

Financing of current account deficit in new member states and Croatia*

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Abstract

The aim of this paper is to analyze the transition results in the countries of the last wave of accession to the European Union. After they joined the EU, the average productivity growth dropped in the first year, but later this was overcome. While the rate of GDP growth rose in most NMS countries, current account deficits remained very high and foreign direct investments were not capable of covering current account deficits in all NMS countries. Both the rising external debt in many NMS countries and the accumulation of household debts resulting from fast credit growth create a risk in most countries. The comparative analyses show that some governments need to work at sustainable economic policies to keep inflation under control and reduce external vulnerability. The conclusion of the paper is that regardless of the availability of EU funds, national investment policy will have considerable impact on the real growth of the economy.

Key words: catching-up, transition, labour productivity growth, investment policies, external risk, foreign debt

JEL classification: O057, F15

1. Introduction

The paper contains the quantitative analysis with a quality approach that takes into account macroeconomic effects of macroeconomic variables on the economies of the EU New Member States. The first section analyses the transition in the new EU member states and Croatia. Analysis is based on the EBRD, UNCTAD, Eurostat and OECD statistics. Countries that joined the EU integration experienced strong convergence in the period 2001-2007 and catching up with the USA. The process of convergence has been helped by large inflows of capital into the NMS. As a

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consequence, consumption and investment grew faster while rising EU funds helps sustain consumption and investment higher. The special emphasis is given to the productivity growth given the effect of labour utilization on the difference between productivity and per capita income.

The second section analyses the FDI flows in NMS. With the fall of communism in central and eastern European countries (CEECs), FDIs have become the most important method for placing capital. Motives behind FDIs investments vary, from easing entry into the domestic market to the different idiosyncratic motives for investment. Whatever the motives may be, the fact is that FDIs have grown rapidly. FDI flows grew considerably faster than trade in goods and services (World Investment Report 2005). Foreign Direct Investments (FDIs) are influenced not only by government policies, but also by profit seeking motives of the company behaviour and technology. The role of FDI and TNC activities in the global economy is still growing and that is reflected in sales, property, added value, employment and export of foreign subsidiaries. It also has been claimed that FDI allows the transfer of technology, especially in the form of new varieties of capital input, while the recipients of FDI often gain employee training in the course of operating the new business and profits generated by FDI which contribute to corporate tax revenues in the host country (Razin and Sadka, 2001; Feldstein, 2000). There are, of course, international trade effects of FDIs. Host governments often focus predominantly on the export aspects of FDI, forgetting that import coefficients of the projects are also important, as they may affect the overall trade balance

(Jovančević R., and Šević Ž., 2006). A successful FDI has impact on both exports and imports, besides employing locally attracted resources. That enables faster economic growth, especially when the country is more economically integrated. This is even more interesting for former socialist countries that had no market economy for half a century. The insight into results shows that current account deficits remained very high, and foreign direct investments were not capable of covering current account deficits in all NMS. However, FDIs are not a substitute for domestic capital. It seems that a high share of FDI in total capital inflows may be a sign of a host country's weakness rather than its strengths, according to research by Hausmann and Fernández-Arias (2000). Further analysis shows that successful catching-up was followed by foreign trade imbalances.

The third part analyses the foreign debt, which might be an important source of economic growth. Finally, we gave conclusion.

2. Transition in the new EU member states and Croatia

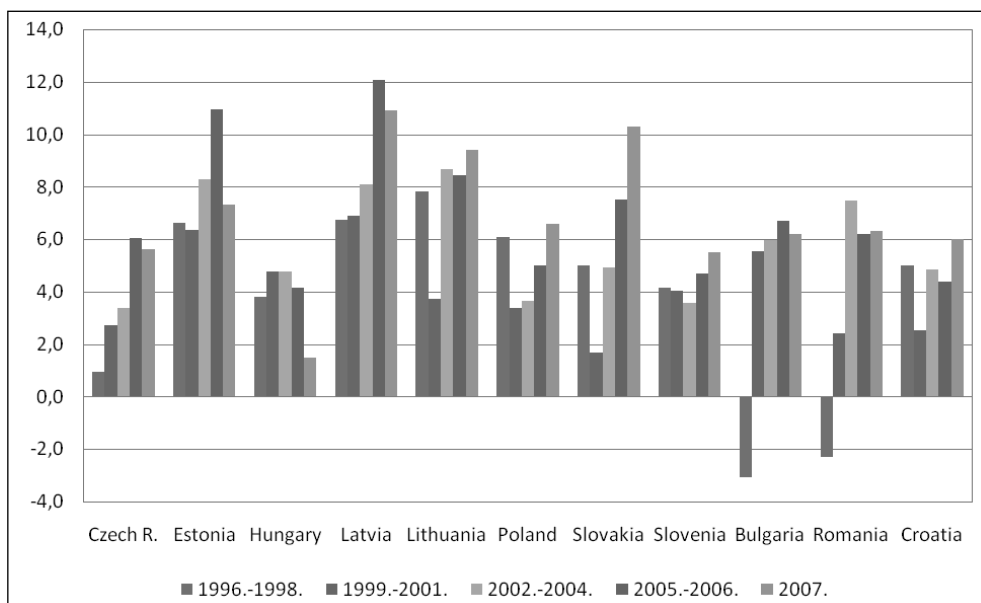
The new member states are catching up with the major advanced West European economies. The new EU member states have benefited from their integration into the European single market, by opening up new trade and investment opportunities

and by anchoring macroeconomic and institutional reforms. Over the past 12 years, GDP growth in emerging Europe accelerated to 6.3 percent in 2006, and the growth rate declined only slightly in 2007 (EBRD, 2007).

Croatia has also benefited from EU accession negotiations that began on October 2005 and is continuing to do so. Croatia continues to meet the Copenhagen political criteria and implemented the minimum standard agreed by the EU acquis. A clear view of performances of the accession countries is presented in figure 1. Real GDP growth held up dynamics in most accession countries until 2006, although the pace of economic expansion decelerated in some countries in Central and Eastern Europe. The growth in emerging Europe slowed moderately to 5.5 per cent in 2007, reflecting the cooling of the expansion in Western Europe (World Economic Outlook, 2007). GDP growth was obtained, in spite of increases in oil prices in 2005 and 2006. However, high oil prices could generate potential effects in wage and price-setting performance, pushing up inflation and impacting investment behavior (OECD, 2004).

The NMS follow the convergence hypothesis according to which countries with relatively lower levels of per capita GDP grow more rapidly. Growth and per capita income figures indicate that catching-up has been successful in most NMS and Croatia (Figure 1).

