ECONOMIC ANALYSIS

The Oil impact on EM Europe's structural current accounts: A tale of two countries

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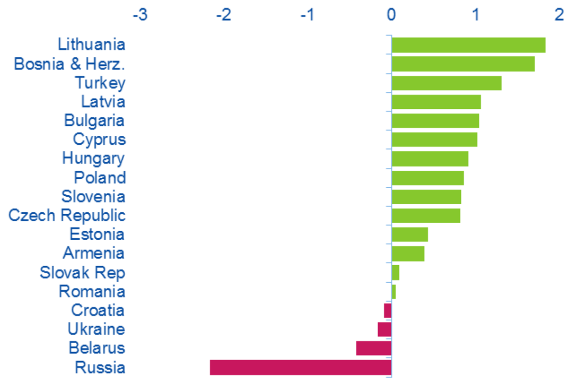
Summary

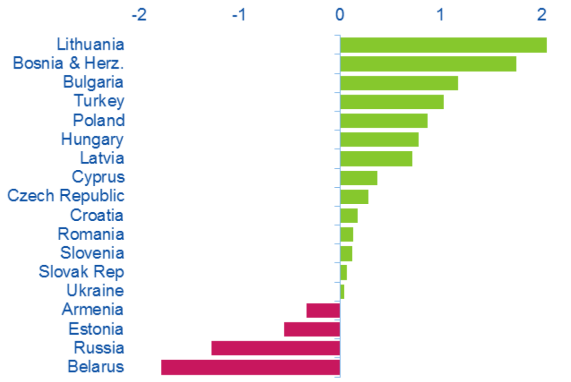
- We examine the oil price effects on the current account balances (CAB) of the Emerging European economies. To deal with, we decompose current accounts into cyclical and structural components.
- The emerging Europe (excluding Russia) current account balance is net winner of the new oil paradigm not only in cyclical position but also in structural aspects.
- Turkey and Bulgaria are net structural beneficiaries from new oil environment, still the net oil importer nature of the environment will continue to drag the current account balances.
- The slump in investment in EM Europe after the global crisis and trade & other factors components are supporting the structural surplus in many emerging Europe countries. Despite the improvements, the oil balance, financial factors and demography will remain as structural drags on current account balances for most of them.
- A tale of two countries emerged. Turkey is being one of the clear winners of the new oil price paradigm. The new oil price scenario and some adjustment on the private demand (particularly credit) have helping to reduce the CAD in near 6% pp of GDP during the last 4 years. However, the actual CAD is mostly structural so the reforms to tackle the private savings problem should be implemented in order to obtain further gains.
- Russia represents the loser position given the still high dependency on energy. While most of the adjustment has been cyclical, an slow but steady decline in the structural surplus is ongoing

Figure 1A
Cyclical effect* (2016) of the oil price decline on the CAB (in % of GDP)



*The cyclical effect corresponds to the cyclical contribution of the oil trade balance in 2016, driven mainly by oil prices.
Source: BBVA Research

Figure 1B
Structural CAB winners/losers from the oil price decline (Structural CAB change during 2012-2020 in % of GDP)



