Press Points for Chapter 6: Divergence of Current Account Balances Across Emerging Economies

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Key Points

- Since the mid 1990s current account imbalances have become more divergent across emerging markets, with rising deficits in emerging Europe contrasting with large surpluses in emerging Asia.

- Rapid domestic financial liberalization and EU integration have been the main drivers of capital inflows and led to long-lasting and sometimes large deficits in emerging Europe. But high capital account openness and fixed exchange rate regimes, present in several emerging European countries, imply risks for abrupt endings. Membership in the European Union is however an important mitigating factor.

- Less open capital accounts and financial sectors account for a substantial part of the surpluses in emerging Asia. However, a large fraction of the current account surpluses remains unexplained by standard factors. There is some evidence that valuation of exchange rates and the desire to build high levels of international reserves may have played a role.

Chapter 6 of the WEO examines the growing divergence of current account balances among emerging economies. In emerging Asia, current accounts averaged a surplus of about 5 percent of GDP in 2007, while in emerging Europe current accounts reached an average deficit of 10 percent of GDP in 2007 (see figure). Within emerging Asia, the pattern is more diverse with some persistent large surpluses and a few substantial deficits. Furthermore, the current account surpluses that had emerged in Korea and the Asian Tigers in the aftermath of the 1997-98 crisis came down recently (with the exception of Malaysia), while China started accumulating large current account surpluses beginning 2002-2003.

The chapter finds that structural variables, particularly the degree of financial liberalization, have been the main factors explaining the different regional trends. In emerging Europe, the large current account deficits are related to the rapid liberalization of
the domestic financial markets and capital accounts, which attracted large capital inflows and prompted a rapid rise of foreign bank ownership. EU integration also enhanced foreign capital inflows by improving prospects for economic and policy stability. Economies in emerging Asia typically have less open capital accounts, and liberalization of domestic financial markets has lagged other regions.

However, a large fraction of the surpluses in emerging Asia remains unexplained. One candidate explanation is the undervaluation of their exchange rates and there is some evidence supporting this claim. However, it is difficult to establish definitively whether the low exchange rate levels reflected deliberate policy action—for example, an attempt to build high levels of international reserves after the Asian crisis—or other unidentified factors that moved current accounts into surplus after 1997. Such factors are, however, not easy to identify.

Current account deficits in emerging Europe are not only larger but also have lasted longer compared to historical experience in emerging economies. On average, current account deficits in emerging Europe have lasted 9½ years, about 3 years longer than in other emerging economies, and most of these spells are still ongoing. Economic factors, such as high initial net foreign asset positions, growth opportunities, and open capital accounts, partly account for the longer length but the chapter’s estimates show that many of the deficit episodes in emerging Europe are at or beyond the upper end of their expected duration (see figure).

While the basic characteristics of emerging European economies explain their prolonged deficits, they do not rule out hard landings. Looking at resolution experiences of current account deficits, the chapter identifies several risk factors for abrupt endings. These include fixed exchange rate regimes and open capital accounts, which are characteristics of several countries. While the choice of a fixed exchange rate regime may be motivated by many factors and in particular the desire to enter the euro area, countries that make this choice need to protect themselves against external vulnerabilities by ensuring that product and labor markets are flexible, that strong financial regulatory and supervisory frameworks are in place, and that macroeconomic policies are consistent with domestic and external balance.