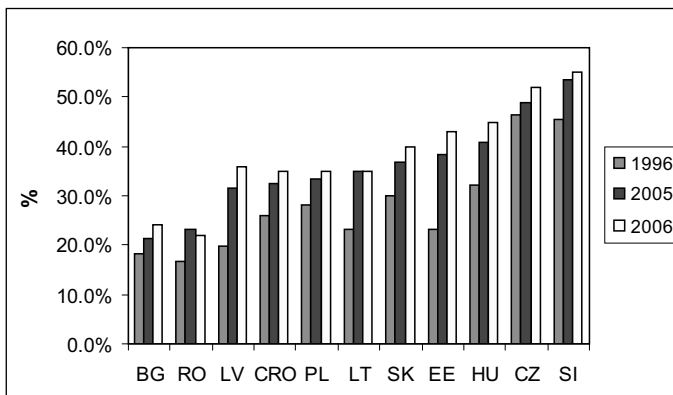
Figure 1: Growth of real GDP per inhabitant in new EU member states and Croatia, 1996-2007 (in per cent)



Source: Based on data from Eurostat, 2008

The progress, which has been made, graphically presented in figure 2, represents the existing gap in per capita GDP (expressed in PPP) for analyzed countries compared with US per capita GDP. The length of marks between 1996 and 2006 represents the progress achieved by a given country in this period and catching up with the USA. The convergence has been particularly remarkable in Slovenia, Czech Republic and Hungary. Slovenia shows favorable progress due to export expansion and higher gross fixed capital formation and so far is the first country that has met the Maastricht criteria and joined the euro area without any difficulties. Baltic countries are showing considerable improvement in the level of GDP per capita, but their growth is by large part financed by FDI inflows. Croatia is also catching up in GDP per capita relative to USA, while Bulgaria and Romania are doing the same with slower pace. The performance of emerging economies is due to their strong commitment to create an attractive business environment (including lower tax burden) and sound macroeconomic policies.

Figure 2: Per capita income gap relative to the US (USA = 100)



Source: Based on figures from Eurostat, 2007

Rising EU funds help sustain consumption and investment. A total of EUR 1 908.8 million was paid in 2006 for compensation and pre-accession strategy to the EU-10 New Member States (EU Commission, 2008). As in 2005, the largest recipient in 2006 was Poland, followed by the Czech Republic and Hungary. The total of the budgetary compensations for the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia (EU-10), agreed in the Copenhagen accession negotiations, was executed in 2006 for a total of EUR 1 073.5 million (EU Commission, 2006)². In 2006, the ratio of EU allocated expenditure on GNI: — it reached 3.59 % in

² In 2006, the ratio of EU allocated expenditure on GNI: — it reached 3.59 % in Greece ahead of 3.45 % in Lithuania. They were followed by Malta (3.25 %), Latvia (2.56 %), Portugal (2.44 %) and Estonia (2.39%); between 1.63 % and 2.22 % was in Hungary, Poland, Cyprus, Slovakia and Ireland; the lowest recipients were Slovenia (1.38 %) and Czech Republic (1.24 %). Croatia has also benefited from the three pre-accession instruments: Phare (EUR 80 million), ISPA (EUR 35 million), SAPARD (EUR 25

Greece ahead of 3.45 % in Lithuania. They were followed by Malta (3.25 %), Latvia (2.56 %), Portugal (2.44 %) and Estonia (2.39%); between 1.63 % and 2.22 % was in Hungary, Poland, Cyprus, Slovakia and Ireland; the lowest recipients were Slovenia (1.38 %) and Czech Republic (1.24 %). Croatia has also benefited from the three pre-accession instruments: Phare (EUR 80 million), ISPA (EUR 35 million), SAPARD (EUR 25 million), and continued to be eligible for the regional programme CARDS (EU Commission, 2008). However, EU funds could not be considered as a magic wand of sustainable growth but merely as an instrument of the EU support for restructuring of economies in order to reach greater competitiveness in the single market.

Recently, some worrying developments arise that put into the question the future sustainability of high economic growth (overheating and the growing current account imbalances). Emerging economies have run out of additional capacity because investments do not keep up with economic growth. Effects of rising food prices are also visible in most NMS where food has a much higher weight in household spending (30-40% of the consumer price index) compared to only 15% in the G7 economies. It could have both social and political impact (Economist, May 2008).

Analyzing the structure of the GDP growth in 2006 in NMS, the data shows high GDP growth in Estonia, Latvia, Lithuania and Romania to be predominantly driven by high private consumption, while the growth in foreign trade deficit has a smaller effect. Overheating remains a great challenge in all those countries. In the Czech Republic, the growth of GDP was driven by the high level of investments, and fast expansion in export, similar as in Hungary where net exports remained the main driver of economic development. In some of these new member states, the impact of growth of fixed assets contributed considerably to GDP growth and this explained partly the differences in growth rates. In Bulgaria, Poland, Slovenia and Croatia, expenditure on construction contributed to a higher growth rate (EBRD Report, 2007).

A sizeable portion of those investments is due to rising disposable incomes and easy access to credit. However, banks financed those investments mainly through cross-border interbank loans. Credit facilities continued to strengthen consumer spending and investment, especially in the Baltic and in southeastern Europe. A significant portion of credit in the Baltic and other emerging Europe has been denominated in, or indexed to, foreign currency. Considerable portion of the credit was earmarked to buying dwellings. Such lending raises macroeconomic concerns. Credit booms in the NMS have been supported by financing through foreign parent banks and have impact on widening external deficit and overheating. Booming credit has boosted private domestic demand and contributed to higher inflation and growing external deficit.

We can see from the table 1 that financial deepening was driven by the large expansion of bank intermediated credits. Financial deepening was very fast in Estonia, Latvia, Croatia and Slovenia while Czech Republic and Poland have experienced a much

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more restrained pace. In the convergence process, diversification and risk sharing have materialized through foreign banks' operations and the inflow of FDI. In the search for higher profitability, foreign banks have diversified themselves by endowing affiliates abroad with large amount of risk capital (IMF, 2007).

Table 1: Credit to Non-financial Corporations and Households, 2000-2006

- GDP=100

Countries	2000	2003	2004	2005	2006
Bulgaria	14.9	28.5	41.4	50.1	62.1
Czech R.	34.2*	33.2	34.5	38.5	45
Estonia	28.5	37.6	48.1	67.4	95.4
Hungary	35.6	42.9	45.6	59.8	55.6
Latvia	19.5	40.6	51.1	70.8	93.1
Lithuania	14.8	23	28.6	38.3	54
Poland	24.3	28.2	26.9	28.8	34.7
Romania	12.4	18.6	21.5	25.9	34.6
Slovakia	..	32.3	29.7	35.3	40.1
Slovenia	44.4	51.7	54.9	67.4	76.9
Croatia	49.9	66.7	70.1	83.5	96.6

Notes: Data include direct cross-border credit.

Sources: Bank for International Settlements; IMF, World Economic Outlook, November, 2007

Financial deepening is a positive process where increases in credit levels accompany economic development. However, credit growth may be unwarranted. Gains in equity and property markets raised the value of collateral and eased access to credit. This in turn fueled demand and valuations in asset markets. The risk will raise once asset prices and collateral values collapsed and interest rates go up, making debt servicing more difficult (Bernanke, 1996).

