Financial Integration in Europe: Evidence from Eastern Europe

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Motivation for the research

- In the boom years leading up to the financial crisis of 2008-09, Western European banks moved aggressively into Eastern Europe.

- Central and Eastern Europe (CEE) and South Eastern Europe (SEE) experienced exceptionally high foreign capital inflows and deteriorated current account balances and net foreign asset positions.

- Although, we are in the midst of the sovereign debt crisis, financial integration in Europe can be observed. Capital—in its different definitions—flows from richer to poorer countries, or in other terms from low to high-growth countries.
Motivation for the research

- The fact that capital flows from richer to poorer countries in Europe is different from what is happening outside of Europe (Gill and Martin, 2012).

- One explanation comes from the reassuring effect, which is based on Robert Mundell’s intuition and the endogenous optimum currency area theory (Warin, Wunnava, and Janicki, 2009).
Main research questions

• The current account deficits are the mirror image of the foreign capital in these economies. Why were the current account deficits of Eastern European economies so high and persistent over the last two decades?

• What were the main drivers of the external imbalances and foreign capital inflows?

• Is the experience of SEE countries different from the other European economies?

• Is the development through international financial integration worth the risks?
Financial Integration in Europe: An Analysis of the South Eastern European Countries

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Abstract

Although structural and institutional reforms are underway in most South Eastern European (SEE) economies, the unprecedented levels and large swings of external imbalances still occupy relatively high positions on the policymakers and researchers agenda. Widening external account deficits may reflect rapid capital formation or private consumption booms, but more importantly, there are country-specific thresholds beyond which market participants are unwilling to finance these deficits. This study examines the main determinants of the widening and persistent external current account deficits of the SEE transition countries. Given the increasing academic interest in the new open-economy macroeconomics, the propositions of an intertemporal model of current account determination are tested. The applied work rests on a dynamic panel data model on data for 30 European countries. The empirical results consistently find strong evidence in favour of persistence in the current account dynamics. This study questions the validity of previous findings based on less developed econometric techniques, introduces transition-specific variables, argues that the validity of the intertemporal framework is downplayed in the case of the transition economies.

Key words: intertemporal trade; current account; external sustainability; net foreign assets; foreign exchange reserves.
Structure of the presentation

• Some stylized facts on the external imbalances of the European transition countries

• An intertemporal perspective to the current account determination

• Empirical specification

• Estimation results

• Concluding remarks
Emerging Europe has been converging towards the advanced economies...

**Figure 1:** GDP per capita of selected economies (PPP-adjusted, 1960-2012)

Source: World Economic Outlook Database, The International Monetary Fund, October 2012.
...deepening financial integration in Europe has been observed before the sovereign debt crisis...

Figure 2: Financial integration of selected economies (percent of GDP, 1994-2008)

Note: Financial integration is measured as foreign assets plus liabilities. The interquartile range reflects the region between the top and bottom 25 percent of the distribution among the countries in the group.

Source: Updated and extended version of dataset constructed by Lane and Milesi-Ferretti 2007.
Eastern Europe experienced very high and persistent current account deficits...

**Figure 3:** Current account balances of selected European economies (percent of GDP, 1994-2011)

Source: World Economic Outlook Database, The International Monetary Fund, October 2012.
... and the net foreign asset positions also significantly deteriorated...

Figure 4: Net foreign asset positions in selected European economies (non-weighted averages, in percent of GDP, 1993-2008)

**EU-15 countries**

**Central and Eastern European countries**

**The Baltic States**

**South Eastern European countries**
Foreign banks moved aggressively into Emerging Europe...

**Figure 5:** Foreign bank ownership (as a percentage of banking system assets)

Source: Claessens and van Horen 2012.
Stylized facts
In Europe, capital flows to high-growth countries

**Figure 6**: Current account balances and per capita GDP growth, 1997-2011

Source: Gill and Martin, 2012.
Emerging Europe suffers neither from “China syndrome”...

