# Impact of the economic downturn on the balance of payments of the new EU member states

Algimantas Misiūnas[1]

*Abstract.* **The article analyses the balance of payments of 12 new EU member states in the period from 2007 to 2009. The impact of the economic downturn, which began in 2008 and continues through the present, has been stronger in the new than in the old EU member states. It is particularly obvious as one analyses their balance of payments: evident changes in the balance of goods mainly due to a drop in imports, a decrease in flows in the balance of services, breaks in capital flows. All the above-mentioned factors pressurised many countries into reducing official international reserves. The analysis presented in the paper shows that different countries reacted to the changes in the economic situation in different ways – made different decisions about dealing with the difficulties encountered.**

*Keywords:* **balance, payments, account, deficit.**
**JEL: E010, E100, C820**

## I. Introduction

Until 2008, the economy of the countries which had joined the European Union in 2004 and later was rapidly growing. In most of these member states, the average of real GDP growth rates in 2004–2007 exceeded 5 per cent, in the Baltic States – 8 per cent. These rates were markedly higher than the real GDP growth rates of 2–3 per cent observed at that time in the old EU member states. It was hoped that the rapid GDP growth in the new EU member states, which was mainly conditioned by the expansion of exports and growing domestic demand, would reduce differences between the economies of the new and the old member states. However, the outbreak of the economic crisis affected the new member states greatly. The most dire consequences were observed in the Baltic States, where real GDP growth rates in 2004–2007 were the highest. In Latvia, where the real GDP growth rate in 2007 reached 10 per cent, a decrease of 4.6 per cent was observed in 2008, while in 2009 the real GDP growth rate was already as low as minus 18 per cent. In Lithuania and Estonia, real GDP growth rates in 2009 dropped to minus 14.8 and minus 14.1 per cent respectively. In the rest of the new EU member states, except for Poland, real GDP growth rates in 2009 were also negative (with a minus sign).

Financial turmoil, inter alia, had an impact of the countries' balance of payments. Changes were observed in the balance of goods and services, balance of income, current transfer flows. Considerable changes were observed in the outflow of domestic and foreign direct and portfolio investment. There were marked changes in other investment liabilities, which often led to changes in the values of the surplus and deficit in the balance of payments per se.

It is reasonable to investigate the period of 2007–2009 since the year 2007 was a year of a rapid growth in the new EU member states, while the start of the economic downturn in 2008 and its continuation through 2009 made a different impact on different countries.

*Purpose of the paper*: Through the analysis of the balance of payments of 12 new EU member states, to determine their peculiarities and reasons for changes in 2008–2009. The indicators discussed in the article are not only those of all new EU member states but also those of the following groups thereof: new EU member states belonging to the euro area (Cyprus – CY, Malta – MT, Slovenia – SL, Slovakia – SK), the Baltic States (Estonia – EE, Latvia – LV, Lithuania – LT), other countries (Bulgaria – BG, the Czech Republic – CZ, Hungary – HU, Poland – PL, Romania – RO).

## II. Viewpoint on the Sustainability of the Balance of Payments

In the changed situation, the economies of the new EU member states have been growing at a faster rate than those of the old member states; however, the problem caused by openness – the formation of a large current account deficit of the balance of payments – has been deepening as well. A constant and large current account deficit increases the probability of a currency crisis, current account deficit and breaks in capital flows [6].

In the presence of a constant large current account deficit, big external debt and negative expectations about the economic growth, the confidence of investors about the capability of a country for repaying debts may decrease. In a situation where a large portion of foreign investment is made up of short-term (not direct) investment, a decrease in expectations about return on investment may result in an intensive capital outflow from the country – a break in foreign capital flows. A sudden capital outflow impacts on the national exchange rate (induces a decrease in a free exchange rate, reduction in official international reserves, which, in turn, encumbers the maintenance of a fixed

[1] Algimantas Misiūnas is with the Faculty of Economics and Finance Management, Mykolas Romeris University, Ateities st. 20 LT–08303 Vilnius, Lithuania and Faculty of Economics, Vilnius University, Sauletekio str. 9, LT-10222 Vilnius, Lithuania

exchange rate), thus increasing the risk of a currency crisis. The depreciation of national currency is usually followed by a substantial decrease in the current account deficit.