Although preparations to join the European Union in many countries led to economic reforms, it is hardly enough only to fulfill the requirements of the *acquis*: the focus must be on improving competition in New Members. Most NMS reported strong labour productivity growth rates in the period 2004-2006. One factor that contributes to the difference between productivity and per capita income that should be taken into consideration is the employment growth rate in those countries. The data show that the average annual employment growth rate was not a sizable contributor to GDP growth (EU Commission, Competitiveness Report, 2006). The effect of employment / population ratio in 2006 was the lowest in Hungary (-11%), Poland and Slovakia (-10 %), which was significantly below the EU-27 average (-6,6%). Baltic countries recorded higher effects of employment, but still negative - Latvia and Estonia (-1% each of them) and Lithuania (-6%) while Romania had -4% and Bulgaria faced 0% effect of employment/population ratio (table 2).

However, data on productivity need to be complemented by data on working hours. The data suggest that annual labour productivity growth accelerated in the most of the new EU member states. Strong effect of working hours in 2006 were present in Hungary (6%), Estonia (5%), Czech Republic and Poland (4 % each) and Latvia and Romania (2% each), while other countries were faced with lower effect of working hours on productivity: Lithuania (1%), Slovakia (-1%) and Slovenia and Bulgaria (-2%). Despite the considerable rate of growth of productivity in NMS, the difference between the levels of productivity is still high. In comparison with the US productivity, the EU-15 have reached 90% of US productivity per hour, while EU-12 NMS have got only 38%, which leaves the productivity in enlarged EU-27 community on the level of 78% (table 2).

Table 2: The Effect of Labour Utilization on the Difference between Productivity and Per Capita Income, 2006

Countries	Productivity		Effect of working hours (in percent)	Effect of employment/population ratio (in percent)	Per capita income	USA=100
	Productivity GDP/hour	USA=100				
Malta	32.2	64	0	-14	22,193	50
Slovenia	30.4	60	-2	-3	24,172	55
Cyprus	27.7	55	0	-2	23,794	54
Slovakia	25.9	51	-1	-10	17,740	40
Hungary	25.4	50	6	-11	19,750	45
Czech Republic	23.7	47	4	1	23,007	52
Poland	20.4	41	4	-10	15,367	35
Lithuania	20.1	40	1	-6	15,453	35
Estonia	19.7	39	5	-1	19,052	43
Latvia	17.9	36	2	-1	16,008	36
Bulgaria	13.1	26	-2	0	10,597	24
Romania	11.8	23	2	-4	9,785	22
EU-15	45.3	90	-10.70	-6,00	32298	73
EU-12 (NMS)*	19.3	38	2.90	-6,10	15452	35
EU-27**	39.2	78	-6,30	-6,60	28731	65

* referring to new membership of the European Union as of 1 May 2004 and including Bulgaria and Romania

** referring to all members of the European Union as of 1 May 2004 and including Bulgaria and Romania

Source: Maddison, 2007; based on OECD and Eurostat National Accounts, OECD Economic Outlook and Labour Force Statistics, with GDP converted to US\$ at 2006 EKS PPPs (updated from 2002 benchmark PPPs)

The large part of the difference in labour utilisation in the US and the EU follows, however, from the difference in hours worked per worker. Analyses show that workers in Central and Eastern European countries tend to work longer hours. However, results change when we compare worker and hour productivity. Old EU member states experienced higher hourly productivity while the reverse is true in Hungary, Czech Republic, Estonia and Poland. The data shows that the gap in GDP per capita with the US stems from low labour utilisation rather than weaker productivity. A question is whether the lower employment rate and the lower number of hours worked in Europe can be attributed to institutional failure or to a stronger preference for equity or for leisure (Nickell et al., 2005). OECD studies show that longer weekly working hours in the US than in Europe reflect the differences in the number of hours worked by women (OECD, 2008).

We observe that labour productivity looks higher in NMS after the year 2004 than in old members. Acceleration is especially pronounced in the year 2005 over the year 2004, in the Baltic States, Slovenia, Romania and Slovakia.

Table 3: Growth in total working hours

Countries	Growth in total working hours (annual average, per cent)					Acceleration/deceleration	
	1995-2006*	2000-2006*	2004	2005	2006	2005 over 2004	2006* over 2005
US	1	0.2	1.2	1.5	1.8	0.4	0.3
EU-15	0.9	0.7	1.1	0.7	1.3	-0.4	0.7
EU-NMS ^a	-0.1	0	0.4	2	2.3	1.6	0.3
Bulgaria	1.1	1.9	4	2.4	2.7	-1.7	0.3
Cyprus	2.7	3.3	3.1	2.4	1.6	-0.7	-0.8
Czech R.	-0.4	-0.4	0.8	1.6	1.3	0.8	-0.3
Estonia	0.3	2	0.5	2.7	5.5	2.2	2.7
Hungary	1.8	2	-0.7	-0.1	0.4	0.6	0.6
Latvia	0.8	1.8	-1.6	2.4	4.3	4.1	1.9
Lithuania	0.7	1.1	1.3	6	0.9	4.7	-5.1
Malta	0.8	0.6	1.1	2	0.7	0.9	-1.3
Poland	0	0	1.2	2.9	2.9	1.7	0.1
Romania	-1.2	-1.7	-1.5	1	2.3	2.6	1.3
Slovakia	-0.5	0.3	1.7	3.4	2.7	1.7	-0.6
Slovenia	0	0.1	-1.8	0.2	1.2	2.0	1.0

* 2006 is preliminary; (a) - referring to new membership of the European Union as of 1 May and including Bulgaria and Romania

Source: TCB/GGDC database

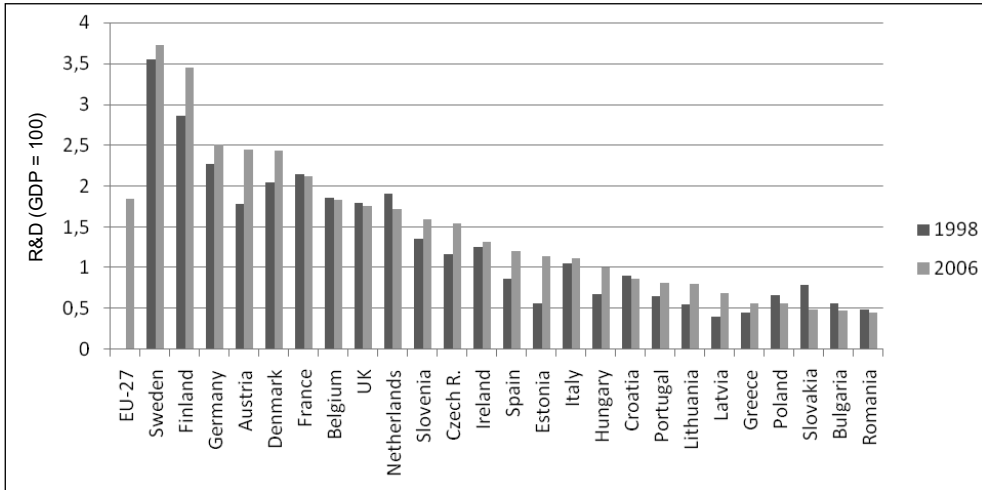
Being productive is more than just catching up with the best player. Those data have to be interpreted carefully because in some European countries many unskilled people with low productivity are unemployed and thus not included in the statistics about the national productivity. Therefore, we can find that in new member countries where the growth in total working hours is low the productivity is low, too. What should be done is to correct productivity numbers for the effects of employment rate (Jean-Philippe Cotis. 2005).

