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Robert C. Shelburne*

Current Account Deficits in the New Member States: Causes and Consequences

Rapidly growing and fundamentally sound economies like those of the new EU member states should be able to borrow externally and thereby run large current account deficits for a considerable period of time. They have been doing this for almost a decade and as a result their businesses have been able to invest more and their residents consume more than would have been possible otherwise. That development model is now being tested severely by the current financial crisis. The degree to which they will be able to maintain capital inflows and growth over the next year will have important implications not only for them, but for what is generally considered to be a desirable development model. The world's overall assessment of the acceptability of, and the need for, a fundamental reform of the current international monetary architecture will also depend critically on what happens in these economies.

The 12 new member states of the EU (NMS) have been running quite sizable current account deficits which have averaged 5.6% of GDP over the last decade. These deficits have increased slightly since these countries officially joined the European Union. The average deficit during 1999-2003 was 4.9% of GDP while it increased to 6.3% of GDP during 2004-2008.¹ Using non-weighted averages the increase has been slightly larger, growing from 5.1 to 8.9% of GDP due to the fact that the current account deficits have been particularly large in the smaller Baltic economies. Large current account deficits, although somewhat typical of all the emerging economies in Europe, are presently atypical of most emerging markets which have increasingly been running current account surpluses. For 2008, five of the NMS had current account deficits greater than 10% of GDP and all of them were above 3.0%. With the global tightening of credit conditions, these deficits now represent a serious macroeconomic vulnerability; the required economic adjustments in terms of exchange rates, credit growth, asset prices, and fiscal spending will be significant and could potentially precipitate domestic financial crises in these economies. Already Hungary and Latvia have experienced some difficulty and over the next year a number of others are likely to require IMF borrowing or some other form of assistance in order to replace their more limited access to private international capital markets.

Savings and Investment in the NMS

Given these sizable, persistent and somewhat atypical current account deficits, questions arise as to what have been the underlying factors causing them. Since a current account deficit is an accounting identity equal to the difference between national savings and investment, one way to address this question is to ask whether they are due to insufficient savings or excessively large investment; in other words, in the identity below, is the negative current account (CA) due to S (savings) being too small or is I (investment) too big?

$$CA = S - I$$

There are however, several ways that this question can be answered. For instance, the actual values of savings and investment can be compared to international norms in order to see to what degree the NMS values are "abnormal". Alternatively, current values of saving and investment can be compared to historical values for these economies when they did not have large current account deficits in order to see what changed in order to bring them about. Unfortunately for a clear interpretation of the underlying cause of the NMS deficits, these two approaches provide somewhat different answers. In Figure 2, savings and investment in the NMS are provided for the last decade and are compared to that of its closest reference

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¹ Bulgaria and Romania did not join the EU until 2007 while the other ten joined at the beginning of 2004. Although this article focuses on the 12 NMS, the situation of the south-east European countries, some in various stages of EU accession, are roughly similar.

Figure 1
Current Accounts of the NMS

1999-2008

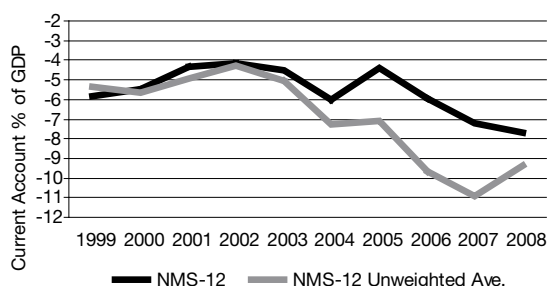
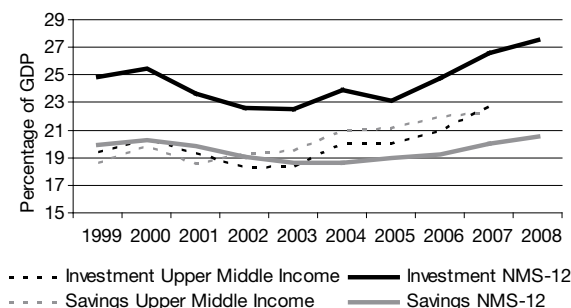


