PLATFORM FOR DISCUSSION
Speaking note

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GLOBAL IMBALANCES, EXTERNAL SECTOR VULNERABILITY AND CAPITAL FLOWS – SELECTED COUNTRIES OVERVIEW

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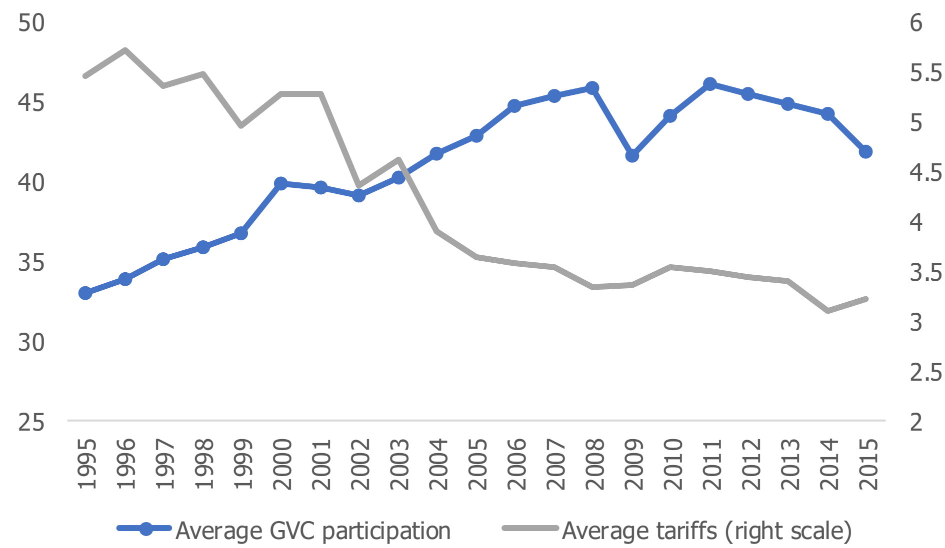
Global Imbalances, External Sector Vulnerability and Capital Flows – Selected Countries Overview

Overview of the global external imbalances

The discussion on the issue of global imbalances and the overall profile of the external sector comes at a very proper moment, given the rollback of the globalisation and rising trade tensions. The recent changes might affect the external imbalances globally, if not directly, then indirectly by affecting macroeconomic fundamentals of the economies. Tariffs can define productivity, output and employment over the longer term, and thus affect the potential to grow. In the last three decades, the decline of tariffs gave ground to global value chains, enhanced competition and improved productivity across countries.

Chart 1 Tariffs and Global Value Chain Participation[2]
(Value added weighted average over countries and sectors percent)



Source: Source: IMF, WEO April 2019

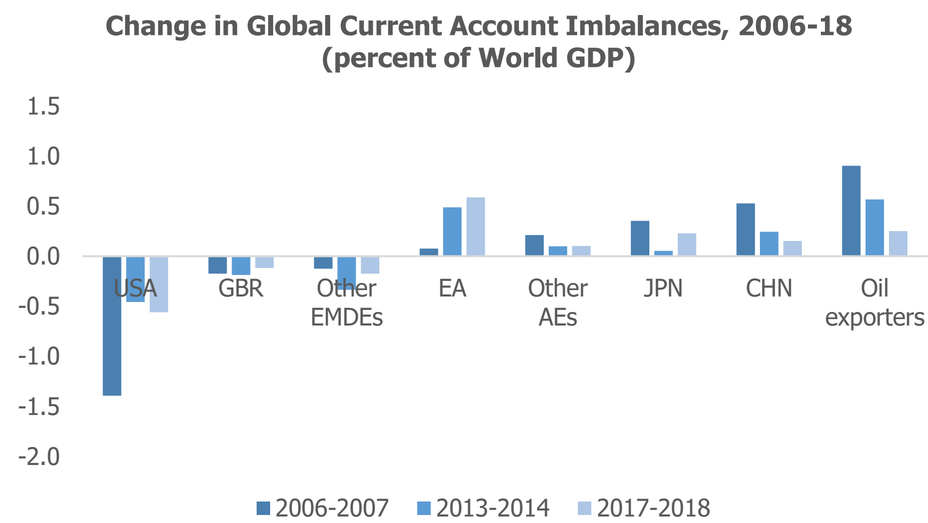
Global external imbalances have been at the forefront in the macro discussions and risk assessments. One of the first steps when scrutinizing external positions and imbalances is the current account position. **Current account imbalances can be healthy or a sign of**

[2] Chart extracted from the IMF WEO, April 2019.

macroeconomic and financial stress. In many cases, **current account imbalances can be entirely appropriate,** even necessary. For instance, in converging economies, with vast investment opportunities, they benefit from foreign funding, and can afford to accumulate debts (by running current account deficits), provided they can repay them out of future income. **Sometimes, however, external imbalances can point to macroeconomic and financial stress**. Economies that accumulate external liabilities on too large scale may become vulnerable to sudden stops in capital flows that force abrupt cuts in spending – making financial crises more likely.

Before we do a stocktaking of the current external imbalances, it would be useful to provide for a longer-term view of their evolution. The occurrence of the global crisis had a strong impact on narrowing the global current account surpluses and deficits. In the aftermath of the global financial crisis, global current account imbalances (the absolute sum of surpluses and deficits) fell sharply from about 6 percent of global GDP in 2007 to about 3½ percent in 2013. The narrowing of aggregate current account imbalances was led by the United States on the deficit side and by China, Japan, and oil exporters on the surplus side. Meanwhile, the current account balance of the euro area moved from a close balance in 2007 to a surplus of about 2½ percent of GDP in 2013, driven mainly by sharp external adjustments in most euro area debtor economies, while surpluses in Germany and the Netherlands remained large. In key emerging market and developing economies, current account deficits expanded, supported by easy global financing conditions enabled by quantitative easing policies in advanced economies. **Yet, after 2013 this process stalled, and we do see immense concentration of imbalances in advanced economies.** These economies on aggregate have seen some increase in their current account deficits, led primarily by the United States, and a rise in current account surpluses, mainly in the euro area and Japan.

