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Rainer Tomassovits and Joachim Becker

Eastern Europe: Structural Current Account Deficits and Increasing Foreign Debts.

Contact: office@ipe.or.at

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Rainer Tomassovits and Joachim Becker (Vienna, October 2006)

Central and Eastern Europe has been the region with the most rapid growth of foreign debt among the "developing and transition economies" over the last decade – it almost quadrupled between 1992 and 2004 (Fárek 2004: 8, tab.). The growth of foreign debt is closely related to the persistent current account deficits. Both trends are alarming, but are hardly publicly discussed. Many of the figures are worse than those of Latin America in the pre-crisis years of the 1990s.

Though current account deficits are persistent, significant shifts of the current account's composition have occurred over the last decade. These changes will be mapped in the first part of this paper while the debt situation will be summarised in the second part. Finally, the risks of a possible financial crisis are briefly discussed.

Changes and Continuities in the Balance of Payments

It is important to analyse how the composition of the balance of payments, and the current account in particular, has changed. The current account consists basically of the balance of trade, the balance of services, the balance of income, and the transfer balance. The balance of trade deals with the exports and imports of goods. In principle, it can be influenced by the government through a number of measures ranging from tariff policies to non-tariff measures (e.g. hygienic requirements) and currency devaluations and revaluations. With the entry into the European Union (EU), East European states have lost the autonomy to formulate national foreign trade policies. These policies are now being formulated at the EU level. Imports of services can be restricted by appropriate national legislation. Free movement of services, however, is enshrined as a basic principle in the EU treaties. Presently, EU legislation is under way to further restrict national regulation of borderlands service provision. This leaves Central East European governments basically with the option to devalue or revalue their national currency. In most cases a devaluation would favour exports and act as a break on imports. The accession process to the monetary union, however, limits the room to manoeuvre of policy-making in this arena, too. An eventual adoption of the Euro would eliminate the option of a national currency policy. Another import sub-balance of the current account is the balance of income. It includes profit remittances and interest payments. In principle, profit remittances can be restricted by national regulations. Such regulations, however, are not compatible with present EU rules. Profitability might be affected by currency policies but a devaluation or revaluation does not directly affect profit remittances and therefore does not have any influence whatsoever on interest payments. Thus it is extremely difficult to reduce a negative balance of income. Usually a negative balance of income is the consequence of capital imports in the past. Insofar capital imports are short term solutions. Such imports may be needed to level out a negative current account. Capital imports, however, have a negative impact on the current account at a later stage: A negative spiral of a deficit in the current account – capital imports – a growing deficit in the current account (as result of higher profit remittances and interest payments) – growing capital imports might emerge. Such a spiral cannot go on indefinitely.

As we shall see in more detail in the following paragraphs, the deficits of the sub-balances of the current account have shifted from strongly negative balances of trade to strongly negative balances of income. This is an alarming tendency since it is extremely difficult to revert.

The Balance of Payments Country by Country

Poland's balance of trade deficit increased during the 1990s until it reached its peak level in 1999 (14 bn €). After this maximum in 1999 the deficit has been able to be reduced to 2.2 bn € in 2005.

The balance of services has been positive all over the period with little fluctuations. The balance of income has been persistently negative with a significant worsening in 2004 when a deficit of 9.28 bn € was incurred compared with 3.2 bn € in 2003. Transfer payments to Poland have been high. In 2005 the current transfers balance achieved its maximum at 5.6 bn €. The current account deficit amounted to 4.3% of GDP in 2004, but decreased to 1.4% in 2005. Financial account fluctuated heavily between 3.5 bn and 11.9 bn €, reaching this peak level in 1998 and again in 2005.