Figure 2
Domestic Savings and Investment Rates in the NMS Compared to Other Upper Middle Income Countries



group, the upper-middle income countries.² For the NMS, investment exceeds savings as expected from the current account identity presented above, and the increase in the difference in the last several years is due solely to an increase in investment as savings actually increased very slightly. Unfortunately there is no historical period for which there is consistent and reliable data where savings and investment were equivalent which would allow a more complete answer to this question. Thus, from a historical point of view all that can be said is that the more recent increases in the size of the deficits in the NMS are due to increasing investment.

However, a comparison of the NMS with the upper-middle income countries suggests that deficient savings is also important. The NMS have on average an investment rate which is higher by four percentage points of GDP due possibly to the many opportunities of EU membership although this differential has not increased since well before EU accession. In terms of other geographical comparison groups, investment rates in the NMS are above those in Latin America but below those in east Asia. In terms of savings, the NMS have savings rates in the range of two to three percentage points of GDP lower than the upper-middle income countries. Thus, comparatively speaking, the NMS appear to under-save and over-invest, with the latter slightly more important.

This pattern of deficits for the NMS is really not that different from the longer-term pattern of the southern European economies (Greece, Portugal, and Spain) which have also financed much of their investment over the last two decades from foreign borrowing. In fact, even now, these three economies, in aggregate,

² The use of the appropriate reference group has important implications for this comparison as savings and investment rates for the NMS are lower than for many developing countries but somewhat higher than the advanced economies.

have even larger deficits (as a percentage of GDP) than the NMS. Empirical research has shown that being in the EU increases the magnitude of the absolute value of the current account as a percentage of GDP while being in the eurozone increases it further; the poorer economies generally have deficits.³ The so-called Feldstein-Horioka β estimate of the correlation between savings and investment was only 0.14 in the eurozone during 1991-2001. This suggests that in the eurozone investment is now largely independent of savings with the difference readily financed by international capital flows.

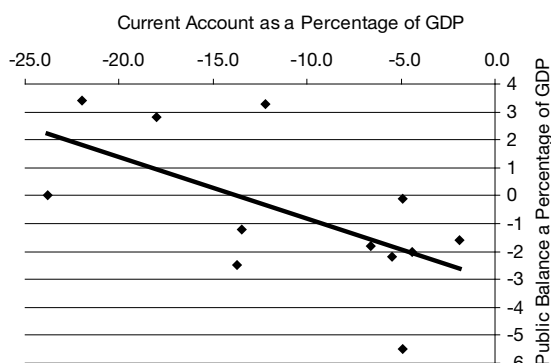
What lies behind these savings and investment patterns? A factor often alleged to contribute to a current account deficit by lowering savings is a government budget deficit, the so-called twin deficits proposition. Since a government budget deficit represents dissavings, it is clear from the identity above that lower public savings could reduce total national savings and thus create a current account deficit. However, except for Hungary, the NMS do not have large public deficits and therefore this would not appear to be a significant factor causing savings to be so low in these economies.⁴ In fact as shown in Figure 3 there is a rather strong negative relationship between the budget balance and the current account balance for these economies.

Thus the reason for low domestic savings in the NMS must be low private savings, but exactly why pri-

³ O. Blanchard, F. Giavazzi: Current Account Deficits in the Euro Area: The End of the Feldstein-Horika Puzzle?, in: Brookings Papers on Economic Activity, No. 2, 2002, pp. 147-209.

⁴ It is sometimes alleged that public dis-saving leads the private sector to compensate by saving more as they anticipate higher future taxes will be necessary to pay off the debt accumulated. This proposition, known as Ricardian equivalence, has mixed empirical support.