The most precise definition of the sustainability of the balance of payments is, probably, the following: The current account deficit is considered to be sustainable if a country is able to tackle outstanding external public debt (with no substantial changes in the economic policy and maintaining the current consumer behaviour); in case of a negative shock, is not hit by a crisis due to external debt (is not faced with major borrowing difficulties, is not forced into limiting the movement of capital, changing exchange rate arrangements); and is not threatened with sudden changes in foreign capital flows [3].

The sustainability of the current account deficit may be assessed with regard to the size of the current account deficit (a constant current account deficit exceeding 5 per cent of GDP is often considered to be not sustainable) and the size of the accumulated external debt. It is also influenced by the type of investment (direct or portfolio) from which the current account deficit is funded [1].).

For the assessment of sustainability, also used is the analysis of current account balance factors, which historically is seen from three main perspectives. **From the viewpoint of elasticity**, the current account balance is analysed as import/export balance, with relative prices as the key decisive factor. Trade deficit may be eliminated by the drop in the real exchange rate, the impact of which on the foreign trade balance depends on the elasticity of export and import demand in respect of prices. **From the viewpoint of absorption**, the current account balance is equal to the difference between national savings and domestic investment; therefore, the current account deficit is assessed with regard to the level of domestic investment and savings. In order to reduce the current account deficit, national savings should be encouraged and the state budget deficit should be reduced. **From the viewpoint of intertemporal choice,** savings and investment solutions are influenced by income growth and interest rate expectations. The current account imbalance is caused by intertemporal utility maximisation, when consumers compare income flows in the current and in the coming period and, in order to maximise utility in all periods, borrow and acquire assets abroad. Thus intertemporal consumption adjustment takes place: the countries whose income in the current period is relatively low, while expectations about the income level in the future are optimistic, borrow; the countries where per-capita income is relatively high – lend [2].

When analysing the factors impacting on the current account balance, one investigates the factors impacting on international trade (changes in income, exchange rates), national savings and domestic investment rates (economy and income growth rates, growth rate expectations).

One of the conditions for the sustainability of the current account deficit – correspondence between the dynamics of the current account deficit and the intertemporal solvency condition. The accumulated public external debt and current account deficit should be covered by the current account surplus in the future – the discounted external debt should tend to zero. However, if only the above-mentioned (intertemporal solvency of the country) condition is satisfied and in the presence of a constant current account deficit, investors may still lose confidence in the State, which may result in a break in capital flows – intensive capital outflow from the country [5].

## III. TRENDS IN THE BALANCE OF PAYMENTS OF THE NEW EU MEMBER STATES

Based on the data of Eurostat and national central banks, it was calculated that the biggest change in the balance of payments in the period in question was in Bulgaria, the smallest – in Estonia.

The global financial turmoil and economic downturn made a huge impact on trade and service balances, largely influenced exports and imports of goods, payments for and revenue from services. The said changes made an impact on the formation of the current account deficit/surplus (see Fig. 1 and Table 1), while changes in the financial situation largely affected investment flows.