Source: BBVA Research

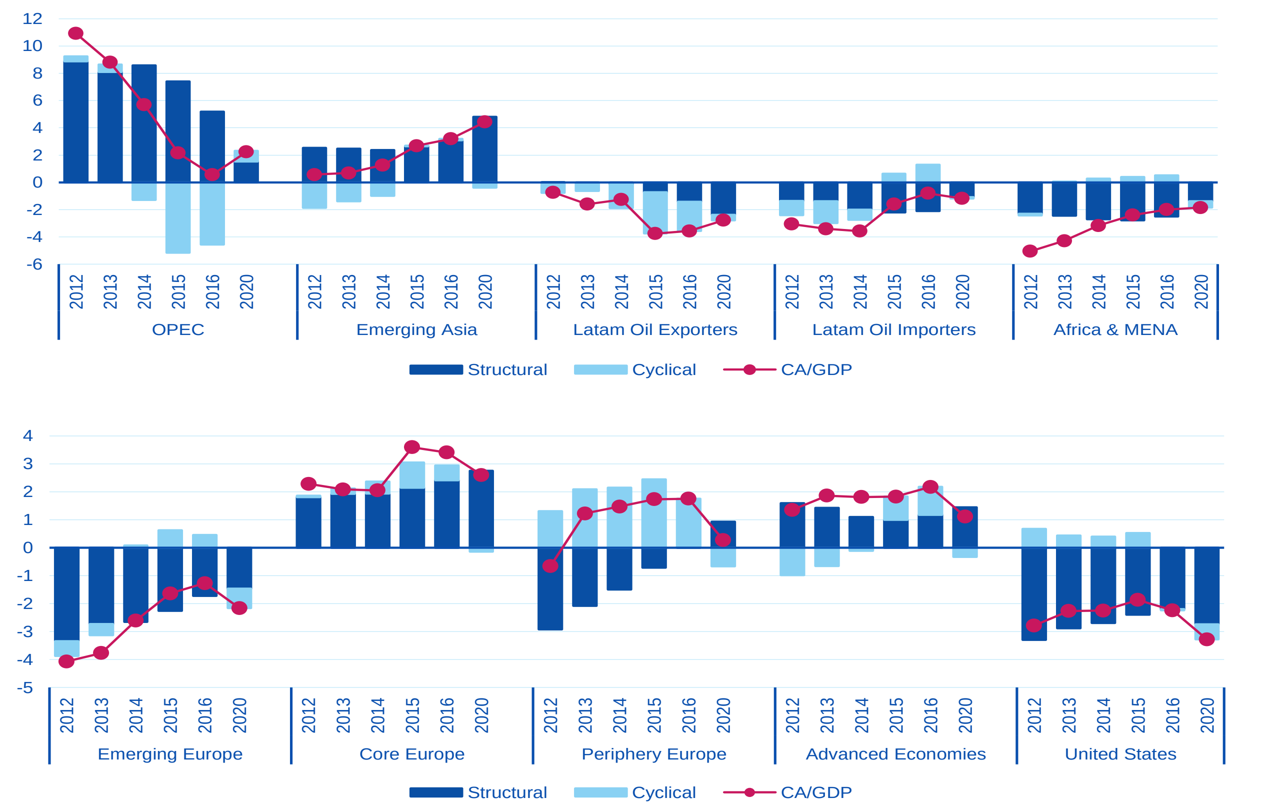
Lower oil prices cyclically improve EM Europe Current Account Balances

Current account balance (CAB) decomposition[1] to structural and cyclical for the Emerging Market (EM) Europe countries (excluding Russia) suggest that at an aggregate level the country group has been significantly benefiting from low oil price climate since mid-2014 through a direct impact on their net energy bill (see Figure 1A-1B).

The peculiar feature of Emerging Europe is that the region usually maintains an structural deficit and as a region (an excluding Russia) is a net energy importer. This means EM Europe excluding Russia is an absolute winner of the oil price game.

Our analysis puts forward that Emerging Europe exc. Russia CAB has been mainly delivering structural deficit and this outlook will continue to be the same by the medium term. According to our forecasts on average, CAB/GDP ratio will advance from around -3% in 2013 to nearly -2% by 2020 with the new oil paradigm. The new oil price outlook, the slump of investment and the de-leveraging after the financial crisis have helped to the reduction of the CAD, and will continue to reduce the structural deficit by about -0.7% of GDP, while the cyclical position will reverse by 2020 compared to 2015-2016 with a rise in the oil prices[2].

Figure 2
Decomposition of current account balance into structural and cyclical components (% of GDP)