Figure 3
The Relationship Between Government Budget Deficits and Current Accounts in the NMS, 2007



vate savings in the NMS is so low is not sufficiently understood. It might be expected that these economies would have high savings and current account surpluses if they followed the basic intertemporal consumption smoothing hypothesis of the current account.⁵ Given that there has been a recent spurt of growth in these economies, this theory suggests that savings should have increased and the current account improved. A possible reason that this has not happened is that open advanced economies and emerging markets appear to respond differently to a spurt of economic growth.⁶ When advanced economies experience growth, agents tend to view it as a positive transitory income shock and they therefore increase savings consistent with this hypothesis. However, when a similar growth spurt happens in an emerging market, agents interpret it not as a transitory shock but as a sign that there has been a likely increase in long-term growth and thus they increase consumption consistent with consumption smoothing. Thus in both cases households desire to smooth their consumption over time, but the key difference is how agents interpret the implications of recent growth for their expectations about long-term growth. Thus in the NMS, the recent growth has been interpreted by residents not as a spurt of growth but as meaning that these economies are now in the process of converging towards western European living standards and as a result they are choosing to borrow now off their anticipated future income. Generally, current account deficits are to be expected in countries where the pop-

⁵ M. Obstfeld, K. Rogoff: *Foundations to International Macroeconomics*, Cambridge, MA 1996, MIT Press.

⁶ M. Aguiar, G. Gopinath: *Emerging Market Business Cycles: The Cycle Is the Trend*, NBER Working Paper, No. 10734, Cambridge, MA 2004, NBER.

ulation has expectations that future economic growth will be relatively high compared to other countries, as households in the fastest growers will have the greatest demands for increasing consumption (absorption) above current income levels.

However, this is not always so, as is obvious from the Chinese case; thus additional factors need to be considered. One additional consideration that may account for the relatively low rates of savings in the European emerging markets is that they are somewhat unique amongst emerging economies in that they are rapidly aging societies. Cross-sectional empirical research on savings has found that aging is associated with lower savings (as the old dis-save) and investment (due to lower labour force growth) with the effect on saving being greater, so that aging societies are more likely to run current account deficits.⁷ Thus this factor may be an important reason why savings are low in the NMS relative to east Asia despite the fact that both are fast growing regions.

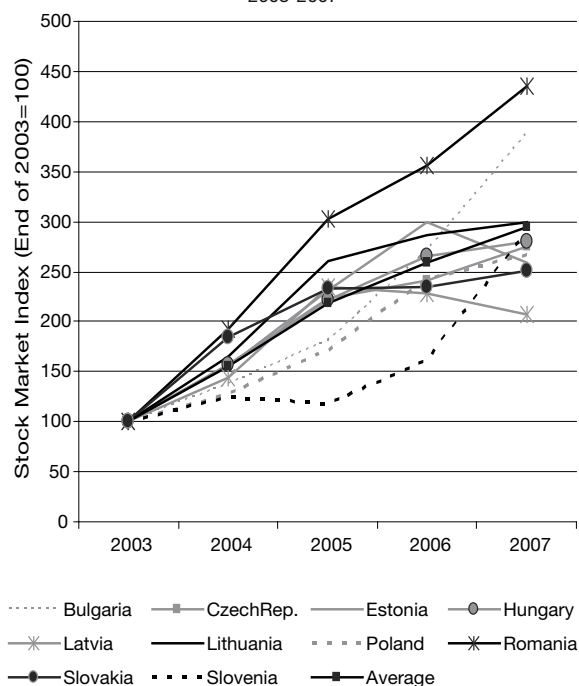
In addition to their expectations about future income growth and the aging of the population, the NMS also have well-developed safety nets and retirement systems which reduce the need for precautionary and life-cycle savings. A further important consideration must be the rapid increase in wealth from asset price inflation, which has allowed households to reduce the need to save out of current income. This is essentially the factor that explains the low savings rate in, and the current account deficit of, the United States. In most of the NMS the prices of both housing and financial assets have been increasing quite rapidly. Nominal house prices in national currency increased during 2002-2006 at an annual rate of 36.4% in Estonia, 23.8% in Lithuania, 23.5% in Bulgaria, 11.9% in Hungary, 9.9% in Slovenia and 9.8% in the Czech Republic.⁸ Although stock ownership is not widespread in the region, the value of stocks has appreciated considerably over the last five years. In Figure 4 the stock market index for 10 of the NMS between 2003 and 2007 is plotted; the average of these indexes tripled between 2003 and 2007. The index was up by a factor of four in Bulgaria and Romania. Of course there were reversals in asset prices in 2008 and as a result some increase in savings is expected in the future.