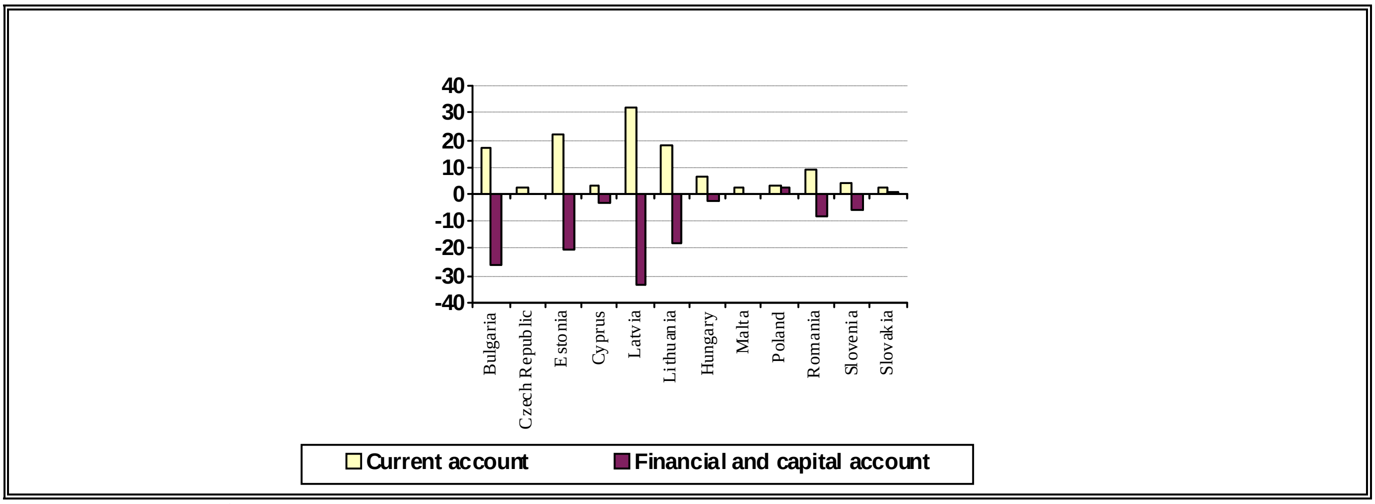
The data in the figure clearly show where (in which countries) changes in the balance of payments over three years were the biggest. In 2007, the Baltic States, Bulgaria, and Romania were characterised not only by high GDP growth rates but also by the highest current account deficits (see Table 1). In 2008–2009, deficits were rapidly decreasing, and the Baltic States were already characterised by surpluses, which was influenced by decreased – owing to a large drop in imports – foreign trade deficits. The Baltic States were always characterised by positive balances of services, while during a period of economic downturn even managed to improve these figures.

The five countries analysed are distinguished from the rest of the new EU member states by positive current transfers balances, which also contributes to the improvement in current accounts. During a period of crisis, the citizens of the countries in question earn rather big money in other – richer – countries and remit considerable amounts of cash to their families and relatives.

There were no major distinctions observed in capital accounts. In financial accounts, however, the following particularities may be noted. During economic downturn, financial accounts acquired a minus sign. Although it was to a certain extent influenced by direct investment balances (since they have decreased considerably owing to the change in inward and outward direct investment flows), a much larger impact was made by investment portfolio and other investment balances, which in 2009 acquired a minus sign owing to a change in the foreign assets-to-liabilities ratio (liabilities markedly increased).

The current accounts of the balance of payments of the new EU member states belonging to the euro area (Malta, Cyprus, Slovenia, and Slovakia) have been showing similar trends; however, those distinguished from the rest of the new EU member states by most of the balance of payments positions are Cyprus and Malta. The latter countries are characterised by a particularly large deficit of the balance of goods and surplus of the balance of services. This situation is somewhat similar to that in the Baltic States, where the surplus of the balance of services also partly compensates for the deficit of the balance of goods.

In 2008, compared to 2007, larger deficits had been recorded on the current account of the new euro area entrants (except for Malta), while in 2009 current account deficits in the said countries shrunk. It was influenced by changes in the trade balance. Despite the fact that export and import flows weakened, trade balance deficit was falling in all new euro area entrants, while in Slovakia, in fact, a trade balance surplus was recorded. Changes were also observed in the balance of services: the balance of services surplus and deficit, recorded in 2008, decreased in 2009. Changes in the balance of income and current transfer flows also contributed to the overall decrease in current account deficits.




*Source: Compiled with reference to the data EUROSTAT, IMF database*

Fig. 1. Changes in the deficit/surplus on the current, capital and financial accounts of the balance of payments in the new EU member states (compared to GDP, per cent), 2007–2009

In 2008, compared to 2007, larger surpluses had been recorded in the financial accounts of the countries in question; in 2009, however, their financial account surpluses decreased (in Cyprus, due to the decrease in the volume of portfolio investment foreign assets and other investment, while in Malta mainly due to the outflow of portfolio investment foreign assets and changes in other investment flows). In Slovenia, a surplus of portfolio investment liabilities was recorded, which was partly compensated for by direct and other investment outflow, which conditioned a significant decrease in the financial account surplus. Meanwhile, in Slovakia, direct and portfolio investment outflow was compensated for by the positive flow (inflow) of other investment.