The trade balance deficit of the Czech Republic decreased in the second half of the 1990s. This was at least partly a result of a devaluation of the Czech Koruna. After a rise at the beginning of this century, the trade balance turned positive the first time in 2005. Services showed a high surplus in the 1990s balances, before in 2002 a significant decline occurred (2001: 1.7 billion €; 2002 0.7 billion €). A clearly negative trend can be observed for the income balance with record deficits in 2004 (4.94 bn €) and in 2005 (4.78 bn €). The current account deficit amounted to 5.2% of GDP in 2004 (but similar to Poland this rate decreased in 2005 to 2.1%). The financial account varied a little during the 1990s between 2.5 bn € and 3.4 bn € (with two exceptions in 1995 and 1997). The same can be said about recent years but the amount of the surplus has been much higher (between 4.1 bn € and 5.7 bn € and one exception in 2002 – 11.3 billion €).

Slovenia's trade balance deficit reached its maximum level in the years 1999 and 2000 when it was for the first time higher than one billion €. In the following years it has been reduced before it bursted the one billion barrier again in the last two years. In comparison with the trade balance, Slovenia has a very high service balance surplus, during the 1990s and again in 2005 it was higher or almost as high as the trade deficit. Slovenians income was positive all over the last decade, in 2001 it turned negative and climbed to over 0.2 billion €. Slovenia recorded a rather low current account deficit of 2.0% of GDP in 2005. The financial account fluctuated heavily over the period, since 2002 there is a positive trend with a peak level of 831 million € in 2005. An interesting point here is that direct investment flows from Slovenia abroad has been higher than direct investment in Slovenia.

Hungary's trade balance has also exhibited a deficit for the whole period. In 2000 the deficit amounted to 3.2 bn € before declining to 1.6 bn € in 2005. The surplus of the service balance was over one billion each year (except 1999) with its maximum in 2001. Until 2003 it changed to a deficit of 401 million €. Today Hungary reports again a surplus of 448 million €. The income balance shows a very clear negative trend, it reached its highest level in 2005 (5.6 billion €). In 2004 the current account deficit amounted to worrying 8.8% of GDP. In 2005 it is still at the very high rate of 7.4%. Three lines of development can be stated for the financial account: the shift from a deficit in 1996 to a 6 billion € surplus in 1999, then a decrease to 2.6 billion € in 2002, the year another shift occurred with an increase that led to an 11.8 billion € surplus in 2005 with a more or less equal distribution among direct investments, portfolio investments and other investments.

Slovakia has reported permanent trade deficits, reaching its highest level in absolute numbers in 2005, i.e. 2 bn €. The negative trend typical of income balances in the region is also discernable for Slovakia with an extreme increase from 0.3 billion € in 2004 to 1.6 billion € in 2005. The current account deficit reached the very high level of 8.6% in relation to GDP in 2005. Financial account is positive at a constant level. Two exceptions should be stated for 2002 (due to an increase in direct investment) and 2005 (due to an increase in short-term other investment) when the surplus exceeded the four billion € barrier.

In 1997 the trade balance deficit of Estonia was for the first time higher than one billion €. During the following years a slight reduction has occurred, since 2002 it has risen again to the present value of 1.5 billion €. The service balance has a positive trend and exceeded 800 million € in 2004 and 2005. The income deficit of Estonia increased each year from 1998 on and reached the level of 560

million € in 2005. In 2004, Estonia displayed the highest current account deficit/GDP ratio among the Central East European states – a staggering 12.7%. In 2005 this ratio was still at 10.7%. This extremely high deficit was obviously related to the currency board system and the ensuing overvaluation of the national currency. The financial account surplus has been over one billion for the last three years.

Latvia's balance of trade deficit shows a continuously rising trend. It reached 2.4 billion € in 2005. The service account displays a constant surplus while the income has turned into the red balance only during the last three years. The current account displays a rapidly growing negative balance which amounted to 12.3% in 2004. With 12.4% in 2005, Latvia is the new record holder in the region. The surplus of the financial account has increased constantly to 1.6 billion € in 2005, dominated by the category of "other investment".

Lithuania's figures show similarity to the other Baltic states although the ratio current account deficit/GDP has shown better results when reaching 7.2% in 2004 and 7.0% in 2005. The deficit of the balance of trade has tended to widen with 2.3 bn € in 2005. The balance of services has been positive whereas a sharp increase of the deficit of the income balance has been recorded during the last three years. Similar to Latvia, the importance of current transfers and a high surplus of the capital account has increased in the last two years. The financial account has reached its peak at the end of the 1990s before declining thereafter. It has remained constant for the last three years at a level of about 1 billion €.