The other variable in the current account identity is investment and the NMS have rates that are almost

⁷ B. Bosworth, G. Chodorow-Reich: *Saving and Demographic Change: The Global Dimension*, Population Aging Working Paper, Washington, DC 2006, Brookings Institution.

⁸ B. Egert, D. Mihaljek: *Determinants of Housing Prices in Central and Eastern Europe*, BIS Working Paper, No. 236, September 2007.

Figure 4
Stock Market Indexes in the NMS
2003-2007

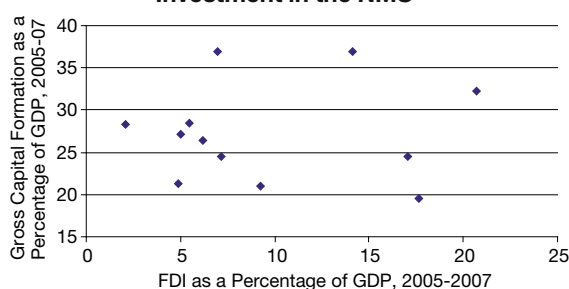


4 percentage points of GDP greater than the upper middle economies overall. The NMS reliance on foreign savings to finance a significant proportion of their investment is what economists had generally expected would happen once financial markets became globalised. With these economies fully integrated into the prosperous EU market and with considerably lower wages and relatively highly skilled labour, it would appear that firms in these economies would be quite competitive and thus a high level of investment would be expected. In addition, these economies have been quite open financially to foreign investment. Euroisation is quite high in the region due to either the adoption of the euro, or a strong peg to it, or its widespread use without any *de jure* connection, and as a result borrowing costs have been considerably lower than in other emerging markets.

Just as capital inflows can finance increased consumption instead of investment, it is the case that the different types of capital inflow affect capital formation differently. For example, empirical research has found that inflows in the form of bank loans and bond funds tend to crowd out domestic investment while FDI tends to increase it.⁹ In addition, FDI has been

⁹ B. Bosworth, S. Collins: Capital Flows to Developing Countries: Implications for Savings and Investment, in: *Brookings Papers on Economic Activity*, No. 1, 1999, pp. 143-169.

Figure 5
The Relationship between FDI and
Investment in the NMS

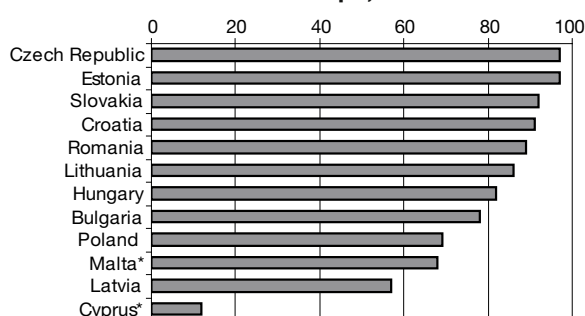


found to be more stable over time. As a result, FDI has been presented as the most desirable type of capital inflow and the one most likely to be associated with increased investment and growth. For the countries as a group, FDI has most likely increased investment, but within the NMS, as shown in Figure 5, there does not appear to be much of a connection between the level of FDI and the country's overall investment rate. Although there is nothing necessarily inappropriate with financing consumption externally, policymakers may need to direct more attention towards ensuring that FDI contributes to, rather than substitutes for, domestic investment.