During a period of crisis, probably the most stable indicators of the balance of payments were recorded in Poland and the Czech Republic, while in Hungary major fluctuations were observed. In the said countries, current account deficits have been gradually decreasing owing to improving balances of goods, although the impact of the balances of services (in contradistinction to, for example, the Baltic States) was insignificant. In 2009, the current account deficit of the Czech Republic shrunk almost 3 times, which was mainly due to a marked increase in the trade balance surplus; meanwhile, although the surplus of the balance of services decreased 3 times, it had no major impact. It should be noted that the Czech Republic and Hungary in 2009 were distinguished from the rest of the new EU member states by particularly high positive balances of goods. It was only in Poland, quite a number of citizens of which have been working in rich countries throughout the last decade, that current transfers had a major impact on the current account.

In the three countries (the Czech Republic, Hungary, and Poland), financial accounts have been stable; however, this stability was achieved owing to different factors. In the period in question, a downward trend in foreign direct investment outflow was observed in all three countries; in the Czech Republic and Poland, however, a marked improvement in investment portfolio balances was observed (although it was achieved owing to an increase in liabilities), while in Hungary – vice versa. In Hungary, the stability of the financial account was achieved owing to high other investment liabilities, although of portfolio investment foreign assets markedly decreased.

Bulgaria and Romania are the countries which have entered the EU most recently. Current account deficits in these two countries have been decreasing throughout the period in question. Similarly to other countries discussed in the paper, it was conditioned by a decrease in deficits of the balance of goods; however, it was only in Bulgaria that a major positive impact of the balance of services was observed.

A deterioration in the economic situation resulted in a decrease in official international reserves of all new EU member states, which was particularly evident in Latvia and Hungary (not for nothing are the latter countries often referred to as facing a tense financial situation).