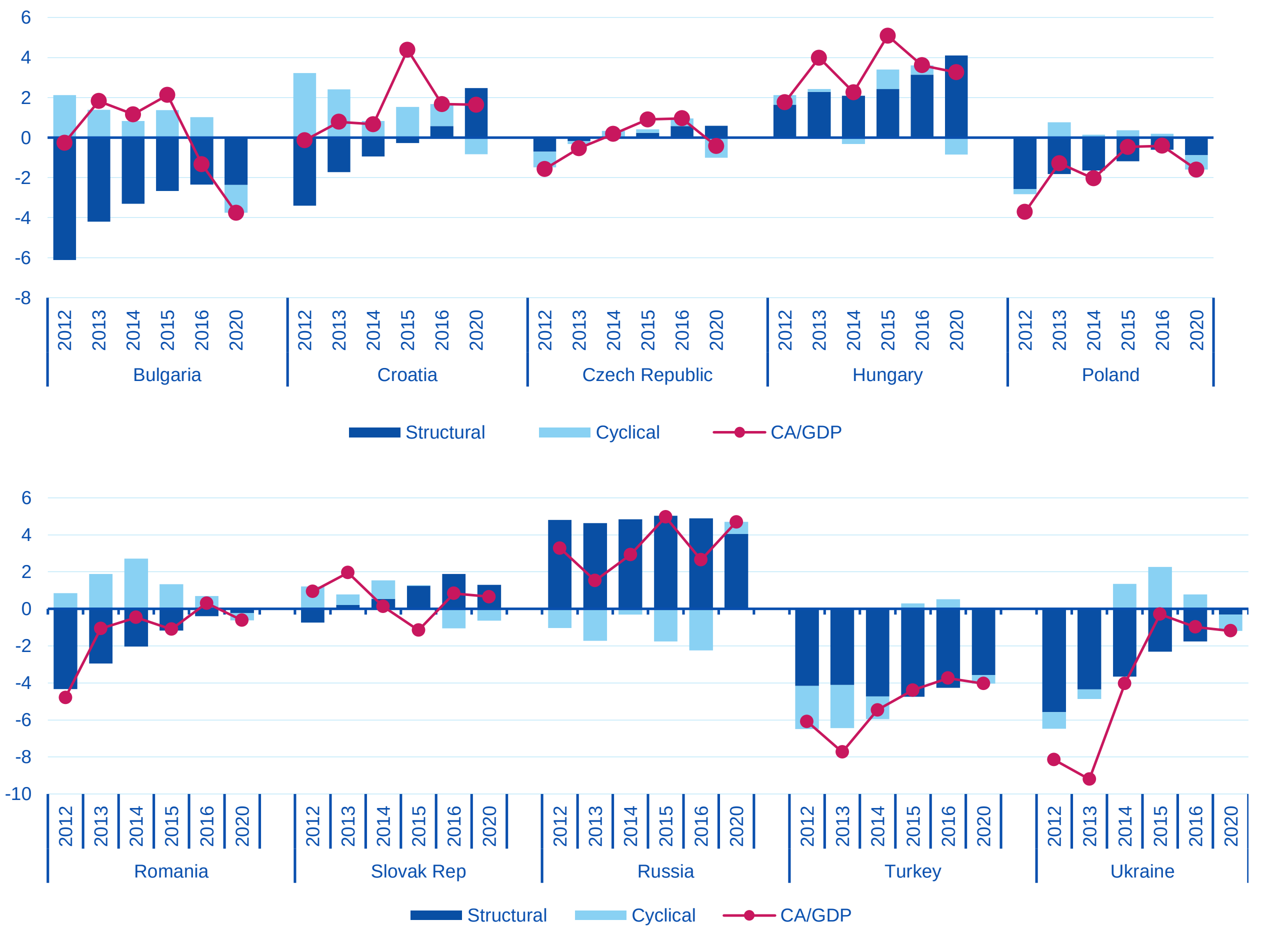
Source: BBVA Research

1: Structural factors are those having a permanent or long-lived effect) . Our model studies the variability of current account in its structural and cyclical components using combination of 1) Panel data model and 2) Bayesian time series model. For details refer to our recent Economic Watch.
2: BBVA's baseline Brent Crude Oil Price ($/bbl) estimates current stands 30.3 in 2016, rising gradually to 59.6 in 2020.

Our model-based country specific analysis propose that by 2016 among 18 EM Europe countries, 14 of them benefit cyclical gains from low oil prices while Russia, Croatia, Ukraine and Belarus are adversely affected through low oil prices' cyclical impacts. Turkey and Bulgaria are the top beneficiaries of the low oil prices.

Notwithstanding, although we estimate that the fall in the oil prices help Emerging Europe exc. Russia CAB to recover in aggregate level, country-specific details offer various heterogeneous aspects both in the structural and cyclical counterparts of the balances. Figure-3 exhibits comprehensive cyclical and structural evolution of the current account balances throughout the years for selected countries among Emerging Europe, implying that most of the EM Europe countries are in a cyclically benefiting position by 2016, *though not all through low oil prices*. Comparatively, although Croatia and Ukraine are adversely affected by the low oil prices, other cyclical effects such as investment, output gap and private credit push the overall cyclical part up to the positive zone. Consequently, next to low oil prices, country specific positions are also corrected through other factors. By 2016, most of the EM Europe countries enjoy positive cyclical effect through investment in addition to the oil price effects.