The Nature of NMS Capital Inflows and their Vulnerability

The capital inflows into the European emerging markets are somewhat unique in regard to the specific institutional mechanism that has channelled this capital into these economies. The banking systems there are primarily foreign-owned; west European banks either obtained NMS banks when they were privatised during the transition or have made greenfield investments. The level of foreign ownership is much higher in the NMS than in other emerging market geographical regions although foreign ownership appears to have increased significantly over the last decade in a number of regions including Latin America. The degree of foreign ownership is shown in Figure 6. Generally foreign ownership is in the form of subsidiaries rather than branches. Foreign ownership in the Baltic economies is primarily from Sweden while for the other NMS it is primarily from Austria and Italy. Essentially the west European parents have been loaning money to their eastern European subsidiaries which then financed investment projects in the NMS. Since the funds provided by the parents were usually in euros, the east European banks often lent in euros to minimise currency risks. This practice, however, has potentially increased default risks from balance sheet effects of

Figure 6
Percentage of Foreign Ownership of Bank Assets
in Eastern Europe, 2007



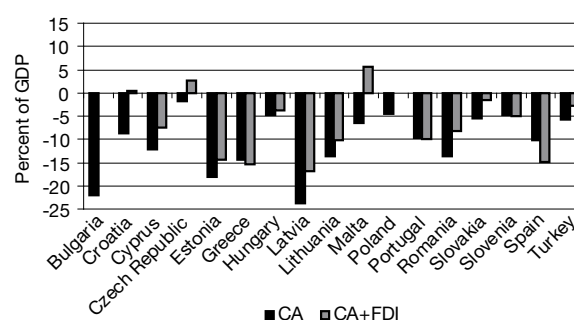
Note: Asterisk for 2003 data.

unanticipated exchange-rate depreciations and has thereby created an additional source of vulnerability for these economies.

An issue of current importance, of course, is the degree to which these current account deficits pose a financial vulnerability for these countries. A significant current account deficit is perhaps the most important explanatory variable in predicting subsequent financial and/or currency crises. Thus a current account deficit which lasts for more than a transitory period is often perceived in policy circles to represent an obvious economic problem, like inflation or unemployment, that requires a policy induced adjustment. However, from a more theoretical point of view, when the current account deficit is the result of rational private sector saving and investment decisions and there are no market distortions, there is no generally agreed upon justification for government action to reduce the current account deficit since (in most economic models) none of the usual policies can be shown to increase intertemporal social welfare. This would appear to be the case even in instances where the current account deficit is so large as to be unsustainable in the long run. In this case market participants supposedly will adjust their savings and investment decisions as time goes on in such a manner as to bring about the economically efficient adjustment.¹⁰ An obvious question is whether or not there are widespread distortions or market failures that would invalidate these conclusions. In addition, given a number of macroeconomic constraints that existed to varying degrees, including limitations on exchange-rate flexibility, monetary policy and liberalisation of the capital account, the policy options for addressing these current account deficits were somewhat limited. Thus it is not clear that the

¹⁰ O. Blanchard: Current Accounts in Rich Countries, in: IMF Staff Papers, Volume 54, No. 2, 2007, pp. 191-219.

Figure 7
Current Accounts and Adjustment for FDI, 2007



failure of the NMS to more aggressively contain their deficits represents a real policy failure.

It is often alleged that current account deficits financed by FDI inflows are unlikely to be problematic as these flows are likely to be much more stable than other types of capital inflows. FDI does in fact account for a significant portion of most of these economies' deficits as shown in Figure 7, which includes a few others for comparison's sake. This was certainly one reason that policy makers were inclined to ignore these deficits.

However, new projects need not be undertaken and reinvested earning can instead be repatriated if economic conditions deteriorate. It should be noted that in Malaysia in 1996 the current account (4.6% of GDP) was fully financed by net FDI inflows (5.3% of GDP) and FDI fell by more than half between 1996 and 1998 (\$5.08 billion to \$2.16 billion). Thus, although FDI may be more stable than other types of capital inflows and an analysis of the vulnerability posed by a current account deficit may need to consider the proportion financed by FDI, it is simply incorrect to view FDI as invariant to market turmoil.