Chart 2 Change in Global Current Account Imbalances, 2006 -18[3]
(Percent of world GDP)

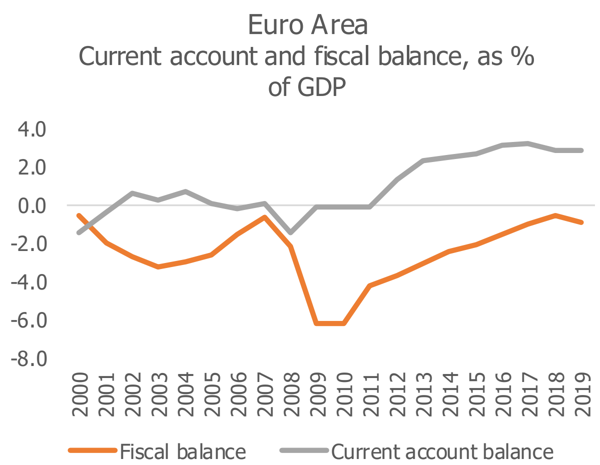


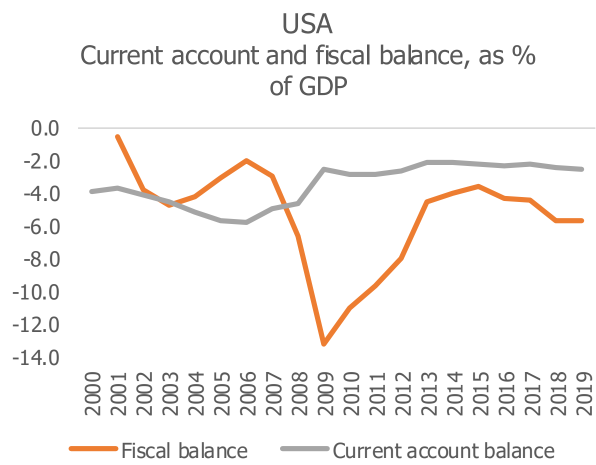
Source: IMF, External sector report, 2019

The decline of current account balances over the past decade reflects a combination of macroeconomic policies and terms-of-trade effects. **Fiscal policy and credit conditions** have been key drivers of current account dynamics since the crisis, such that economies with tight (easy) fiscal policies and credit contractions (expansions) have generally experienced an increase (decline) in their current account balances. **However, the policy drivers have shifted. In the aftermath of the global financial crisis, the narrowing of deficits in advanced economies was driven mainly by private sector demand compression and deleveraging, and despite countercyclical fiscal policy efforts**. This was mirrored by lower current account balances in surplus economies, largely reflecting a collapse in global demand and trade. Since 2013 divergent fiscal policy stances and credit conditions in key economies have contributed to the rotation of imbalances toward advanced economies. Advanced economies' aggregate current account surpluses (euro area, Japan) have remained large or risen further since 2013, reflecting a combination of lower energy prices, tighter fiscal policy, and continued private sector deleveraging in some cases. Meanwhile, aggregate current account deficits of advanced economies rose slightly, underpinned by renewed fiscal easing in the United States.

[3] Chart extracted from the IMF External Sector Report, 2019.

Chart 3 Current Account and Fiscal Balances in the Euro Area and the USA





Source: IMF, WEO October 2019, database

The dynamics of the balances is not always indicative on the appropriateness of the external position is. The deviation of the current account from its fundamentals and desirable policies provides for additional substantial information on the correction needed. According to the IMF (2019), 35–45 percent of overall current account surpluses and deficits were deemed excessive in 2018. Higher-than-warranted balances remained centered in the euro area as a whole (driven by Germany and the Netherlands) and in other advanced economies (Korea, Singapore), while lower-than-warranted balances remained concentrated in the United Kingdom, the United States, as well as in some emerging market economies (Argentina, Indonesia). China's external position was assessed to be in line with fundamentals and desirable policies, as its current account surplus narrowed further, although an achievement of a lasting external rebalancing will require gradual reining in expansionary macroeconomic policies and adopting further structural reforms.

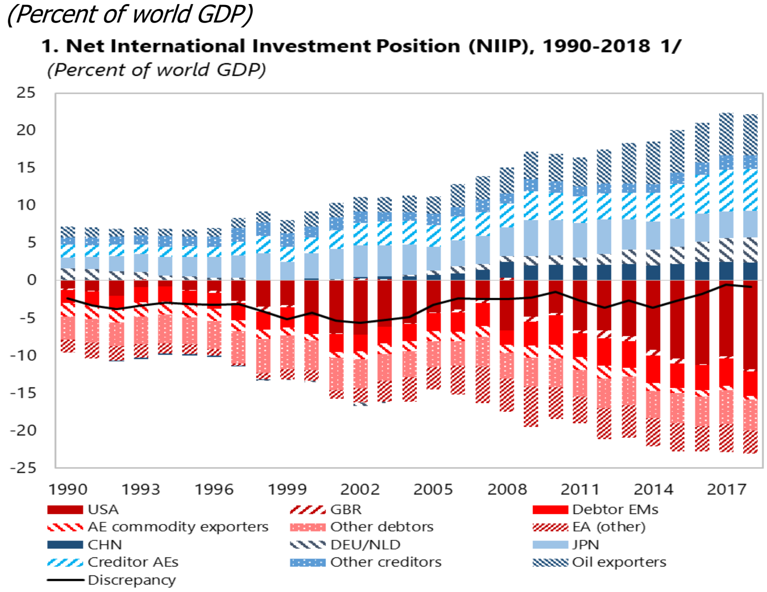
The mirror image of the current account balances, are the financial flows. After the crisis, global map of financial flows changed, mostly due to the shift in the global financial conditions and relative growth differentials between emerging and advanced economies. Following quantitative easing programs in advanced economies in the aftermath of the global financial crisis, portfolio and other investment capital flows to emerging market and developing economies intensified, which, together with accommodative macroeconomic policies, contributed to currency appreciation pressures and larger current account deficits. These trends, however,

started to reverse at the beginning with the 2013 taper tantrum episode as growth differentials between advanced and emerging market economies narrowed and the prospects of monetary policy normalization in advanced economies gathered strength. Direct investment remained relatively stable and less sensitive to changes in global financial conditions and US dollar movements.

Despite the narrowing of global current account imbalances, stock imbalances have continued to widen to reach record levels. At 40 percent of world GDP, the world's net international investment position — the sum of net creditor and net debtor positions — **is now at a historical peak and four times larger than in the early 1990s**. Among the top debtors, the net international investment position of the United States is now close to –50 percent of GDP, down about 40 percentage points since 2007.

Chart 4 Net International Investment Position (NIIP), 1990-2018[4]

(Percent of world GDP)



Source: IMF, External sector report, 2019

The snapshot of the global external profile reveals narrowing of the imbalances after the global crisis and concentration in the advanced economies. Despite the lower magnitude, large part of the current account imbalance seems not to be aligned with the fundamental and desirable policies. Furthermore, lower flow gaps, visible through

[4] Chart extracted from the IMF External Sector Report, 2019.

lower current account and financial flows, were not sufficient to curb stock imbalance visible through the historically highest global NIP. Given the uncertain global environment, driven by the rising trade tensions, **external flow and stock imbalances could widen again, although this will much depend on the assumed policy response in different countries**. **Further disruptions** to trade and supply chains *are one of the major risks* that can affect the external imbalances, as well. Higher tariffs on bilateral trade can come at significant economic cost, not only for the countries involved, but also for others. These effects are greatly amplified by global supply chains, which transmit spillovers from bilateral tariffs, affecting countries up and down the value chain. An intensification of trade tensions or a disorderly Brexit outcome — with further repercussions for global growth and risk aversion — could, however, affect other economies that are highly dependent on foreign demand and external financing. Over the medium term, in absence of corrective policies, trade tensions could become entrenched, and further divergence of external stock positions could trigger costly disruptive adjustments in key debtor economies that could spill over to the rest of the world. According to Bloomberg analysis, the strongest negative impact from the trade tensions could be felt in 2021, affecting the global GDP negatively by 0.6 p.p., with several scenarios in place - failure of reaching an agreement and limited escalation of the trade tensions; failure of reaching an agreement and trade war; and reaching an agreement in 2020. It is imperative that all countries avoid policies that distort trade. Recent trade policy actions are weighing on global trade flows, investment and growth, including through confidence effects and the disruption of global supply chains, with no discernible impact on external imbalances thus far, but risks remain.