Figure 3
Decomposition of current account balance into structural and cyclical components (% of GDP)



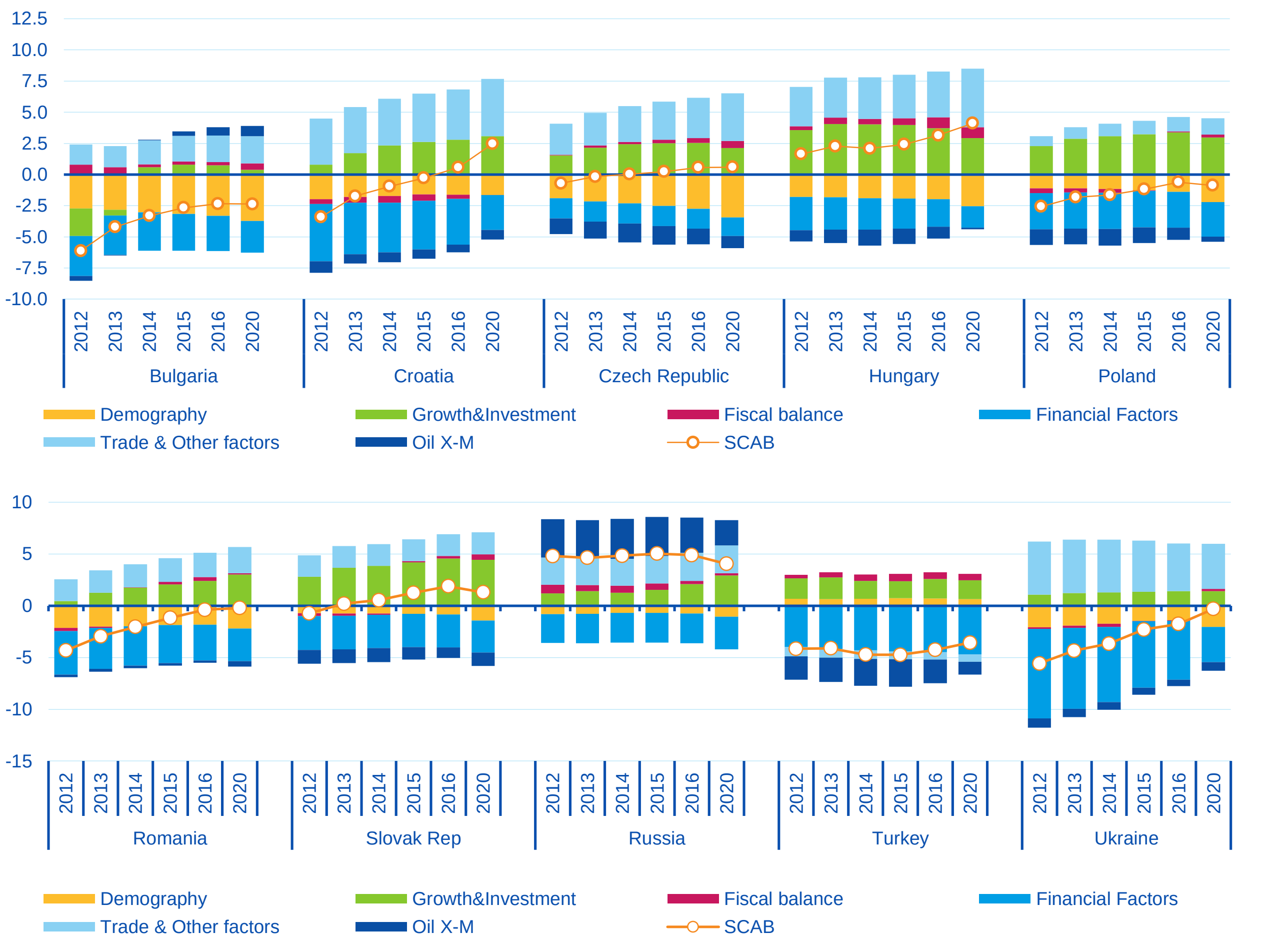
Source: BBVA Research

Our forecasts shows that the structural position of some countries will remain intact (like Turkey, Bulgaria, Czech Republic, Poland). Nonetheless, although by 2016 Croatia's CAB surplus is mostly cyclical, this outlook will change by 2020 and structural segment will take over the surplus. For Czech Republic and

Ukraine, the bargain between the counterparts will be vice versa as mostly structural CAB deficit by 2016 will turn into cyclical in general by 2020. Mainly structural component will keep predominating the CAB for the rest of the countries.