An unresolved question is whether the integrated banking systems linking western and eastern Europe will prove during the current crisis to be either channels of contagion where the financial crisis that has affected banking solvency in western Europe moves eastward; or whether, given the inability to borrow on "frozen" international capital markets, these relationships will provide a lifeline of liquidity. How this plays out over the next year will determine the perceived desirability throughout the developing world of liberalising banking systems and allowing foreign ownership for decades to come. The region has benefited considerably from the pro-active assistance of the ECB to non-euro economies including Hungary and Poland,

and the swap facility set up by the central banks of Denmark and Sweden to aid Latvia. Additional EBRD support, especially that to foreign-owned bank subsidiaries, in compensating for declining private inflows is also a positive development; its assistance to the other non-EU transition economies is also important for maintaining stability in the larger region. These alternative sources of finance are extremely important because the IMF simply does not have the funds in sufficient quantities to replace the drop-off in private flows.

An additional consideration in assessing the vulnerability of NMS current account deficits is that they receive net transfers from the EU due to the benefits they get from the EU Social and Cohesion funds; these have been and are projected for the next several years to be several percentage points of GDP. Normally transfers would appear in the balance of payments above the current account line so they would finance additional imports without worsening the current account; in such a case they would not be a factor that needed to be considered in assessing the current account situations of these economies. However, it is believed that there are a number of accounting idiosyncrasies regarding these which have the result of "artificially" enlarging the current accounts of the NMS. For example, it is generally thought that these countries' contributions to the EU are usually included above the line, but that their payments from the EU, especially for investment projects, are included below the line in the capital account. Thus the "proper" inclusion of all the inward transfers, some of which currently appear in the capital account, would have the effect of reducing the size of their deficits. It is, however, difficult to quantify the magnitude of this problem due to the uncertainty about where these funds have been placed in the balance of payments statistics.

The Future Implications Resulting from the Global Financial Crisis

One of the main arguments for having an open financial system is the ability of a rapidly growing but capital-scarce emerging market to be able to borrow externally to finance its development. This is of course what the NMS as well as the other European emerging markets have been doing over the last decade. A properly designed international financial system should be able to carry out this function without the process inevitably ending in some form of financial crisis which wipes out all or a significant amount of gains from the capital inflows. The current system, however, has proven to be arguably inadequate in fulfilling this

objective. Countries that have relied extensively on external capital, whether it be Latin America in the 1970s to 1980s, east Asia in the 1990s, or eastern and central Europe today, tend to end up in a crisis. In each case, it is always possible to argue that the countries made some mistake to bring on the crisis, whether it be large fiscal deficits as in Latin America, excessive real estate investment, foreign-currency-denominated loans, or fixed exchange rates as east Asia and perhaps likewise in emerging Europe today.

The degree to which the European emerging markets can weather the current crisis will have major implications for what is viewed to be a suitable development model as well as for the degree to which the international monetary system will need to be reformed. If these economies get through this global financial crisis with only a moderate downturn in growth, it will suggest that relying on net external capital is a reasonable development model and that the international monetary system may need only measured reform in its architecture. However, if they should suffer major crises, such as those in east Asia in the 1990s, it will suggest that relying on net external capital is foolhardy given the current system. In such a situation, it will be clear that when so many different countries, under so many different economic circumstances, experience crises from relying on private capital inflows, that there is a fundamental systemic problem in the current design of the international monetary system. As a result, there will likely be calls for a major reform in the current design of the world's monetary system on par with what happened in Bretton Woods in the 1940s.

In conclusion, rapidly growing and fundamentally sound economies like those of the NMS should be able to borrow externally and thereby run large current account deficits for a considerable period of time. They have been doing this for almost a decade and as a result their businesses have been able to invest more and their residents consume more than would have been possible otherwise. That development model is now being tested severely by the current financial crisis. The degree to which they will be able to maintain capital inflows and growth over the next year will have important implications not only most obviously for them, but for what is considered to be a desirable development model most generally. In addition, the world's overall assessment about the acceptability of and the need for a fundamental reform of the current international monetary architecture will also depend critically on what happens in these economies.