External imbalances in the CESEE region countries

In the following section, we provide for a short overview on the external position of the region[5], analyzed through the current account position of the individual countries and the region as a whole, as well as the international investment position.

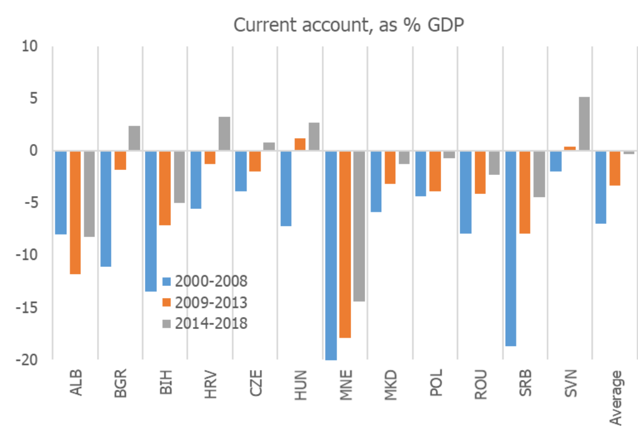
The pre-crisis global context was marked with low aversion to risk, strong confidence and global liquidity glut. The environment was conducive to rising cross – border capital flows, which underpinned demand and led to significant deterioration of current account balances. The burst of the crisis brought sudden reversal of capital flows, loss

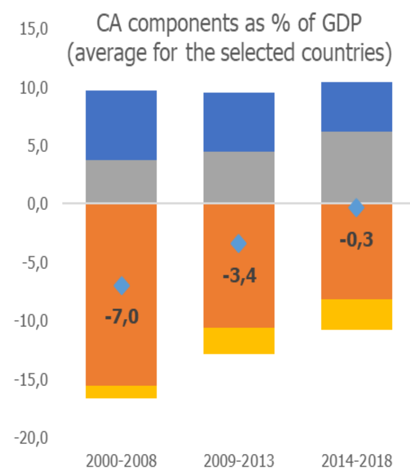
[5] This part of the presentation in focused on eleven counties belonging to the CESEE region: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, the Czech Republic, Montenegro, North Macedonia, Poland, Romania, Serbia and Slovenia.

of confidence and risk appetite, demand contraction and sharp correction of external imbalances. A decade after the crisis, current account balances seem to be moderate across board, with many of the countries even exhibiting surplus. The initial post-crisis adjustment might have been cyclical in nature, and a correction process of unsustainable excesses.

Observing the dynamics, before the crisis the average CAD for the region[6] equaled around 7% of GDP. High deficits were present across the board, with the new EU member states like the Czech Republic (average current account of 3,9% of GDP), Poland (4,4% of GDP) and Slovenia (2% of GDP) performing significantly better than some of the Western Balkans countries (Montenegro with average current account of 44,6% of GDP, Serbia 18,8% and Bosnia and Herzegovina 13,5%). With the emergence of the crises, the current account was adjusted. The larger the pre-crisis deficit, the larger the adjustment. On average the 2018 data shows around 10 p.p. improvement in the current transactions balance. Strengthening of the current account position is continuous, with gradual closing of the deficits. Some countries even exhibit surplus, such as the case of Slovenia, the Czech Republic, Croatia, Bulgaria and Hungary.

Chart 5 Current Account

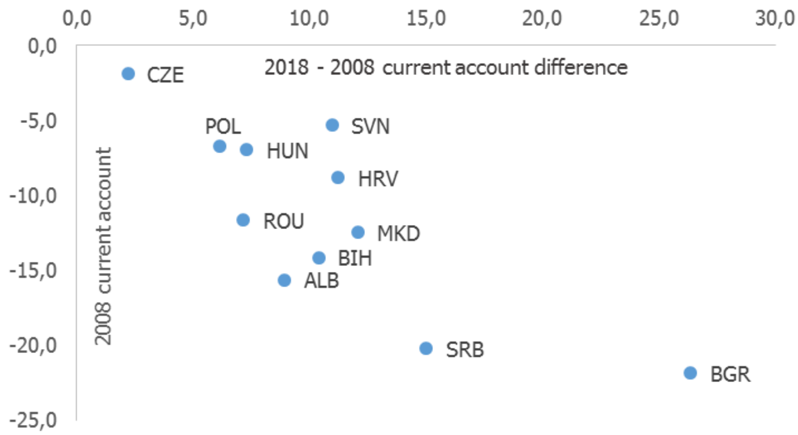




Source: IMF, BOP database

[6] The averaged numbers exclude data for Montenegro and Serbia due to the shorter time span of their BOP series.

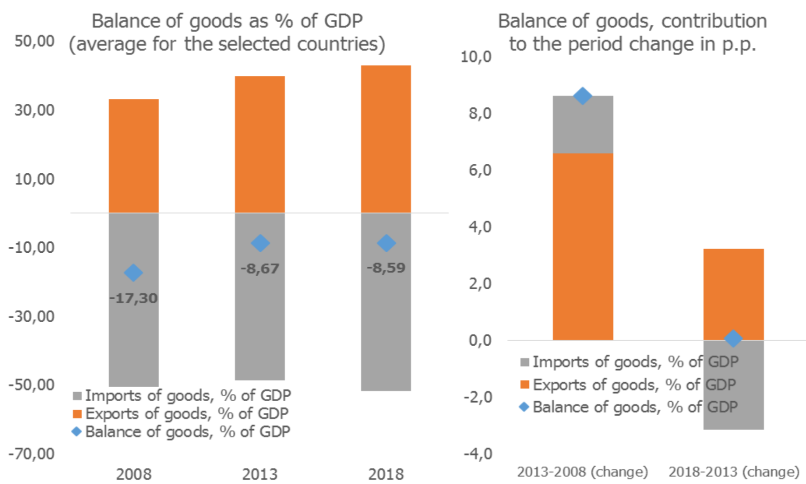
Current Account Adjustment



Source: IMF, BOP database

Observing the adjustment, through structural lenses, one can notice that the adjustments in the current account was predominantly driven by the balance of goods and services. The deficit in the balance of goods narrowed from an average of 15.6% of GDP in the 2000 - 2008 period to 10.6% of GDP, and in the following 2009 - 2013 sub-period to even lower share of GDP in the last four years of 8.2% of GDP. Additionally, the surpluses in the services shows steady increase, a dynamic that is more visible in economies with more developed tourism sector. While the initial adjustment in the acute phase of the crisis was through compression of imports, what followed afterwards was remarkable shift in export, which kept the trade deficit markedly bellow the pre-crisis level. Hence, in 2018 the average trade balance hovered around 8% of GDP, compared to 17% of GDP before the crisis. Imports is close to its pre-crisis level, while the level of exports surpasses it by close to 10 p.p. of GDP. It indicates that most of the countries managed to proceeds with their reforms on the external front, elevating their export potential and enabling "quietness" of current accounts. Furthermore, looking into the geographical direction of trade for the region, several countries, are heavily exposed to Germany with a share of exports to Germany in total exports of around 30% or above. North Macedonia alone has the largest increase of this share in the last decade (2008-2018) of around 33 p.p. reaching 47% of total exports in 2018. The rising trade integration, indicates larger dependence on external developments, and hence exposure to potential shocks.