Expenditure on R&D is one of the main determinants of productivity. Stimulating R&D spending can improve the absorptive capacity for adapting new technologies. The data about the EU expenditure on R&D shows that their relative shares in GDP rose from 1.25 percent in 1981 to 1.84% with the enlargement (Eurostat, 2008). Compared to the US, Europe invests less in R&D, has lower level of gross efficiency that turns current investments into useful output. In 2004, gross expenditure of the US for R&D were 2.67 % of GDP, and therefore 45% higher than EU expenditures (1.83). In 2006, expenditures for R&D as % of GDP stayed at the level of 1.91% in EU-15. We can conclude that the European Union as a whole will have difficulties in achieving the goal of 3% a year from the GDP until 2010 that was set in the Lisbon strategy.)

Data for 2006 show that the most intensive R&D was in the Nordic countries: Sweden (3.73 % of GDP), Finland (3.45%) and Germany (2.51%) are followed by Denmark and Austria (each with 2.45%), Belgium (1.83%), France (2.12%) – see chart 4. Peripheral countries of the EU, like Portugal and Spain, which lagged behind a lot, are increasing their R&D expenditures, as shown in the chart. Their example is followed by some new country members of the EU (Hungary, Czech Republic and Poland).

Figure 3 shows share of R&D in gross domestic expenditure is generally low in the new member countries. Only four new EU members spent higher percentage of their GDP on R&D between 1998 and 2006. This percentage rose sharply in Estonia (from 0.57 to 1.14) and moderate in Slovenia (from 1.36 to 1.59), Czech Republic (from 1.15 to 1.54) and in Hungary (from 0.68 to 1). In Baltic countries this increase is modest while we observed declining share in Bulgaria, Romania and Croatia.

Figure 3: Gross domestic expenditure on R&D, 1998 and 2006



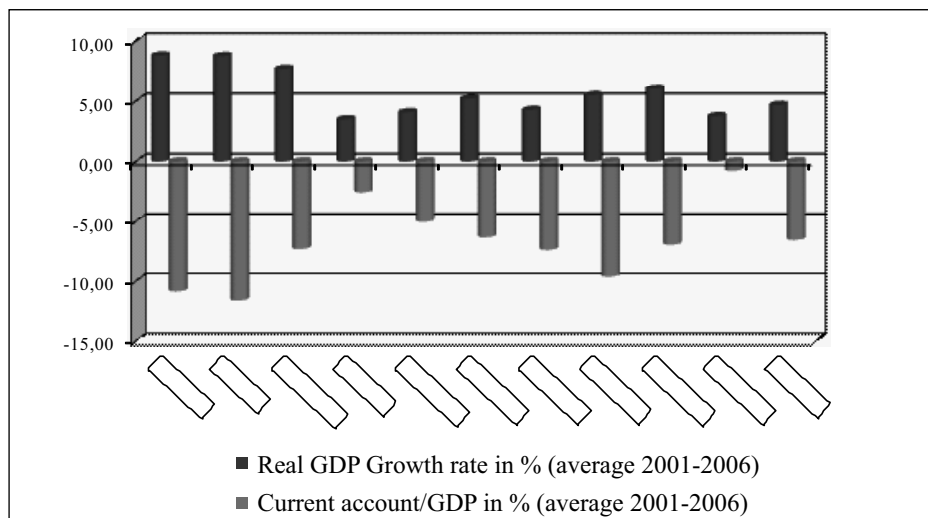
Source: Data from Eurostat and OECD

Trade theories suggest that innovation is the driving force behind exports (Krugman, 1979; Vernon, 1966). Some research found that firms (both innovative and non-innovative) are much more likely to export if they are in sector with a high ratio of research and development expenditures to output (Bleany, M. and Wakelin, K., 2002).

New member states of EU show that successful catching-up was followed by foreign trade imbalances. In many new EU member countries the rate of average current account deficit exceeded the average growth of GDP. In Latvia, the current account deficit widened to 25.3 percent of GDP in 2007, but deficits were also high in other Baltic countries in Estonia (-16.9) and Lithuania (-14.0), as well as in Bulgaria (-20.3) and Romania at -13.8 percent of GDP.

How is this absolute and relative growth of GDP related to current account deficit? The answer is given in figure 4, which correlates the current account deficit (as percent of GDP) with real GDP growth rate for the period 2001-2006. They are linked: the higher the share of current account deficit in a country, the higher its GDP growth rate (see figure 4).

Figure 4: Current account deficits in NMS and real GDP growth rate. 2001-2006.



Sources: Eurostat. CNB and central banks' web sites

Exports benefited from an upswing in Western Europe – the main trading partner – as well as increased integration of the analyzed countries emerging into regional production chains upgrading the quality of exports products. In particular, a rise in exports helped support economies where domestic demand slowed in the face of monetary tightening to reduce inflation after mid-2006. Growth in Hungary continued to be weaker than in the rest of the region, reflecting in part the short-term impact of fiscal consolidation.

The current account deficit in Croatia grew significantly until 1997, when it reached 2.5 billion dollars (Stipetić.V. Jovančević. R. 1996). After 1997 and a short tendency towards its decrease, the deficit related to GDP decreased from 7.0 per cent in 1999 to 3.7 per cent in 2001 and it is estimated to be 7.6 per cent of GDP in 2006. In foreign trade, there was an exceptionally high increase in imports of goods, whereas exports have remained stagnant. The export segment of the economy determines only about one fifth of the aggregate demand for domestic products and services. The coverage of imports by exports was below 50 per cent in 2004-07.