Furthermore, when we examine structural components of the current account balances thoroughly (Figure – 4) we observe that most of EM Europe countries structurally gives surplus through investment and income and this outlook will continue by 2020, while population growth and financial factors (mostly private credit and net financial assets) are structural drag on CAB of Emerging Europe excluding Russia. Other structural factors remain country specific. Comparatively, Czech Republic, Hungary and Turkey enjoy structural surplus through fiscal factors, while Slovenia and Croatia are adversely affected. For the countries which have net energy import, oil will continue to be a structural burden on current account balances by 2020.

Figure 3
Decomposition of structural current account balance into large economic factors (% of GDP)



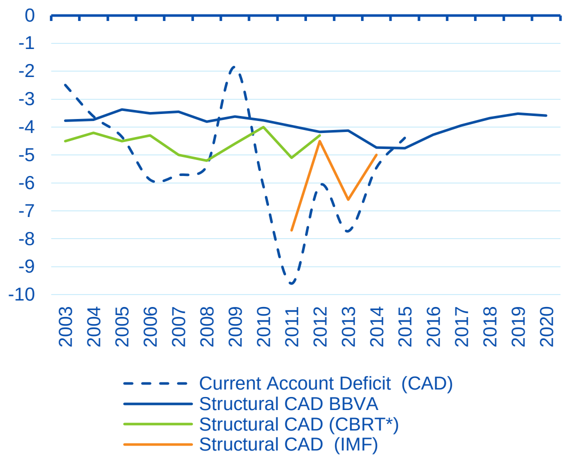
Source: BBVA Research

A tale of two countries: Turkey is among the big winners of the new oil price paradigm…

An interesting case to analyze is the evolution of the current account balance of the Turkish economy. Turkey enriched the EM "fragile" lists during the past years not only because of the high level reached by its current account deficit (10% of GDP in 2011) but also because the rapid deterioration (from 2% after the Lehman crisis in 2009 to 10% two years later).

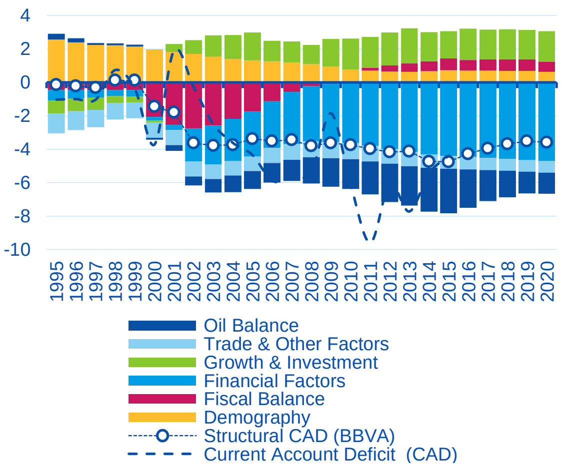
However, the adjustment of the Turkish current account deficit since 2001 has been sizeable and the latest annual figure for the current account shows that most of the cyclical part of the CA deficit has been corrected. Figure - 5 shows the CAD evolution and our structural balance measure jointly with alternative measures by the IMF and the CBRT. The key message for these measures is that the structural current account balance of Turkey was near 4.5% at the end of 2015 according to our model. Thus, almost the entire current account deficit at the end of 2015 was structural and the bulk of the adjustment has come from the cyclical part. Besides, and given that we expect the domestic demand recovery to persist, most of the further adjustments will have to come from the structural component in the coming years.

Figure 5
Turkey: Structural Current Account Balance (in % of GDP)



IMF EBA (2015) and CBRT Notes in Economics: The Cyclical adjusted Current Account Balance
Source: BBVA Research

Figure 6
Turkey: Structural CAB Determinants (% of GDP)



Source: BBVA Research Model

But which are the factors behind the Turkish structural deficit?. The Figure - 6 decompose the savings - investment gap in their determinants. As it can be observed in Figure- 6 demography, investment and fiscal will be maintained in surplus. This is important because unless the structural savings component is corrected the structural CAD will increase once investment reignites.This lead the bulk of problem to the structural

savings component? As the demographic factors and the structural fiscal savings are in surplus, the main factors for the structural deficit are the private sector component. Of this, the financial and credit factors account for most of the imbalance (light blue). Particularly, the excess credit problem (already adjusting) and the lack of development of for private savings constitute the big part of the problem. Beyond this, the structural energy balance is still contributing to the structural deficit although will be reduced substantially in the coming years (as it happened already with the cyclical one). Other trade factors will persist but their contribution are and will be low (pink bars)

In sum, the adjustment of the current account deficit during the recent years has been sizeable. However, most of the actual CA deficit is now structural so, looking ahead, it will more difficult to further adjust without coping with the structural balance. While the energy structural balance will continue to adjust, further adjustments will require further structural reforms to correct the private sector savings structural imbalances.