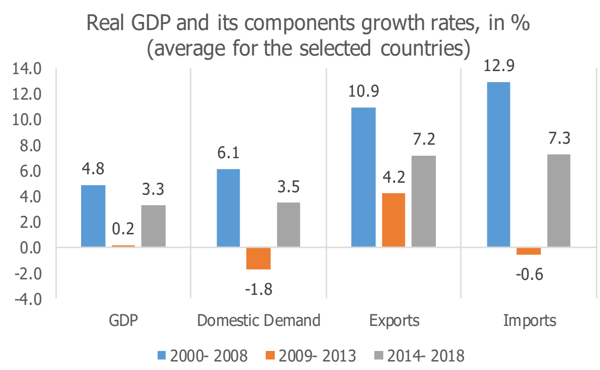
Chart 6 Trade Balance



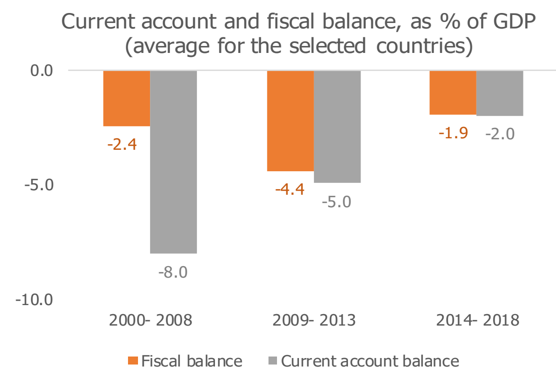
Source: IMF, BOP database

The rising current account imbalance prior to the crisis reflected the strong economic growth, supported by increased financial inflows, mostly in form of FDI and private sector borrowing. Domestic private sector credit intensified, thus fueling domestic demand. As for the fiscal position, as important driver of the current account dynamics, the reveals that in most of the countries (except Hungary, Albania, Croatia) before the crisis fiscal stance was prudent and with fiscal space in place. **The fiscal response to the crisis was countercyclical, with fiscal position strengthening afterwards, but yet its impact on the current account gap does seem to be consistent and visible across the time, suggesting predominant role of the private domestic demand.** Observing the data, one can notice very strong growth of domestic demand before the crisis, on average of around 6%, while as of 2009 until 2013 domestic demand was contracting. In the last couple of years it was brought on a solid grounds, but yet the average growth is more modest at around 3.5%.

Chart 7 Domestic demand and fiscal balance



Source: Eurostat and NBRNM calculations.

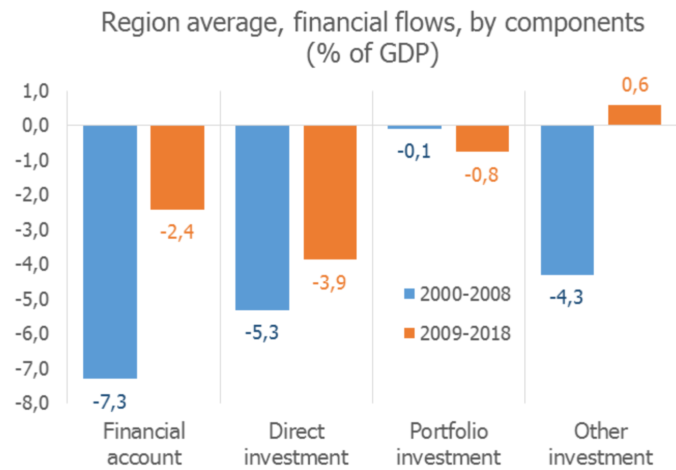


Source: IMF and NBRNM calculations.

Financial flows to and from advanced economies have been much weaker since the global financial crisis. In particular, portfolio debt flows have weakened, reflecting a combination of factors: large government debt asset purchases by central banks, increased fragmentation in euro area debt markets, and much reduced accumulation of reserves by emerging market and developing economies. Other investment flows have also fallen sharply as global banks reduced the size of their balance sheets after dramatic expansion of their cross-border activities during the pre-crisis boom. On the other hand, foreign direct investment (FDI) flows had actually increased slightly relative to the pre-crisis period.

The same notion holds for the region, as well. Financial flows from the region have been much weaker since the global financial crisis. In particular, other investment inflows have fallen sharply and turn into small outflows due to the process of deleveraging. Foreign direct investment (FDI) inflows also experienced slowdown, however the role of the direct investments in some countries is still strong as they were still going through the "expansion phase" when it comes to this type of flows. Portfolio debt flows have increased, reflecting a combination of factors, but mostly as a result of government borrowing abroad by issuing government bonds.

Chart 8 Financial Flows and Their Structure

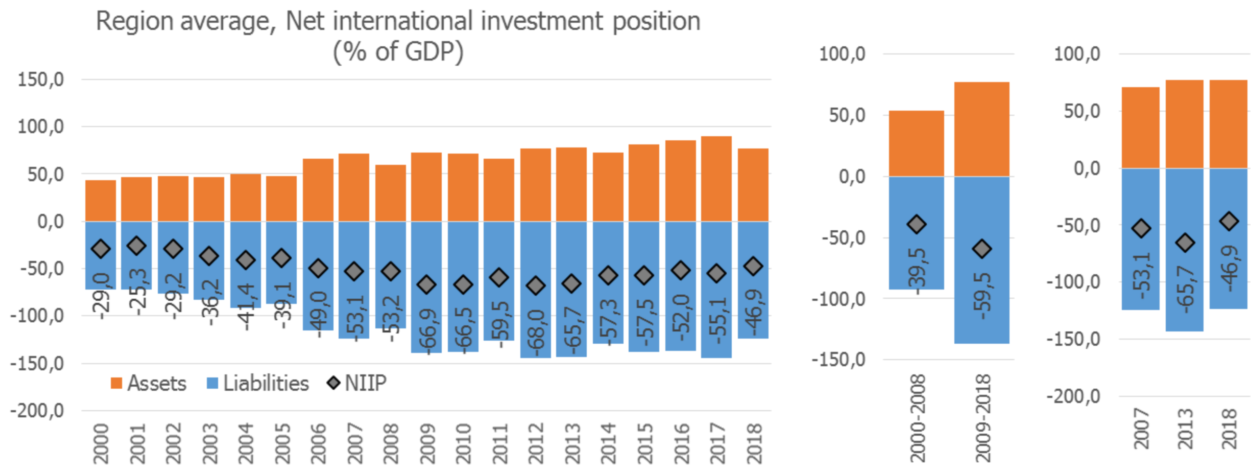


Source: IMF BOP data.