TABLE 1. BALANCE OF PAYMENTS OF THE NEW EU MEMBER STATES (COMPARED TO GDP, PER CENT), 2007–2009

| | Year | BG | CZ | EE | CY | LV | LT | HU | MT | PL | RO | SI | SK |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Current account** | 2007 | -26.8 | -3.2 | -17.8 | -11.7 | -22.3 | -14.5 | -6.6 | -6.1 | -4.7 | -13.4 | -4.8 | -5.7 |
| | 2008 | -25.4 | -3.1 | -9.4 | -17.5 | -13.0 | -11.9 | -7.1 | -5.6 | -5.1 | -11.6 | -6.2 | -6.6 |
| | 2009 | -9.4 | -1.1 | 4.6 | -8.5 | 9.5 | 3.8 | 0.2 | -3.9 | -1.6 | -4.5 | -1.0 | -3.2 |
| **Goods** | 2007 | -25.1 | 3.4 | -17.8 | -29.5 | -23.9 | -15.0 | 0.2 | -18.0 | -4.0 | -14.3 | -4.8 | -1.5 |
| | 2008 | -25.2 | 2.8 | -11.7 | -35.2 | -17.6 | -12.0 | -0.1 | -20.5 | -4.9 | -13.6 | -7.1 | -1.1 |
| | 2009 | -12.1 | 5.1 | -3.7 | -25.1 | -6.6 | -2.9 | 4.3 | -13.5 | -1.0 | -5.9 | -1.8 | 1.9 |
| **Services** | 2007 | 4.1 | 1.4 | 6.1 | 23.0 | 3.5 | 1.6 | 1.0 | 15.4 | 1.1 | 0.3 | 3.0 | 0.7 |
| | 2008 | 2.3 | 2.2 | 7.4 | 27.8 | 4.0 | 1.1 | 0.8 | 17.3 | 1.0 | 0.5 | 4.3 | -0.7 |
| | 2009 | 4.6 | 0.7 | 9.6 | 19.8 | 6.2 | 2.2 | 1.6 | 15.9 | 1.1 | -0.3 | 2.9 | -2.0 |
| **Income** | 2007 | -8.2 | -7.2 | -6.8 | -5.1 | -3.2 | -4.1 | -7.3 | -2.4 | -3.8 | -3.3 | -2.3 | -4.3 |
| | 2008 | -3.9 | -7.9 | -6.3 | -9.7 | -1.6 | -3.3 | -7.2 | -2.9 | -2.6 | -2.7 | -2.8 | -3.4 |
| | 2009 | -4.7 | -6.5 | -2.9 | -2.2 | 6.5 | 0.4 | -6.0 | -6.0 | -3.2 | -1.8 | -1.9 | -2.0 |
| **Current transfers** | 2007 | 2.4 | -0.8 | 0.7 | 0.0 | 1.3 | 3.0 | -0.5 | -1.2 | 2.0 | 3.9 | -0.7 | -0.6 |
| | 2008 | 1.5 | -0.3 | 1.2 | -0.4 | 2.2 | 2.3 | -0.6 | 0.6 | 1.5 | 4.3 | -0.6 | -1.3 |
| | 2009 | 2.7 | -0.4 | 1.6 | -1.1 | 3.4 | 4.1 | 0.3 | -0.2 | 1.5 | 3.5 | -0.3 | -1.1 |
| **Capital account** | 2007 | -2.0 | 0.6 | 1.0 | 0.0 | 2.0 | 1.7 | 0.7 | 0.9 | 1.1 | 0.7 | -0.2 | 0.6 |
| | 2008 | 0.8 | 0.8 | 1.0 | 0.1 | 1.5 | 1.8 | 1.1 | 0.5 | 1.1 | 0.4 | -0.1 | 1.2 |
| | 2009 | 1.4 | 1.1 | 2.8 | 0.4 | 2.4 | 3.4 | 1.4 | 1.2 | 1.6 | 0.5 | 0.0 | 0.7 |
| **Financial account** | 2007 | 36.4 | 3.1 | 15.7 | 11.9 | 21.2 | 12.9 | 7.8 | 2.6 | 6.1 | 13.5 | 5.7 | 4.2 |
| | 2008 | 31.4 | 3.1 | 8.9 | 18.0 | 13.3 | 10.4 | 8.0 | 4.9 | 8.1 | 12.6 | 6.6 | 7.9 |
| | 2009 | 6.4 | 2.7 | -6.6 | 8.1 | -12.6 | -7.2 | 5.0 | 2.2 | 8.2 | 5.2 | 0.1 | 4.7 |
| **Direct investment** | 2007 | 30.6 | 5.1 | 4.6 | 4.5 | 6.8 | 3.6 | 3.4 | 12.1 | 4.3 | 5.7 | -0.6 | 3.6 |
| | 2008 | 17.8 | 4.1 | 3.7 | 0.5 | 3.0 | 3.2 | 1.2 | 7.2 | 2.2 | 6.7 | 1.0 | 3.4 |
| | 2009 | 9.8 | 0.7 | 1.1 | 2.4 | 0.4 | 0.4 | -0.2 | 9.9 | 2.0 | 3.8 | -1.9 | -0.5 |
| **Abroad** | 2007 | -0.7 | -0.9 | -8.1 | -5.7 | -1.3 | -1.5 | -48.4 | -0.4 | -1.3 | -0.2 | -3.8 | -0.3 |
| | 2008 | -1.4 | -0.9 | -4.5 | -15.4 | -0.7 | -0.7 | -39.3 | 10.5 | 2.8 | 6.8 | -2.5 | -0.3 |
| | 2009 | 0.3 | -0.7 | -7.7 | -19.4 | 0.1 | -0.6 | -1.3 | 11.3 | -0.7 | -0.1 | -1.8 | -0.5 |
| **Inside** | 2007 | 31.3 | 6.0 | 12.8 | 10.2 | 8.1 | 5.2 | 51.8 | 12.5 | 5.5 | 5.8 | 3.2 | 3.8 |
| | 2008 | 19.2 | 5.0 | 8.2 | 15.9 | 3.8 | 3.9 | 40.5 | 6.5 | -0.5 | 6.8 | 3.5 | 3.7 |
| | 2009 | 9.5 | 1.4 | 8.8 | 21.4 | 0.3 | 0.9 | 1.1 | 11.3 | 2.7 | 3.9 | -0.1 | -0.1 |
| **Investment portfolio** | 2007 | -1.8 | -1.6 | -2.3 | -2.0 | -2.3 | -0.8 | -1.6 | 6.8 | -1.3 | 0.4 | -6.5 | -0.6 |
| | 2008 | -1.7 | -0.2 | 3.1 | -73.7 | 1.1 | -0.3 | -2.4 | 6.5 | -0.5 | -0.4 | 1.5 | 2.5 |
| | 2009 | -1.8 | 3.2 | -10.5 | -67.1 | 1.5 | 2.6 | -3.5 | -33.4 | 3.6 | 0.4 | 13.3 | -1.5 |
| **Derivative financial instruments** | 2007 | -0.2 | 0.0 | -0.3 | 0.6 | 0.8 | 0.0 | 0.8 | 2.2 | -0.5 | -0.2 | 0.0 | 0.1 |
| | 2008 | -0.1 | -0.4 | 0.3 | -1.1 | -0.3 | 0.0 | 0.0 | -6.0 | -0.2 | -0.2 | 0.1 | -0.2 |
| | 2009 | -0.1 | -0.2 | 0.1 | 0.1 | 1.6 | 0.1 | 0.7 | -1.2 | -0.3 | 0.0 | 0.0 | 0.4 |
| **Other investment** | 2007 | 17.9 | 0.1 | 14.2 | 7.4 | 19.3 | 13.0 | 5.3 | -12.5 | 6.6 | 11.2 | 12.5 | 6.2 |
| | 2008 | 17.5 | 0.6 | 4.9 | 90.7 | 7.6 | 5.0 | 16.5 | -4.7 | 5.8 | 6.5 | 3.8 | 2.0 |
| | 2009 | -1.6 | -1.0 | 2.7 | 72.1 | -11.2 | -10.5 | 8.0 | 27.0 | 3.0 | 2.0 | -11.7 | 6.3 |
| **Official international reserves** | 2007 | -10.1 | -0.5 | -0.6 | 1.4 | -3.4 | -3.0 | -0.1 | -6.0 | -3.0 | -3.6 | 0.4 | -5.1 |
| | 2008 | -2.0 | -1.1 | -3.1 | 1.6 | 1.9 | 2.4 | -7.3 | -4.7 | 0.7 | 0.1 | 0.1 | 0.2 |
| | 2009 | 1.9 | -1.7 | 0.0 | 0.5 | -4.9 | 0.2 | -5.9 | 0.0 | -3.4 | -1.1 | 0.5 | 0.9 |