One can conclude that all the observed countries have reported a trade balance deficit as well as a surplus of the service balance. The transfer balances have generally been positive (esp. in Poland and the Baltic states) and there appears to be a general tendency of significant increases of the deficits in income balances. Foreign direct investments seem to have contradictory impacts on current accounts. On the one hand they contributed – at least partly – to the expansions of good exports. On the other hand they resulted in increasing profit remittances. In a number of states, the deficit of income balances hover around 4% to 5% of GDP. It is extremely difficult to reduce these deficits which mainly consist of interest and profit remittances. While in the 1990s the negative balance of trade was the major cause of the current account deficits, the major cause of the present current account deficits has shifted to the extremely high profit remittances and interest payments. The figures of the current accounts of Central and Eastern European countries have been worse than those in Latin America in the second half of the 1990s which preceded the wave of financial crisis at the turn of the century. With the exception of Nicaragua and Panama, no Latin American country had displayed a current account deficit of more than 10% of GDP. A current account deficit of more than 5% had been a rare occurrence (Cepal 2004: 356, tab. A-7). Since then the financial account surpluses have become more and more important for the balances of payments. But the composition of these surpluses vary from year to year and from country to country.

External Debt

The External Debt Statistics have been reporting a steady increase of external debt over the past decade in all the countries under investigation. In Poland, Hungary and Latvia a sharp increase can be observed from 2002 on until today. Since 2004 the other countries in the region have joined this trend. The percentage increases have been considerably higher than in the debt-prone Latin American economies of the 1990s. They range from a 170.2% increase for the years 1995-2005 in Poland to increases of several hundred per cent in the case of the Baltic states (Lithuania: + 378,6% for 1996-2005, Estonia: + 697.2% for 1996-2005, Latvia: + 1558,2% for 1995-2005). These relative increases are similar to those of the countries of the Latin American Cono Sur in the 1970s and early 1980s. In all these countries, the combination of overvalued national currencies, high current account deficits and rapidly increasing foreign debt resulted in severe financial crises.

Foreign debt is increasingly of a private nature. The Government as a debtor is relevant for the long-term debt.

The overall development is also typical for Poland. Most of the external debt in Poland is long-term, but the short-term debt has increased more rapidly than the long-term debt. The ratio between short-term debt and total external debt has been about 7% in 1995 and 20% in 2005. Total gross external debt has increased from 41 bn € in 1995 to 110.7 bn € in 2005.

The Czech Republic shows a similar picture. Short-term debt is about a quarter of total debt, only between 2000 and 2003 it was close to 50%. In comparison with Poland, public debt appears less relevant with only 20% of external debt accruing to the government-sector. Total gross external debt has increased from 13.6 bn € in 1995 to 38.8 bn € in 2005. In Slovakia the gross external debt grew from 4.5 bn € in 1995 to 22.9 bn € in 2005 which implies a more rapid rise than in the Czech Republic. Slovakia's ratio of gross external debt/GDP reached 60% in 2005 whereas the Czech ratio reached 39% only.

Hungary has had a longer experience with Direct Investment/Intercompany Lending which has been a significant factor since 1995 and is still important today. Most of the external debt is long-term with a more or less constant ratio of short-term to long-term external debt. Hungary's external debt has increased from 24.5 bn € in 1995 to 66.3 bn € in 2005 and is also very high in relation to the GDP. In 2005 this percentage rate was about 75%.

In Slovenia, the gross external debt is similar to that of Hungary, it has increased from 4.3 bn € in 1995 to 19.6 bn € in 2005. The percentage rate related to GDP jumped over the 70% mark in 2005.