Financial integration in emerging market and developing economies has risen substantially over the past two decades, delivering benefits but also posing new challenges. Guarding against a sudden stop or external crisis requires carefully monitoring of different aspects of flow and stock imbalances. Although it seems that flow imbalances narrowed in the region, for completing the picture it is essential to observe the stock positions, as well.

In the last couple of decades, the dynamics of the external balance sheet of the region, examined through the net international investment position, pointed towards a process of significant widening of the negative gap, in the run up to the global financial crisis. Although, this trend to some extent slowed, IIP reached its peak in 2012 and with the beginning of 2013 taper tantrum episode started to reverse. Despite the reversal, on average it is still above the some of the benchmarks, such as the norm of the EC within the macroeconomic imbalances procedure, that equals -35% of GDP.

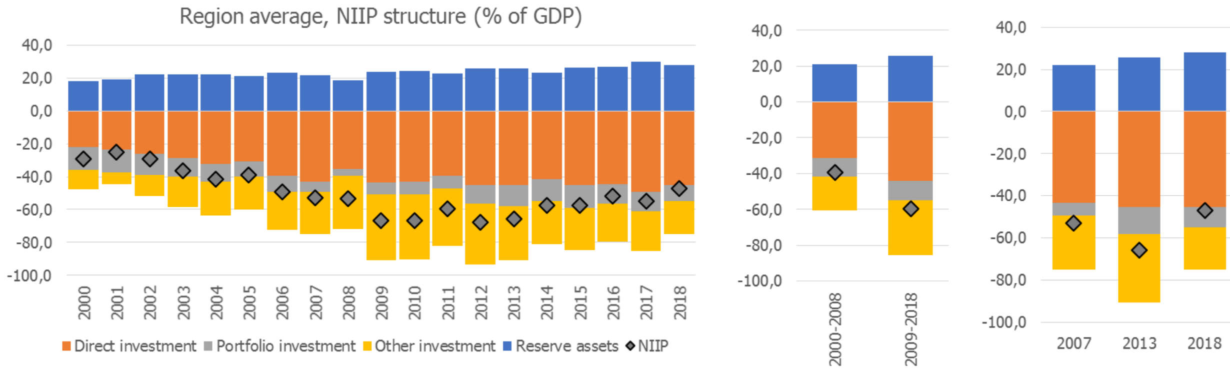
Chart 9 Net International Investment Position



Source: IMF BOP data.

In order to have the complete picture, more granular view is important, as it can reveal whether the pre-crisis mode of the rising financial exposure elevated the external vulnerability of the region, and hence whether the adjustment which followed was more abrupt and costly in economic terms. For instance, the larger weight of direct investment (including the intercompany lending) should in principle improve the external risk profile of the country, as the probability for sudden reversal is low, and in general it does not yield future financing requirements for repayment of the obligations due. This is not the case with portfolio investments, or the other investments, as debt creating flows, where the risk is higher, both in terms of sudden reversals and rising future payment burden. Thus the structural analysis reveals that for the region as a whole, before the crisis in 2007 the role of the direct investments was significantly larger than that of the debt creating flows in creating international liabilities, whereas it turned balanced in 2013. By the end of 2018 as expected, mostly through deleveraging, the level of debt creating flows decreased.

Chart 10 Structure of NIIP

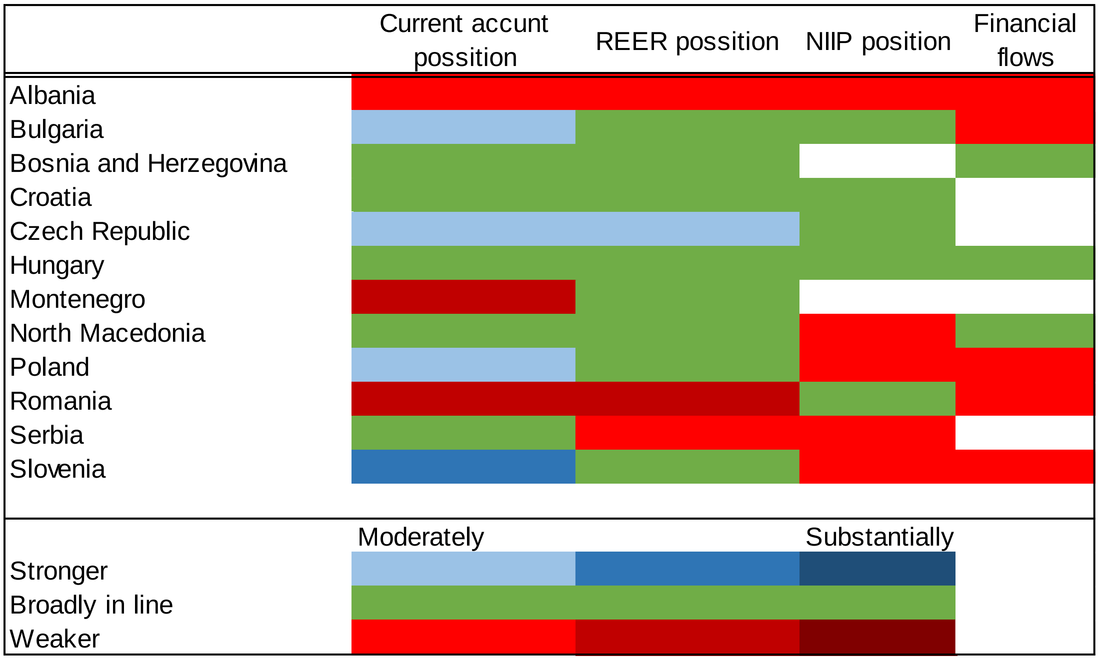


Source: IMF BOP data.

The simple analysis of the external sector profile in the region reveals compression of the current account gaps, slowdown in financial flows, and adjustment of the IIP position. Some of the adjustments might be a reflection of the unsustainable pre-crisis imbalances, some of them are cyclical, and some might be a result of structural shifts that boost competiveness, enable export to grow and gaps to be narrowed. **Whichever the cause, it is critical to assess whether the adjustment and the current level are in line with what the fundamentals and policies would suggest.** For this reason, we use the latest available results from the IMF external sector assessment and we construct a heat map to have broader vision of where the region stands in terms of the external sector imbalances. **The current account focus offers a general conclusion that the region is broadly in line with fundamentals,** with five out of eleven counties having current account in line with fundamentals according to the IMF estimations, and four have stronger position, while three show weaker position than what the fundamentals suggest. **The vulnerabilities are more visible, when financial and NIIPs are observed, with several countries having moderately weaker positions**. This indicates necessity for further policy changes, or bold structural reforms to improve the productivity and correct for the imbalances on the external front. The focus must be even stronger, given the subdued global outlook and rising risks on global trade and GVCs. Most of these countries are small and open, included in GVCs as well, indicating rising risks and need for policies to reduces vulnerabilities and prevent adverse spillovers.