*Source: Compiled with reference to the data EUROSTAT, IMF database*

## IV. ANALYSIS OF THE BALANCE OF PAYMENTS DATA BY QUARTER

The consequences of the economic downturn were unexpected and shocking for many countries; the situation was changing from quarter to quarter and even from month to month. It is therefore reasonable to make an analysis of the data by quarter (see Fig. 2).

From quarterly data on certain countries for 2008 an 2009, the following consistent patterns may be observed:

1) As regards three main current account balances (those of goods, services, and income), the balance of services was characterised by stability in all countries; moreover, it had the largest positive impact on the decrease in the current account deficit and even on the formation of a surplus in most of the countries (except for the Czech Republic and Slovakia, where the balance of goods dominated).2) From the beginning of 2008, the balance of goods was improving in all countries, which was owing to a decrease in imports; however, this situation cannot be given an unambiguously positive assessment since import flows decreased due to the reduced countries' financial capacity to import. This pattern does not fully apply to Slovenia, where from the middle of 2009 the balance of goods was moving towards deficit; however, it showed a relative strength of this country's economy and growing financial capacity to import goods

3) The balance of income was also characterised by stability in all countries (except for the Czech Republic and Cyprus); it remained traditionally negative, except for Latvia and Lithuania, where it was influenced by the investment income balance.

4) Data on current transfers are not shown in Fig. 2; however, their influence on the current accounts of all the countries discussed in the paper may be seen from the data

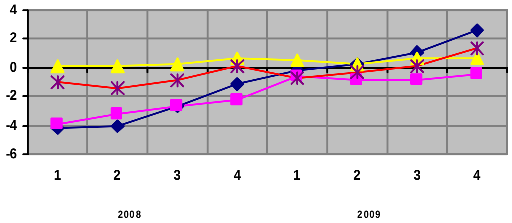
presented in Table 2. During a period of economic downturn, a noticeable growth was observed for private remittances to the Baltic States, Bulgaria, Romania, and Poland.