The Baltic states experienced an explosion of their external debt. In Estonia it has increased from 1.3 bn € in 1996 to 9.5 bn € in 2005. In Latvia the gross external debt was 1.2 bn € in 1995 and 18.2 bn € in 2005. In Lithuania it has increased from 1.9 bn € in 1996 to 10.5 bn € in 2005. In Latvia the gross external debt surpasses GDP – it was 143.3% of GDP in 2005. In Estonia the foreign debt reached 86.2% of GDP in 2005 which is a rather horrendous figure. In the Baltic countries the dependence of short-term debt is much higher than in the other Central East European countries. Above all the short-term gross external debt in Latvia has been traditionally higher than the long-term one. Thus the Baltic states exhibit the alarming feature of an extremely rapidly increasing foreign debt which, in addition, is rather short-term. The external vulnerability of the Baltic states is extremely high.

The relation foreign debt/GDP might indicate future problems of repayments if the figure displays high amounts. In the case of Latvia, the relation foreign debt/GDP was already 143,3% in 2005 which seems to indicate an unbearable burden for the future. Likewise the figure of Estonia – 86,2% - is extremely worrying. Only in the cases of Poland and the Czech Republic, the relation external debt/GDP is below 50%: 38.8% in the Czech Republic and 45.5% in Poland. At least some of the Central East European states ran into troubles regarding their foreign exchange earnings. They might face a situation where they won't be able to service their foreign debt obligations. Most Central East European countries do show worse data than Latin American countries of the late 1990s in regard of the gross external debt/GDP-ratio with (Ugarteche 2001: 75 ss.). In Argentina this figure had been 52.2% in the crisis year 2001 (Cepal 2004: 134, tab. 1), in Brazil 45.0% in the crisis year 1999 (ibid.: 152, tab. 1). At the moment, these thresholds are surpassed by most of the East European countries. It is only the Czech Republic that is considerably below this ratio.

High External – Low Domestic Debt

Another worrisome feature is the relationship between external and internal debt. Domestic debt seems rather low in the respective countries. In relationship to GDP, it reached only less than a third of the ratio the Euro-Zone displayed at the beginning of this decade (Hölscher/Stefan 2006: 192, Tab. 1). In the Baltic states, domestic credits were actually lower than gross external debt. A similar though less pronounced tendency one can observe in Hungary. In Poland the two levels were more or less equal. Only in the Czech Republic and in Slovakia, domestic credit was significantly higher than gross external debt. A high ratio of external debt in relationship to domestic credit indicates an advanced informal Euroization of the economy. This implies a high degree of vulnerability of the payment chains in case of a strong devaluation of the national currency which would occur when investors and creditors would lose confidence in the creditor state. Debtors who earn a national currency but are indebted in Euros would face a revaluation of their debt and severe payment problems. Therefore informal Euroization is another element of external vulnerability.

Conclusions

It can be concluded that a number of Central European states are "in the 'red region' of vulnerability" (Onaran 2006: 249) compared with data of former crises in Latin America. Taking into account the balance of payments situation and the amount and structure of the external debt, the Baltic states appear extremely vulnerable to a financial crisis. In Hungary and Slovakia, the indicators are better than in the Baltic states but, nevertheless, their vulnerability is high. The structures of balances of payments and the evolution of external debts are problematic in the cases of the Czech Republic and Poland but their external vulnerability is considerably smaller than in the afore mentioned states. Slovenia displays the most positive structure of the all balances of payments, nevertheless its external debt has increased considerably. Slovenia would seem to be the least vulnerable of the present EU member states of Central East Europe.

The degree of vulnerability seems to be related to the economic model. Bohle (2006) identifies three models in Central Eastern Europe. The Baltic model is characterised by an almost indiscriminate opening of the economic and the dismantling of the welfare state. The model of "embedded neoliberalism" of the Visegrad states (Czech Republic, Hungary, Poland, Slovakia) is characterised by the active wooing foreign capital in the manufacturing sector and the partial dismantling of the welfare state (though to a significantly varying degree). Slovenia is characterised by a variety of neo-corporatism. Transformation in Slovenia was characterised by the search for social consensus and a high degree of social protection was maintained. The government sought to preserve a space for domestic capital, especially in strategic sectors. External vulnerability is highest in the Baltic model, especially in its most extreme cases of Estonia and Latvia, and it is lowest in the neo-corporatist model of Slovenia. The "embedded neoliberalism" falls in between.

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