Rising demand pressures have contributed to a fast increase in trade deficit. In Croatia, the trade deficit had been growing continuously since 1994 and reached a level of \$5.4 billion in 1997. It continued to be a burden with slow decrease. After 2001, trade deficit grew from USD 4.1 to 10.5 billion in 2006. Exports of goods stagnated around USD 4.5 billion during the period 1994 to 2002. After that period improvement with the rising tendency is visible – exports grew from USD 6.2 billion in 2003 to 10.4 billion in 2006, with imports growing to almost USD 22 billion in

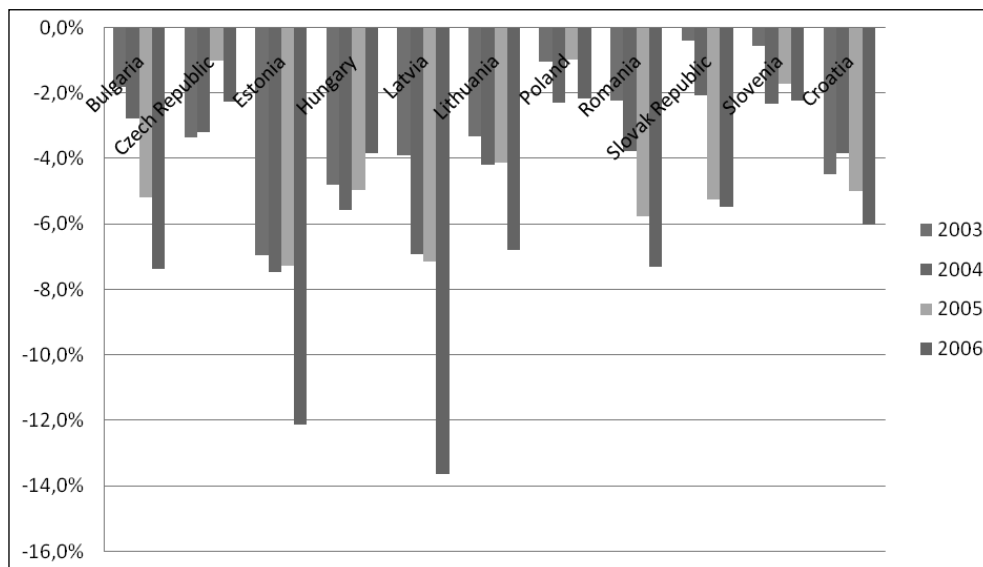
2006 (preliminary data of the CNB). A part of this trade deficit was covered by a surplus in services: the main receiver is tourism (travel). The foreign currency inflows from the export of services in tourism amounted to USD 2.5 billion in 1999 (two thirds of the total receipts from services) and reached USD 7.9 billion in 2006. There is also link between remittances and trade deficit. Namely the remittances have impact on large trade deficit while mainly finance the consumption of imports. Remittances are relatively stable source of inflows and are mainly used to finance private consumption of poorer families.

Significant and rising imbalances in the trade and current accounts and a rising external debt constitute potential risks to macroeconomic stability. The characteristics of the first phase of convergence are acceleration in spending on tradable and non-tradable goods. Tradables can easily import from abroad, while non-tradables need to be produced locally. Excess demand will push up the relative price of non-tradables and create real exchange rate appreciations.

In Central and Eastern Europe, current account deficits continued to widen financed by increasing net capital inflows. In Central Europe, capital inflows have tended to take the form of foreign direct investment in the tradable goods sectors with the resulting exports helping to keep current account deficits under control. Inflation has also been controlled in central Europe, owing in part to monetary policy running inflation-targeting in most countries. This was countervailing to the nominal currency appreciation and the dampening effect of global competition on wages. Expanding demand in the last two years has started to weaken this resource constraint.

Large external imbalances in the Baltic and South-Eastern Europe also raise concerns about possible real exchange rate overvaluation, although it is recognized that some part of the real exchange rate appreciation recently experienced by these countries has been consistent with improving conditions. Supporting factors include strong productivity growth in the tradable sector (the well-known Balassa-Samuelson effect), whereby productivity growth in the traded goods sector leads to an overall increase in prices. This puts upward pressure on CPI-based real exchange rates. Moreover, a part of the real appreciation is likely to have a one-off level adjustment, associated with, for example, the adoption of the EU acquis and the increased availability of foreign capital owing to the coming together of unusually kind global financial conditions and structural changes in the investor base for emerging markets. There is no doubt that in several countries speculative capital flows helped finance current account deficits. However, short-term “financial stability” may end up in a hard landing from unsustainable real appreciation to hyperinflation and financial collapse.

Figure 5: Current account balance (as percent of GDP)



Note: GDP in millions US dollars of 2000, purchasing power parity

Source: International Monetary Fund; World Economic Outlook Database, 2007

In some cases, if a large of FDI originates from one particular country. it may create a perception in the host economy that it has become too dependent on and dominated by the home economy. Such fears are made worse by the fact that net inflows of capital may sometimes be accompanied with current-account deficits including trade deficits. It may lead to a concern in the host economy that large inflows of capital are buying up the country's assets while it is distress from trade deficit (WIR 2006).

3. The FDI flows in new member states (NMS)

In Central and Eastern Europe (CEEC), FDI inflows have continued to grow since transition and liberalization began in the early 1990s. But, in real terms they still represent a low portion of the total investments. This is an indicator of the sensitivity of multinational companies and other capital entries into this market. The conditions of the world economy after 2000 have intensified competitive pressures forcing multinational and other companies to search for locations that are more profitable. Central and Eastern European Countries (CEECs) and China in overall fall of FDIs were the only bright spots: FDIs there rose by 15 per cent. FDI inflows into the NMS countries (including Bulgaria and Romania) a year before accession rose from 14.4 billion dollars in 2003 to 38.6 billion dollars in 2004 and reached 52.2 billion dollars

in 2006 (with leading Poland, Romania and Hungary, see table 4). The upward trend of FDI resulted mainly from a continued rise in reinvested earnings. The main motive for market-seeking foreign investors to invest in the new EU members is the strong economic growth of these countries. For efficiency-seeking investors, competitive labour costs are especially important. High corporate profits boosted the value of cross border M&A, which account for a large share of such flows. The number of greenfield and expansion investment projects increased in NMS in the period of 2002 to 2006, from 125 to 297 projects (WIR, 2007).

We shall concentrate on the FDI trends in NMS countries, which in the 1990s started to reform their former socialist economic systems (see table 4). FDI inflows to the new EU members and Croatia expanded significantly in 2006 for the third consecutive year. FDI flows have grown faster since the period 1995-97: the volume in 2006 in Poland was 3.2 times higher, in Czech Republic 3.3 fold, Slovakia 19.2 fold, Croatia 9.2 fold and so on. The continued rise in FDI flows reflects solid economic growth in these countries and prospects of EU accession.

