007 because of the very low inflation rates of Poland and Sweden – these two criteria can and do conflict. For economies where price increases in non-tradable goods and services embody catch-up effects, attaining the inflation objective may require a degree of monetary tightening incompatible with exchange rate stability – or with their sterilisation capacities

The problem is thus that the more successful the countries are – so attracting capital inflows – the less likely they are to be rewarded by EMU accession, as the difficulty of sterilising the inflows pushes inflation rates higher.

Ironically, a hard landing may facilitate EMU accession.

The emigration challenge

Most of the "+10" countries are faced with the challenge of seeing a part of their workforce emigrate in the rest of the EU. Between 1990 and 2005, the population in the Baltic countries has diminished by 13%. Around half of this trend is attributable to ageing and half to emigration. EU accession has accelerated this evolution: in the two years following EU accession, 2% of the Lithuanian and Latvian populations (and a bit less for Estonia) have emigrated. This trend is likely to continue as EU restrictions are being eased.

While this theoretically is a potential positive long-term development if these workers return home with higher skills, the short-term effect is to heighten shortages in already tight labour markets, sometimes leading to some sort of "brain-drain".

A tightening of the labour market results in higher wages which, if not compensated by high productivity gains, fuels inflation, erodes competitiveness and further delays EMU accession.

The differences in wages per hour in the manufacturing sector are considerable: €30 in France and Germany against €4.4 in Estonia, €3.2 in Lithuania, €2.6 in Latvia, €2.0 in Romania and €1.4 in Bulgaria. This also illustrates the complexity of the problem: apparent cost competitiveness remains comparatively very high (albeit declining), but so does the attractiveness of other EU countries' labour markets – even when taxes are netted out.

Conclusion

- The major threat facing these new EU countries with huge current account deficits is less a repeat of the Asian crisis than the Portuguese syndrome, i.e. a long process of restoring competitiveness through painful structural reforms aiming at boosting productivity.
- EMU accession will eliminate in one strike most of the external debt but will not obviate the need to spur productivity growth as real incomes naturally converge.
- The absence of policy options means that policymakers are unable to influence which risk scenario will materialise. The strength of government balance sheets will help reduce the severity of the potential adjustment.

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