With the start of the economic downturn and financial turmoil, there were no major changes in capital accounts; in financial accounts, however, significant changes in trends were observed for financial accounts (see Table 2). It was to a certain extent influenced not only by a deterioration in investment portfolio balances but also by an increase in liabilities in other investment balances. The most noticeable growth in other investment liabilities was observed in Bulgaria, Lithuania, Latvia, and Slovenia. Meanwhile, in the investment portfolio balances of Malta and Cyprus, breaks in the flows of foreign assets and liabilities were observed, which also partially manifested themselves in Hungary, where major changes took place in inward and outward direct investment flows.

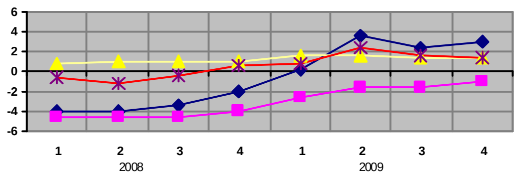
Poland and, in particular, Slovenia were characterised by a high positive investment portfolio balance; however, it was also at the expense of an increase in liabilities.

In summary of the analysis of quarterly data, it may be stated that major changes in the balance of payments of the new EU member states took place in the second half of 2008–first half of 2009. During the period in question, although the current account deficit was decreasing, it was at the expense of a sharp decrease in imports, even though the balance of services remained relatively stable. In the second half of 2009, a recovery in export flows was observed; however, an increase in imports was still impeded by the lack of assets. Meanwhile, investment processes have not yet recovered, and the balances of financial accounts remain negative due to increasing liabilities.