Table 4: Foreign direct investment in new EU member states and Croatia 1992-2007. (Millions of dollars)

Country	1995-1997*	1998-2000*	2001	2002	2003	2004	2005	2006
Czech R.	1763	4998	5639	8483	2583	4974	11658	5975
Estonia	207	424	542	284	891	971	2879	1674
Hungary	2300	3301	3936	2845	2470	4506	7619	6098
Latvia	361	372	163	384	360	637	724	1634
Lithuania	193	597	446	732	179	773	1032	1812
Poland	4355	7659	5713	4131	4225	12890	9602	13922
Slovakia	217	1020	1584	4123	571	3031	2107	4165
Slovenia	228	154	369	1606	181	827	496	363
Bulgaria	235	786	813	905	1419	3452	3862	5172
Romania	633	1370	1157	1144	1566	6517	6483	11394
NMS	10492	20681	20362	24637	14445	38578	46462	52209
Croatia	388	1163	1561	1124	1713	1227	1790	3556
Total	10880	21844	21923	25761	16158	39805	48252	55765

Source: United Nations. WIR 2001, 2004, and 2007; * = annual average

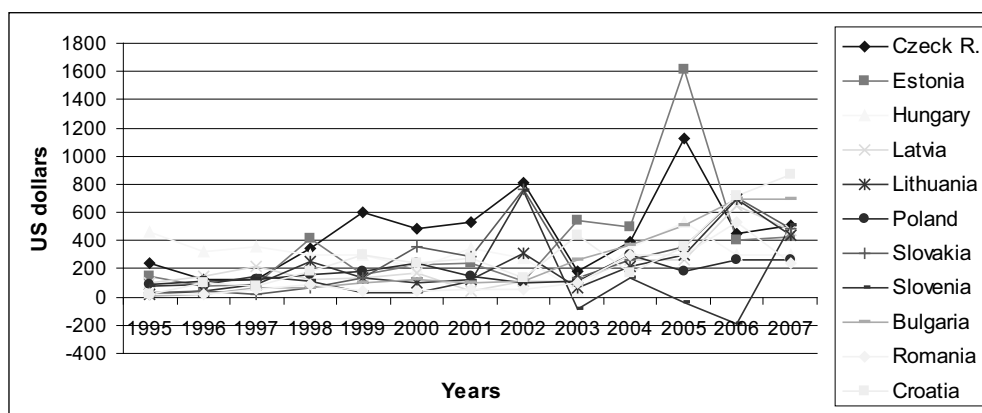
However, considering the countries are of different sizes, the absolute amount does not indicate the importance of FDI for the respective economies. Thus, it is necessary to measure relative importance of net FDI for these countries by looking at per capita base. Figure 7 shows the trend of net FDI in NMS and Croatia. A number of reasons have to be taken into account in order to explain country differences. Hungary was

the lead recipient in the early period of transition in the period 1989-1994 owing to the fact that privatization started earlier compared to others. With the completion of privatization in Czech Republic and Slovenia and later Poland, other countries took the lead.

In the period 1995-1999 the most attractive countries for FDIs (based on per capita inflows) were Czech Republic, Estonia and Hungary (see figure 6). The “wealthy” Slovenia, with better economic performance, had FDI outflows in 2006 (of USD -188.5 millions). Some authors emphasize that the most important specific reasons preventing foreign capital in Slovenian economy were relative small size economy, strong administrative barriers in the middle of the nineties during the main surges in capital flows and global financial crisis. the somewhat conservative attitude of leading economists, government and managers towards foreign “owners” and exclusion of foreigners from the basic privatization scheme (Oplotnik. J.. 2006).

A low level of FDI net on per capita basis was also recorded in Hungary (USD 302.5 million). Both countries are characterized by a high growth rate and a substantial export expansion. Therefore, a successful economic policy depends not only on the size of FDIs. but also on the broader development strategy of a country.

Figure 6: Net FDI per capita in new EU member states and Croatia. 1995-2007 (Millions of dollars)



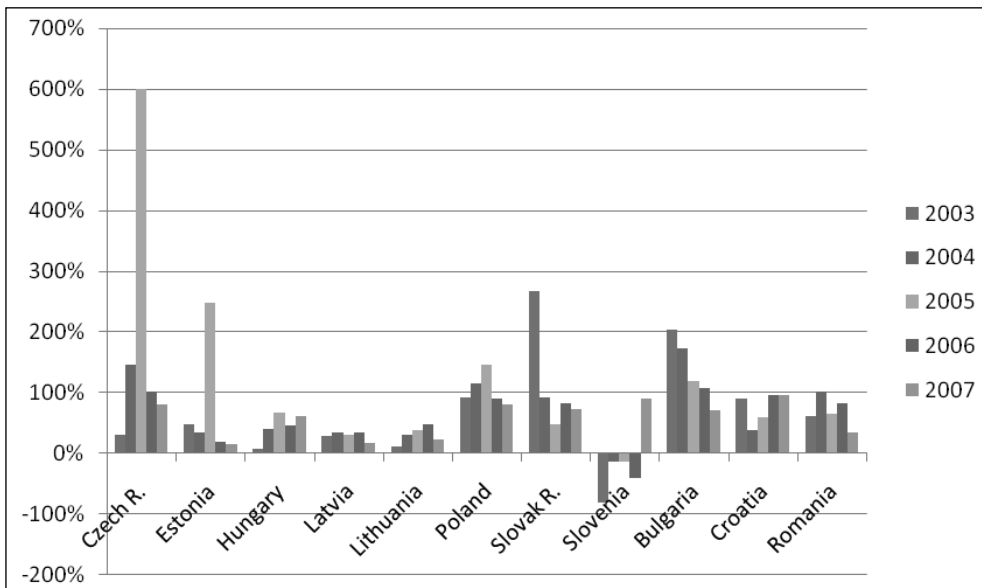
Sources: IMF and EBRD Transition Report, 2007. For 2007 EBRD estimates

In the years 2004-06 things changed: the lowest FDI annual average inflows recorded Slovenia (which became a net investor) and Poland (only USD 247 yearly) followed by Romania (375 USD). Estonia was on the top by net inflow of FDI (USD 839 yearly). followed by Czech Republic (USD 656 yearly), Bulgaria (USD 524) and Lithuania (USD 403).

In Croatia net FDI accounted for 7.4 per cent of GDP in 2006 and almost covered the current account deficit of 7.8 percent of GDP. The FDI continues to finance a large share of current account deficit in Slovakia and Romania. In Bulgaria net FDI covered 100 per cent of the current account deficit in 2006 and these inflows contributed to the strong increase in foreign exchange reserves. In Hungary and the Baltic states net FDI covered less than half of the current account deficit in 2006 making these countries dependent on debt-creating capital flows (in Hungary) or financing from foreign banks (the Baltic States). As a result, external debt rose in 2006 in these countries.

However, in most new EU member states, FDI contribution was not sufficient to bridge their current account deficits before their accession to the EU, which have built up into foreign debt (Mencinger. J., 2003). After the year 2004 the data changed considerably. In some countries foreign direct investment was sufficient to cover current account deficits (see figure 7). The principal risk for emerging countries depends on global economic conditions that might reduce investors' willingness to continue financing their large current account deficits.