Table 1

External Sector Assessment – Latest Article IV Reports



Source: IMF, latest Article IV

Conclusion

The snapshot of the global external profile reveals narrowing of the imbalances after the global crisis and concentration of the imbalances in the advanced economies. Despite the lower magnitude, close to half of the current account imbalance does not seem to be aligned with the fundamentals and desirable policies. Furthermore, lower flow gaps, visible through lower current account and financial flows, were not sufficient to curb stock imbalances visible through the historically highest global NIIP. *As far as CESEE the region is concerned, a simple analysis of the external sector profile reveals compression of the current account gaps, slowdown in financial flows and adjustment of the IIP position.* Some of the adjustments might be a reflection of the unsustainable pre-crisis imbalances, some of them are cyclical and some might be a result of structural shifts that boost competiveness, enable export to grow and narrow the gaps. Latest available results from the IMF external sector assessment points to a general conclusion that the region’s current account balances are broadly in line with fundamentals (five out of eleven counties have current account in line with fundamentals, four have stronger position, while three show weaker position than what the fundamentals suggest). The vulnerabilities are more visible, when financial and NIIPs are observed, with several countries having moderately weaker positions that indicates necessity for further policy changes, or bold structural reforms to improve the productivity and correct for the imbalances on the external front. *Looking into the future, given the uncertain global environment and the rising trade tensions, external flows and stock imbalances could wide again, although this would depend on the assumed policy responses in different countries.* Further disruptions to trade and supply chains *are one of the major risks* that can affect the external imbalances. Higher tariffs on bilateral trade can come at significant economic cost, not only for the countries involved. These effects are greatly amplified by global supply chains, which transmit spillovers from bilateral tariffs, affecting countries up and down the value chain. Thus now more than ever there is an urgent need for policies that reduce external vulnerabilities, and prevent adverse spillovers.

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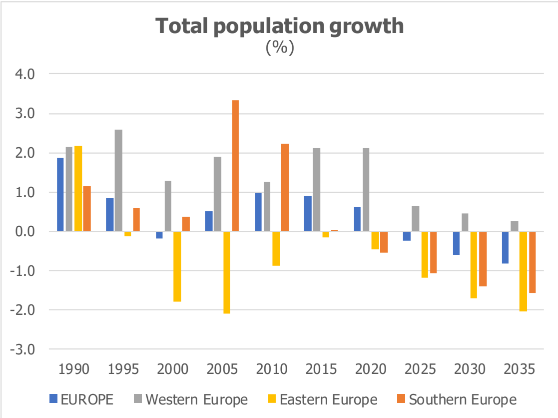
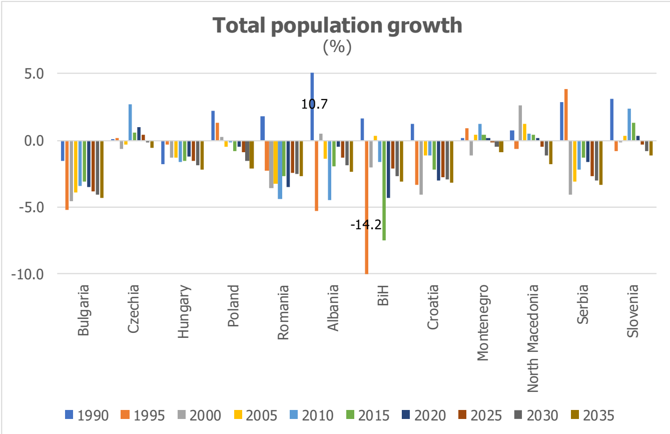
10. IMF Country Report No. 19/32, FYR Macedonia 2018 Article IV Consultation, January 2019
11. IMF Country Report No. 19/293, Montenegro 2019 Article IV Consultation, September 2019
12. IMF Country Report No. 19/37, Republic Of Poland 2018 Article IV Consultation, February 2019
13. IMF Country Report No. 19/278, Romania 2019 Article IV Consultation, August 2019

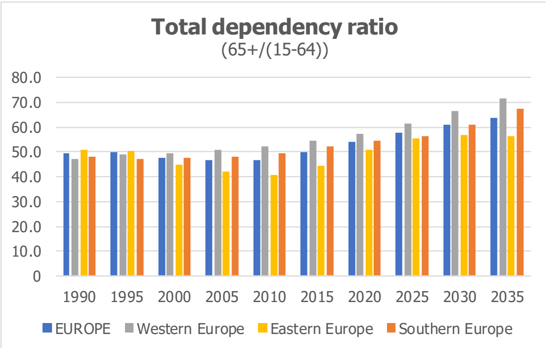
14. IMF Country Report No. 19/238, Republic of Serbia Staff Report for The 2019 Article IV, July 2019
15. IMF Country Report No. 19/58, Republic of Slovenia 2018 Article IV Consultation, February 2019

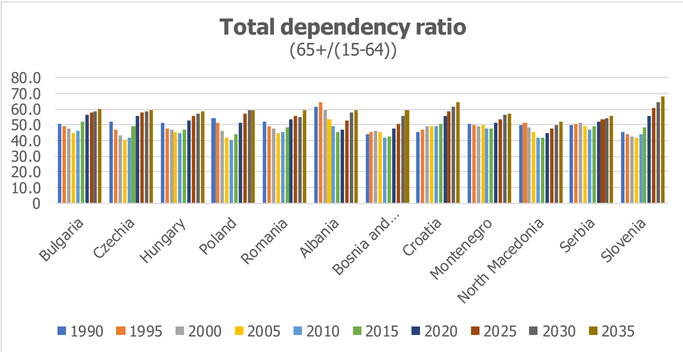
Appendix

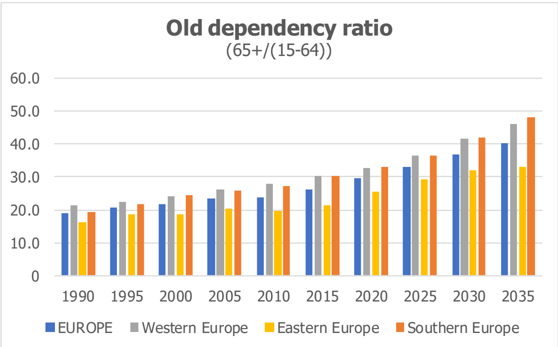
Long-term Challenges for Current Account Balance