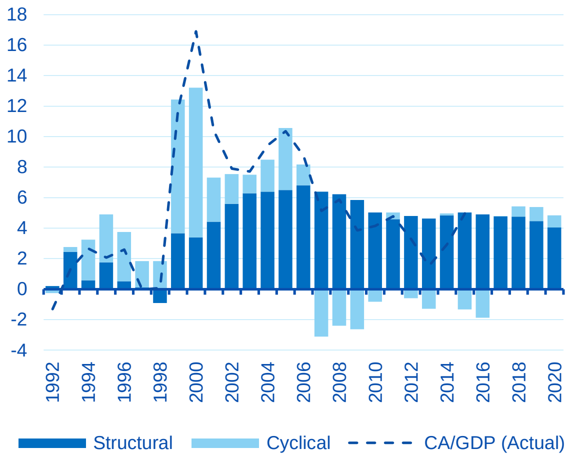
Some of these measures are already in the structural agenda of the Government and if successfully implemented will contribute to the structural adjustment in the coming years.

A tale of two countries: Russia is becoming a clear looser

As a net energy exporter, Russia has suffered the new oil price in their external accounts. Most of the impact have come from the cyclical component but the structural one is steadily declining. From near 12% cyclical surplus at the beginning of this century the latest data shows that the cyclical part has entered in near deficit and stays is this negative position since the last two years.

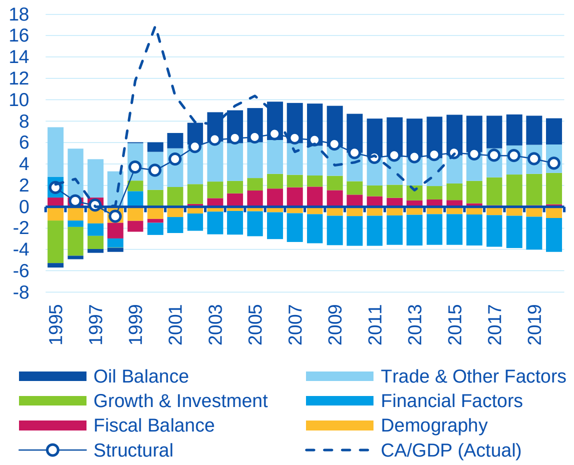
What about the structural current account balance? The figure 6 shows the steady decline of the structural account surplus, from levels around 7% surplus from one which is heading to 4% in the long run. As the underdevelopment of the financial sector and demography will maintain their deficit position, the rest of the component will continue to deteriorate although slowly. The energy balance will maintain contributing to the surplus but his contribution will continue to decline (from near 4% in 2008 to 2.5% of GDP in 2020). While the fiscal balance, also affected by the oil price, will diminish to near 0% in the long run, the trade factors will also shrink. Still, the investment component will support the surplus position but any structural recovery of investment will need of further savings to avoid an additional worsening of the structural current account.

Figure 7
Russia:Structural Current Account Balance (in % of GDP)



Source: BBVA Research, IMF EBA (2015) and CBRT Notes in Economics: The Cyclical adjusted Current Account Balance

Figure 8
Russia: Structural CAB determinants (in % of GDP)



Source: BBVA Research Model

Emerging Europe Benefits both in structural and cyclical side but further adjustment on private credit is necessary

Emerging Europe excluding Russia maintains a current account deficit which is now mostly structural. As the region is a net energy importer, low oil price environment has been helping on cyclical part to decrease the deficit. On structural basis both the new oil price, the slump in investment and some credit deleveraging have helped to improve the external accounts. However, the region's structural deficit position remains rigid by 2020. Looking into detail, financial factors (as lack of financial deepening) remain a key drag on the structural deficit of the region.

Among the big countries there are two country tales. The adjustment in Turkey´s CAD has been sizeable not only due to the oil prices but also the recent adjustment in excess credit. However, most of the CAD is now structural, so the necessary reforms to boost private savings will be necessary to obtain further gains. Contrary, Russian has experience both a sharp adjustment in the cyclical position but also a steady decline in his structural surplus position due partly to the declining oil prices.