Figure 7: Net FDI (Per cent of current account)



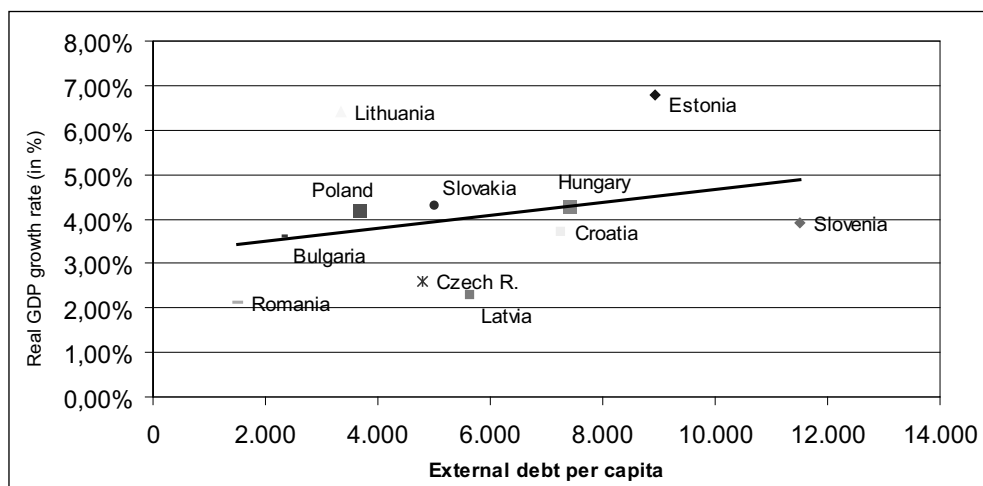
Source: Data from EBRD Transition Report, 2007

The most important fact is that the level of total foreign inflow of capital is not fully correlated with the economic growth, as it can be seen from the figure 8. Estonia has got much higher GDP growth rate (6.8 %) for the period 1996 - 2006 than Slovenia

(3.9%) due to the high inflow of foreign capital. The growth of Slovakia's economy was almost twice as high as the growth of the economy of Czech Republic, in spite of the higher inflow of capital in Czech Republic. High rate of Lithuanian economy (with 6.4 per cent) occurred in spite of the under the average inflow of foreign capital.

Let us conclude: the rate of growth of those transition countries cannot be explained only by the volume of the inflow of foreign capital. It is much more influenced by the effects of higher productivity, higher employment and entrepreneurship existing in those countries. However, higher economic growth is supported by funding from the EU structural Funds in Poland, Czech Republic and Hungary where rising use of EU funds helps sustain consumption and investment.

Figure 8: Real GDP growth (1996-2006) and external debt per capita (2005) in Croatia and peers. (In millions of US dollars)



Sources: EBRD Transition Report May 2006; World Investment Report 2006

4. External debt of transition countries

The inflow of capital, resulting in external debt, might be an important source of economic growth but it could be a burden for the economies too. Over the period 2000-2006, foreign debt in NMS and Croatia increased three times, from US\$181.8 billion to US\$561 billion while the stock of foreign direct investment increased from US\$107 billion to US\$420 billion. There is an enormous difference among countries. In Estonia and Latvia the relative indebtedness increased five times and in Lithuania four times. Relative indebtedness in Hungary and Poland was not so high in the year 2000; however there is evident strong relationship between external debt/GDP ratio and the stock of FDI/GDP ratio (see figure 9 and 10).

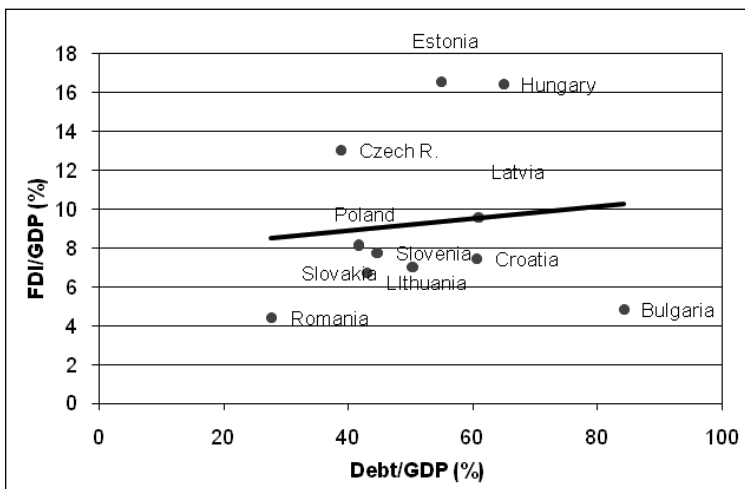
Table 7: FDI Debt and FDI stock in NMS and Croatia

Countries	External debt (mill.USD)		External debt /GDP (%)		FDI (mill. USD)		FDI/GDP	
	2000	2006	2000	2006	2000	2006	2000	2006
Czech R.	21608	58297	38.8	40.9	21644	77460	13.02	34.10
Estonia	3007	16805	54.9	102.3	2645	12664	16.52	49.74
Hungary	30287	105385	64.9	94.1	22870	81760	16.39	44.44
Latvia	4702	23704	60.9	117.9	2084	7532	9.56	21.45
Lithuania	4884	18918	43	63.4	2334	10939	6.71	20.48
Poland	69465	168115	41.7	49.3	34227	103616	8.13	18.32
Slovakia	10804	32206	50.3	47.3	4746	30327	6.99	31.73
Slovenia	4376	31465	44.6	78.5	2893	7452	7.75	15.25
Bulgaria	11165	25901	84.2	78.2	2704	20707	4.82	26.20
Romania	10271	41816	27.7	34.3	6951	41001	4.41	18.20
Croatia	11282	38446	60.6	85.5	3518	26812	7.42	42.19

Source: Transition Report. 2007, and IMF databases; GDP in PPP (current international \$)

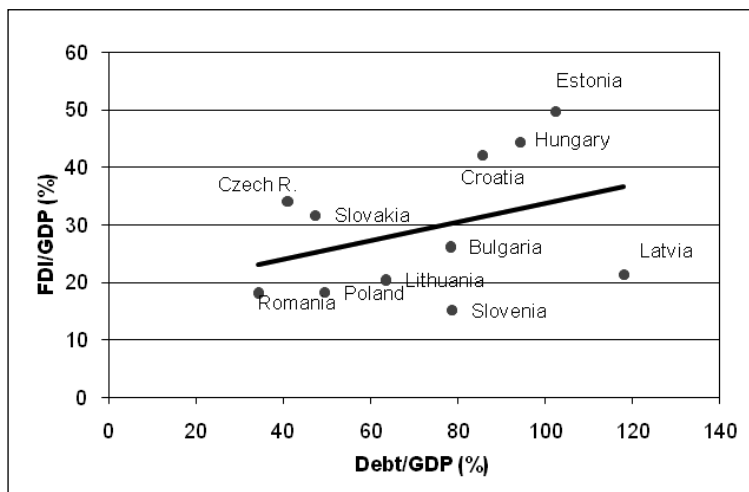
External debt in some new member countries is already high surpassing the mark of 80% (Latvia, Estonia, Hungary and Croatia) which is considered as upper limit for indebtedness. Slovenia and Bulgaria are approaching this level very fast. Only Czech Republic and Slovakia were able to maintain their level of indebtedness at the level obtained six years ago.