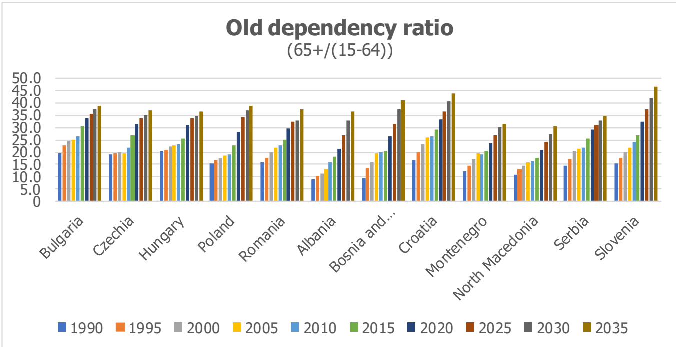


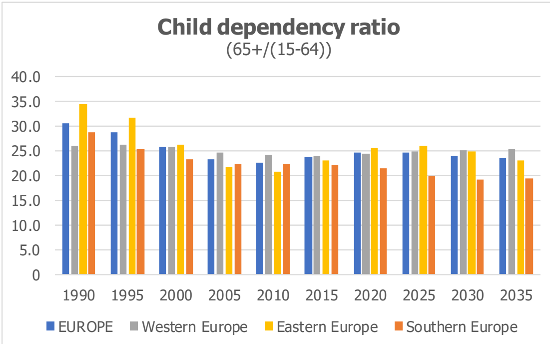











Child dependency ratio
(65+/(15-64))
40.0
35.0
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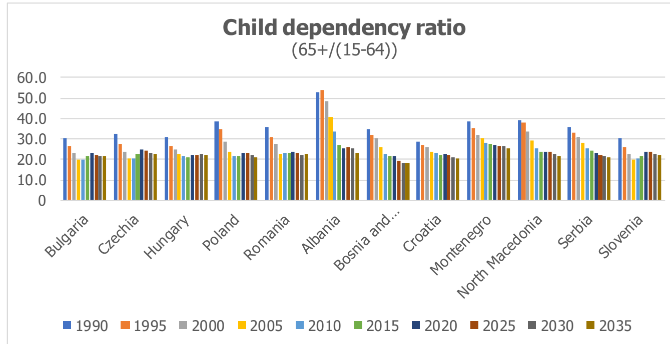
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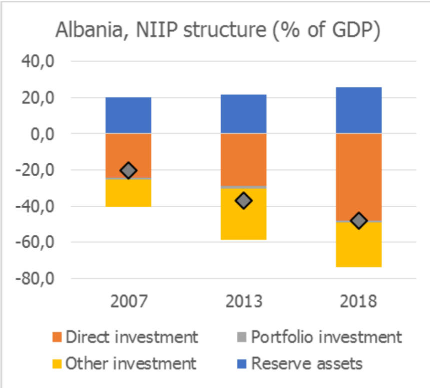
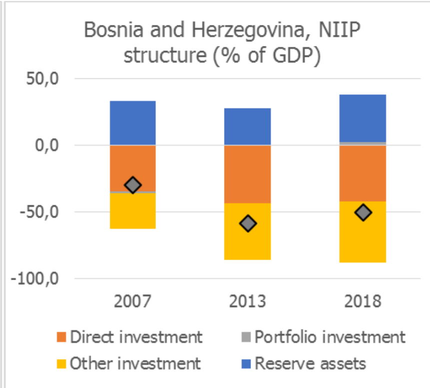
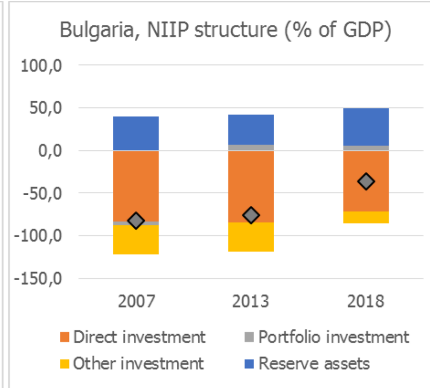
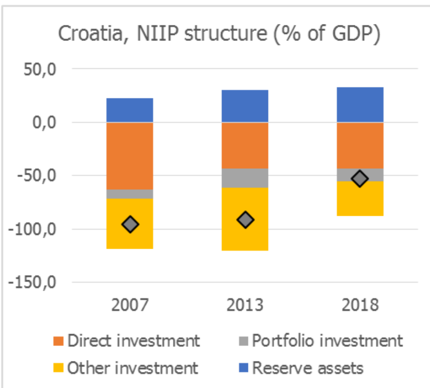
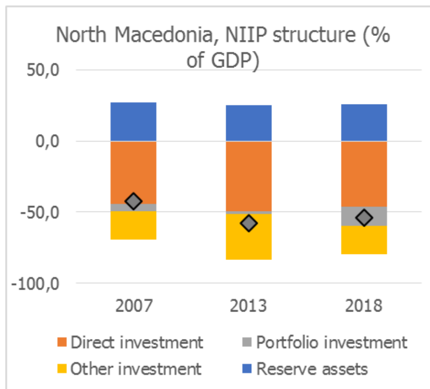
Net International Investment Position, By Countries