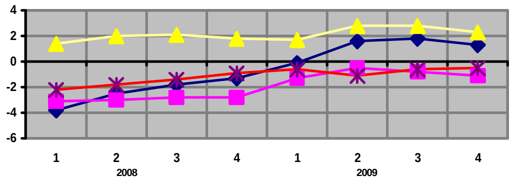
Lithuania



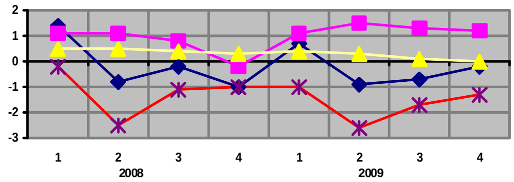

Latvia



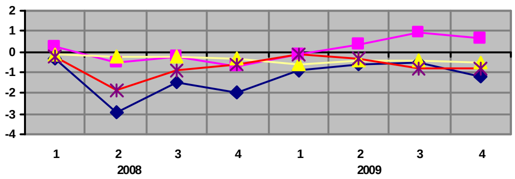

Estonia



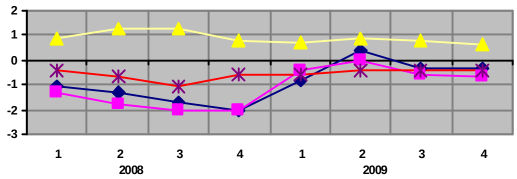

Czech Republic



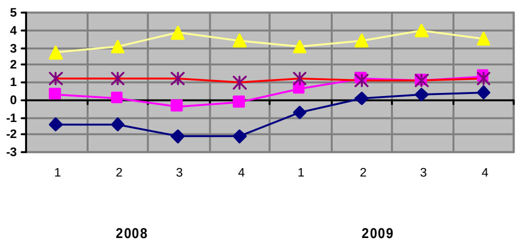

Slovakia



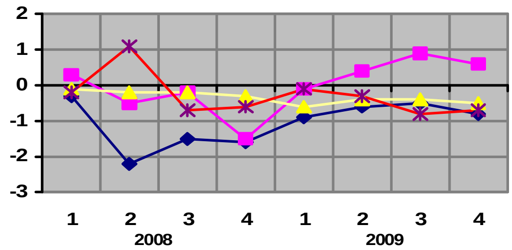

Slovenia

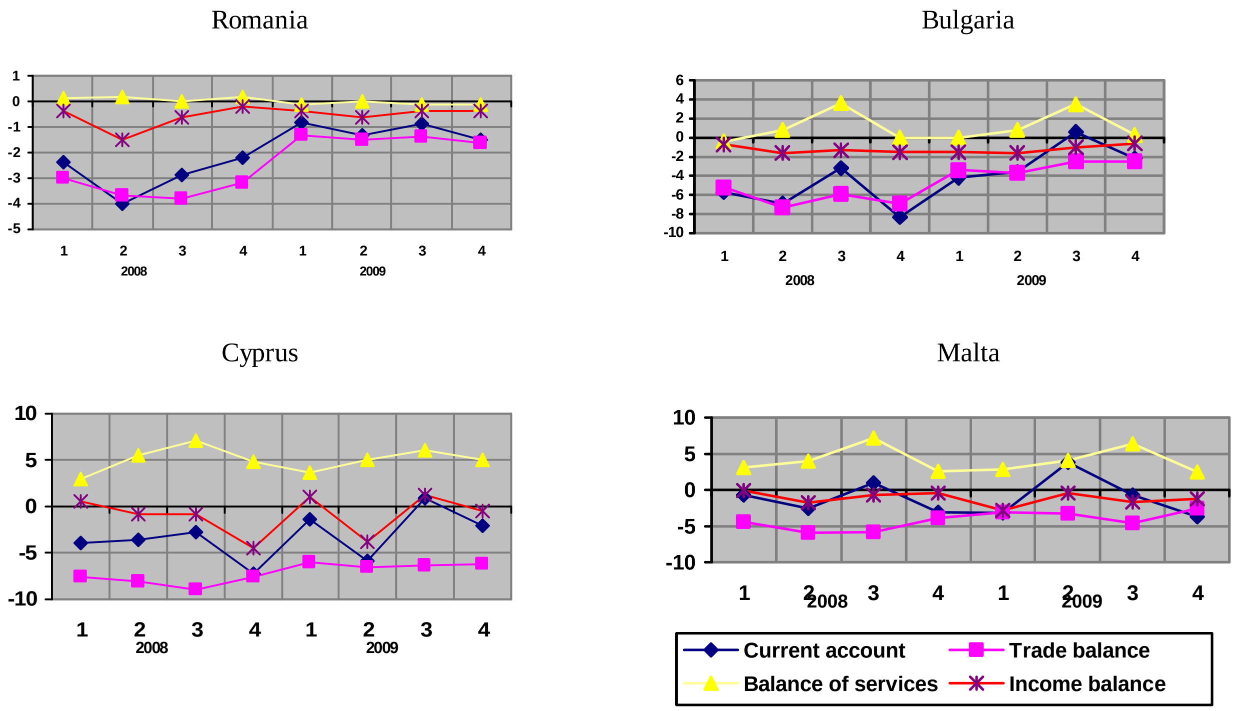



Hungary




Poland






*Source: Compiled with reference to the data EUROSTAT, IMF database*

Fig. 2. Balances of the current account, goods, services, and income (quarterly data, compared to GDP, per cent), 2008–2009

## V. Conclusions

1. During a period of a rapid economic growth, the current account deficit or surplus of the balance of payments of the new EU member states was acceptable if, in the long-term period, the correction or, theoretically, sustainability of the imbalance was expected.

2. In the face of the economic downturn or crisis, current account deficits in most of the new EU member states have been decreasing owing to a decrease in domestic demand and, subsequently, imports. This, together with a simultaneous decrease in export flows, resulted in a decrease in the deficit of the balance of goods. Balances of services in the period in question showed no strong trends; however, in most of the countries, their surpluses were recorded.

3. There were no major changes in capital accounts; in financial accounts, however, deficits were recorded. They were particularly large in the Baltic States, which was owing to a considerable increase in portfolio investment (in Estonia) and other investment (in Lithuania and Latvia) liabilities. In other countries (Bulgaria, Romania, Cyprus, Slovenia, and Slovakia), financial account surpluses were also on the decrease, while in the Czech Republic and Poland they remained relatively stable

4. During a period of the economic downturn, there was an increase in current transfer flows in some of the new EU member states (in particular in the Baltic States, Bulgaria, and Romania), while official international reserves decreased in all new EU member states.

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