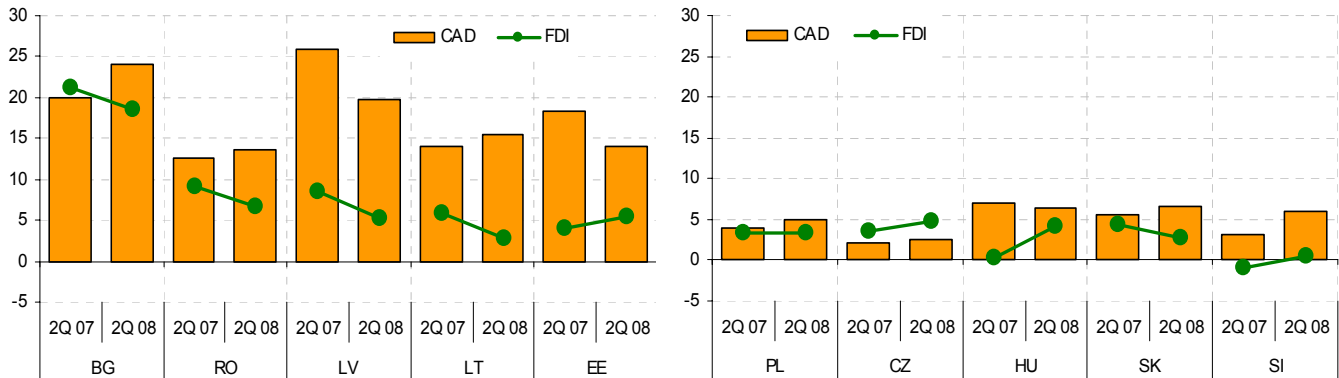


## Balance of Payments

Downward adjustment in the current account deficits in Estonia and Latvia has been substantial this year, but the Baltics, Bulgaria and Romania still have oversized external shortfalls (Figure 19). The current account deficit in Estonia and Latvia narrowed by about 7 and 9 percentage points of GDP respectively from a year earlier, as imports contracted in line with the rapid economic slowdown. The external shortfall narrowed modestly in Lithuania and Romania due to subdued imports. The deficit widened in all other countries, except Poland and Hungary, reflecting export weakness and the surge in oil import prices in the first half of the year. Bulgaria's current account deficit rose to 24 percent of GDP in Q2 2008 from 20 percent a year earlier, thanks to stronger imports of investment goods and high oil import prices.

Net capital flows fell sharply in the Baltics and by a smaller margin in Romania this year. Net capital inflows shrunk by 12.7 percent in 12-months ending June 2008 (compared with a year earlier) in Latvia and by about 8.5 percent in Estonia while it still increased slightly in Lithuania. Despite the decline in net capital inflows, foreign exchange reserves rose in Latvia and Estonia as current account deficits fell by more. In Lithuania, by contrast, foreign exchange reserves fell as compared to end-2007, but this was followed an earlier significant increase reflecting changes in central government deposits with the central bank. This year, inflows of foreign direct investment were large in the Czech Republic and amounted to about half of overall capital flows in Bulgaria, Hungary and Romania. In the Baltic countries and Slovenia, by contrast, borrowing abroad by the commercial banks remained the primary source of external financing.

**Figure 19. Current Account Deficit and Net Inflow of Foreign Direct Investment, 2007-2008 (percent of GDP)**



Source: Eurostat, World Bank staff calculations.

Note: Data on CAD and FDI on annualized basis.

Several countries in the region have large levels of external debt, reflecting the dependence on debt flows in financing large external shortfalls. Gross external debt varies from 40 percent in the Czech Republic, to 71.6 percent in Lithuania, close to 100 percent in Bulgaria, Estonia, Hungary, Latvia and Slovenia. Intercompany debt forms a significant portion of the overall gross external debt in the EU10, with the highest shares in Bulgaria (30 percent) and Hungary (18 percent). Countries with fixed exchange rates have the highest levels of short-term debt relative to GDP, reflecting to large extent nonresident deposits with domestic banks. Short-term debt as a share of GDP, moreover, is rising in five of the EU10 countries.

The looming global slowdown in economic activity makes it unlikely that further adjustments of current account deficits among the EU10 can be driven by exports. It is likely that more sluggish domestic demand in the EU10 and lower prices for imported energy and other commodities will help limit imports and help reduce imbalances in the Baltics and Bulgaria more than elsewhere. While at present policy efforts should focus on limiting the impact of the global financial crisis on the domestic financial system, renewed emphasis on tighter fiscal and monetary policies and appropriate income policies will be needed once the current threat is overcome.