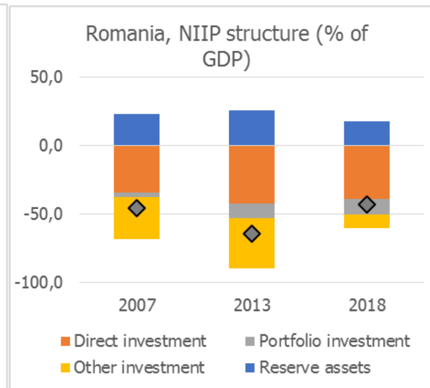


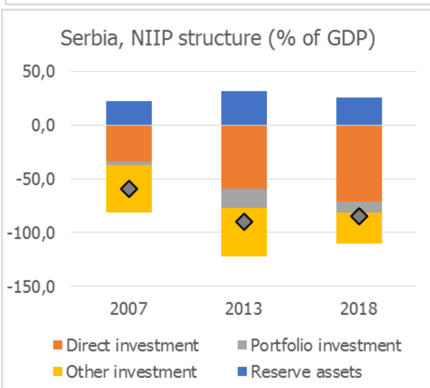


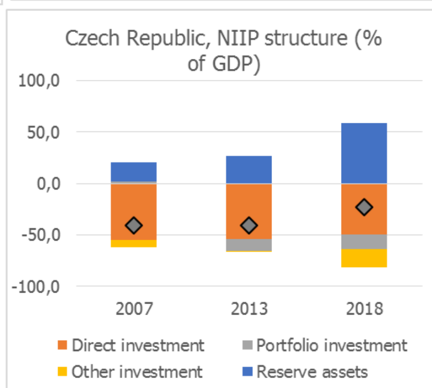


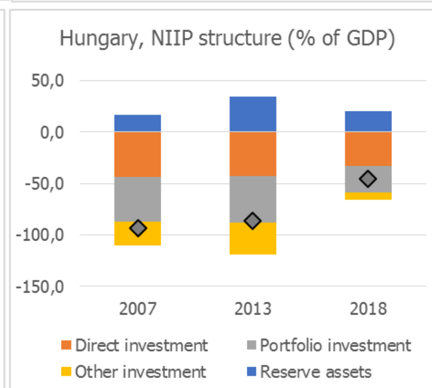


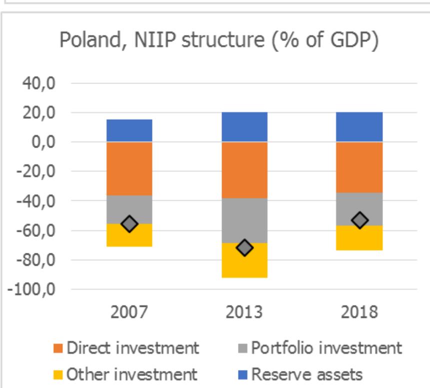


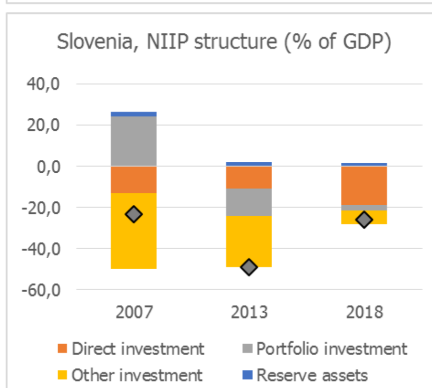




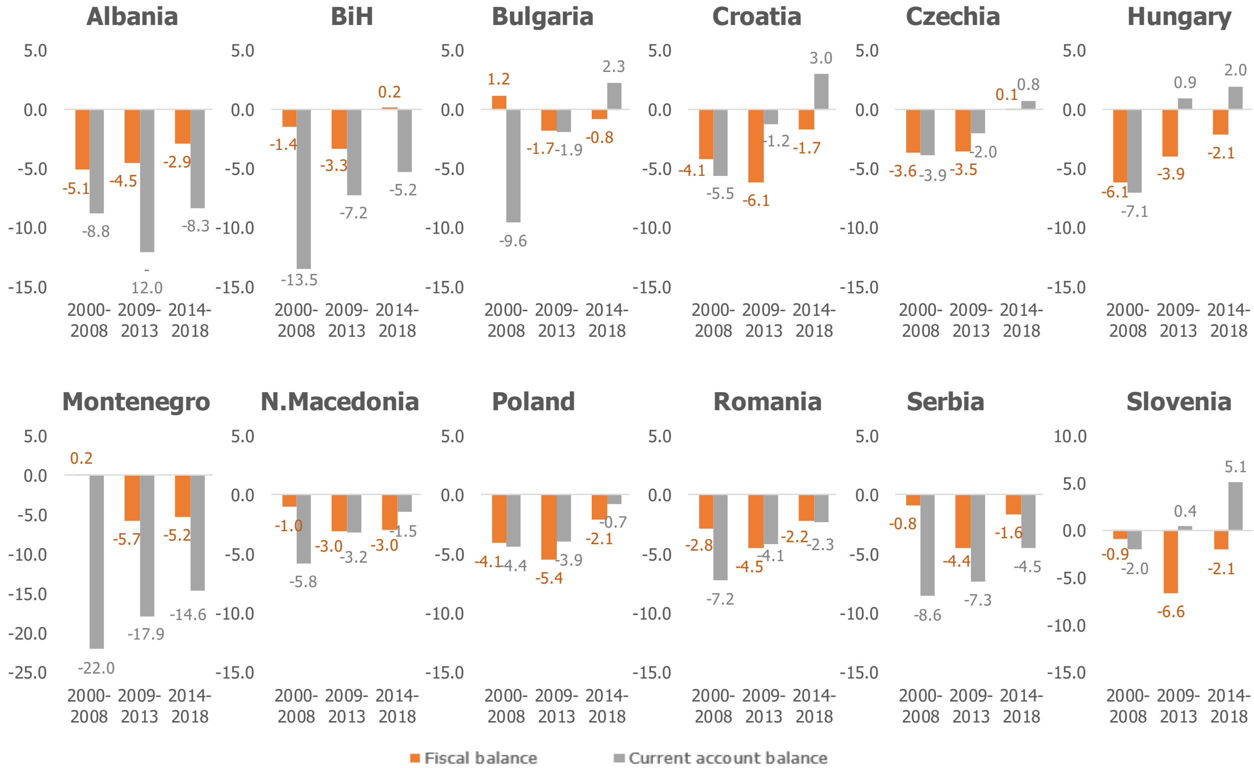






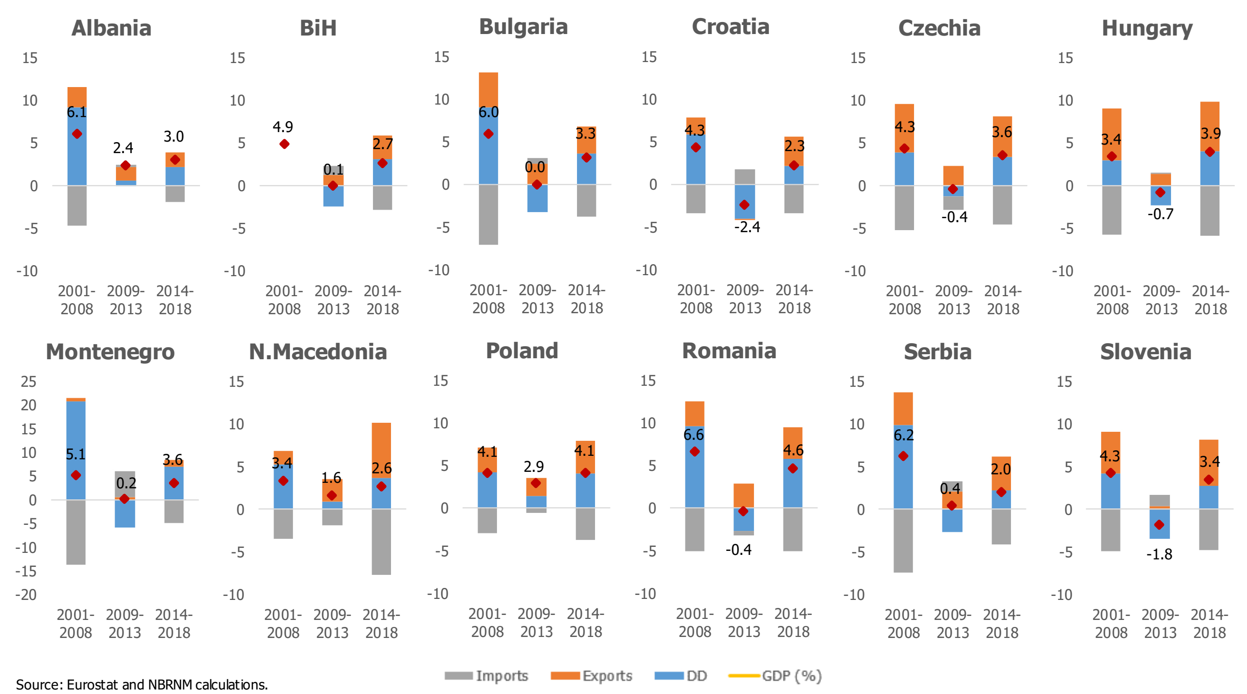


Current account balance and Fiscal balance (% of GDP)



Source: IMF WEO, October 2019 and NBRNM calculations.

GDP growth and GDP components contributions (p.p.)



Source: Eurostat and NBRNM calculations.