Figure 9: Foreign debt and FDI Stock in NMS and Croatia, 2000



Source: Transition Report, 2007 and IMF databases

Figure 10: Foreign debt and FDI Stock in NMS and Croatia, 2006



Source: Transition Report 2007 and IMF databases

Croatia's foreign debt tripled in the period 2000 to 2006, growing from US\$11.3 billion in 2000 to US\$38.4 billion in 2006 with further 9.1% increase by November 2007 (CNB, 2008). This growth is mostly a result of bank debts until the year 2006 with a significant increase of foreign debt of enterprises and household sectors while the government sector foreign debt decreased. The total outstanding debt of Croatia corresponds to about 85.5% of the country's GDP (it was only 21 per cent in 1994). However, a large part of these foreign loans in Croatia were invested in infrastructure projects (roads, bridges etc.). The main risk to growth stems from the strong expansion in domestic credit and the growing commercial bank external indebtedness. These may have a negative effect on already high foreign debt levels and may create appreciation pressures. The Croatian National Bank took a number of measures to control the rise in external indebtedness (one of them is restricting the growth of credit in 2007 to 12%). As a result, the share of foreign liabilities of banks in total external debt fell from 35 per cent (at the end of 2006) to 27.7 per cent and stood at EUR 8.8 billion (at the end of November 2007). By contrast, the share of external debt of enterprises reached 51.8 per cent in total external debt (in November 2007) and stood at EUR 16.5 billion. It is evident that the external debt of enterprises and non banking financial institutions grew at a stronger pace.

Without doubt, future growth in majority of these countries must rely on domestic saving. We can conclude that convergence and catching up with the EU depends on the sustainability of faster economic growth in new members of the EU rather than in old members, and how countries finance their current account deficit, foreign debt and economic development.

5. Conclusion

The NMS follow the convergence hypothesis according to which countries with relatively lower levels of per capita GDP grow more rapidly. Convergence in NMS of the EU has been helped by substantial inflows of foreign capital. The New Members with higher capital inflows experienced a higher GDP growth rates which is predominantly driven by increased private consumption and investments (Estonia, Latvia, Lithuania and Romania). While the rate of GDP growth rose in most NMS countries, current account deficits remained very high and foreign direct investment were not capable to cover current account deficit in all NMS. Analysis shows that successful catching-up was followed by foreign trade imbalances. In many new EU member countries, the rate of average current account deficit exceeded the average growth of GDP. Most of the NMS recorded strong labour productivity growth rates in the period 2004-2006. Despite the considerable rate of growth of productivity in NMS, the difference between the levels of productivity is still high. In comparison to the US productivity, the old EU-15 have reached 90% of US productivity, while EU-12 (NMS) have got only 38%, which makes the productivity in enlarged EU-27 community on the level of 78%. The data shows that the gap in GDP per capita with the US stems from low labour utilisation rather than weaker productivity. We observe that labour productivity looks higher in NMS after the year 2004 than in old members. Acceleration is especially pronounced in the year 2005 over the year 2004. in the Baltic States, Slovenia, Romania and Slovakia. The rate of growth of those transition countries cannot be explained only by the volume of the inflow of foreign capital. It is much more influenced by the effects of higher productivity, lower effect of employment/ population ratio, expenditure on R&D and entrepreneurship existing in those countries. However, higher economic growth is supported by funding from the EU structural Funds in Poland, Czech Republic and Hungary where rising use of EU funds helps sustain consumption and investment.

The inflow of capital results as external debt. External debt in some new member countries is already high surpassing the mark of 80% (Estonia, Hungary, Latvia and Croatia) which is considered as upper limit for indebtedness. Slovenia and Bulgaria are approaching this level very fast. Only Czech Republic and Slovakia were able to maintain their level of indebtedness at the level obtained six years ago. Without any doubt, future growth in majority of these countries must rely on domestic saving.

The conclusion of the paper is that regardless of the availability of EU funds, national investment policy will have considerable impact on the real growth of the economy.

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Financiranje deficita tekućeg računa u novim članicama EU i Hrvatskoj

Radmila Jovančević¹

Sažetak

Rezultati istraživanja potvrđuju hipotezu da su nove članice EU s relativno nižom razinom BDP-a po stanovniku u odnosu na prosjek EU ostvarivale brži ekonomski rast. Takve tendencije i sveukupna konvergencija u novim članicama bila je u velikoj mjeri potpomognuta značajnim priljevom inozemnog kapitala. Zemlje koje su imale veći priljev direktnih inozemnih investicija ujedno su bile zemlje koje su ostvarile najveće stope rasta BDP-a, koji je bio potican privatnom potrošnjom i investicijama (Estonija, Latvija, Litva i Rumunjska). Unatoč visokim stopama rasta bruto domaćeg proizvoda u novim članicama EU, deficit tekuće bilance plaćanja zadržao se na visokoj razini, tako da niti značajni iznosi priljeva inozemnog kapitala nisu bili dostatni za pokriće deficita u mnogim novim članicama EU. Stoga se pokazalo da je uspješna konvergencija bila popraćena s vanjskom neravnotežom. U mnogim novim članicama stopa rasta deficita tekućeg računa bila je viša od stope rasta bruto domaćeg proizvoda. Stope rasta BDP-a tih tranzicijskih zemalja ne mogu se objasniti samo volumenom priljeva inozemnog kapitala, već su one u značajnoj mjeri pod utjecajem učinka veće produktivnosti rada, nižeg učinka zaposlenosti, izdataka za istraživanje i razvoj kao i razvoja poduzetništva. Rastući priljev kapitala rezultirao je u povećanom vanjskom zaduženju u mnogim novim članicama. Zaduzenje je u nekim novim članicama već dostiglo kritičnu točku, prešavši 80% (npr. u Estoniji, Mađarskoj, Latviji i Hrvatskoj) što se smatra gornjom granicom zaduženosti, dok se Slovenija i Bugarska ubrzano približavaju toj granici. Iz navedenog slijedi zaključak da će se budući rast BDP-a većine zemalja morati oslanjati više na domaću štednju, tako da će nacionalna investicijska politika imati značajni utjecaj na rast BDP-a, bez obzira na raspoložive fondove Europske unije.

Ključne riječi: konvergencija, tranzicija, rast produktivnosti, investicijske politike, vanjski rizik, vanjski dug

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