• A country grew faster if it lent rather than borrowed abroad. For emerging economies outside Europe, this is indeed what we see: capital flows from poorer, high-growth countries to richer, low-growth countries. This is the so called “China syndrome.”

• In Europe, capital behaves the way it should: it flows from richer to poorer economies, and countries receiving more capital grow faster.

• The laws of economics hold more firmly the more institutionally integrated the economies have become with Western Europe - by membership in the European Union or by signaling the intention to join.
... nor the “peripheral Euro area” syndrome

• Why are these economies different from peripheral Euro area members?

• Until about 2001, the living standards of Greece and Portugal converged to those of more advanced European economies. But since 2002, labour productivity in Europe’s southern countries has been falling. The unprecedented volume of flows meant that foreign capital inflows replaced domestic saving. Increasingly, though, they did not fund productive investment.

• Obviously, the borrowed money had not always been used well. It had flowed in on the belief that Greek and Portuguese debts would be serviced or repaid. By 2009, it was clear that this was going to be difficult.
Emerging Europe is different

- The case of Eastern Europe is different. How can the foreign savings-growth link be explained in this case?

- The evidence shows that foreign savings in the EU12 and EU candidate countries seem to have enabled the pursuit of investment opportunities that would otherwise have remained unfunded.

- Foreign savings do not substitute for domestic savings in some of the countries in emerging Europe. For countries in or close to the European Union, investment is no longer resource-constrained.
Why is Emerging Europe different?

1. Financial development

- Foreign savings has spurred growth, inter alia, because of the effective financial development.

- Two alternative explanations exist as to what makes financial intermediation effective. One relates to “thresholds in financial development” that improve the flow and quality of information and enhance a country’s absorptive capacity (Blanchard and Giavazzi 2002).
2. Institutional development

• Another explanation relates to “financial frictions” and how they affect financial intermediation. These frictions are linked to the institutional development of individual countries.

• Both insufficient financial development and weak institutions can reduce absorption and cause capital inflows to boost unsustainable private and public consumption or asset-price bubbles that weaken the link to growth.
Why is Emerging Europe different?

3. Favourable composition of international capital inflows

**Figure 7:** Composition of foreign capital inflows in emerging regions, 1997-2008

Source: Stojkov and Zalduendo (2011).
Why is Emerging Europe different?

3. Favourable composition of international capital inflows

- In terms of the composition, capital flows take the form of FDI, portfolio, and banking (or other) flows.

- Clearly, FDI in emerging Europe played a key role; it is particularly large across all three groups of emerging European countries and is positively correlated with growth.

- But the most distinctive feature is the large role played by banking flows, which comprise both wholesale funding and financial FDI. The latter relates to the relationship between parent banks and their subsidiaries. Indeed, no other region appears to experience such a degree of “ownership-driven” capital integration.
Why is Emerging Europe different?

**Figure 8:** FDI Inward Stock (% GDP) and Real GDP Growth, 1997-2008

Source: Stojkov and Zalduendo (2011).
Current account deficits in emerging Europe have been growth-supportive...

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<td>Log of initial GDP per capita [^A]</td>
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<td>-2.327</td>
<td>-2.426</td>
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<td>[0.450]</td>
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<td>Educational attainment of population above 25</td>
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<td>0.470</td>
<td>0.500</td>
<td>0.493</td>
<td>0.479</td>
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<td>[0.119]</td>
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<td>[0.124]</td>
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<td>Population growth</td>
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<td>-0.351</td>
<td>-0.346</td>
<td>-0.342</td>
<td>-0.339</td>
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<td>[0.162]</td>
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<td>[0.156]</td>
<td>**</td>
<td>[0.162]</td>
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<tr>
<td>Relative price of investment</td>
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<td>0.024</td>
<td>0.037</td>
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<td>[0.501]</td>
<td>[0.491]</td>
<td>[0.498]</td>
<td>[0.583]</td>
<td>[0.561]</td>
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<tr>
<td>Trade openness (in percent of GDP)</td>
<td>0.011</td>
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<td>0.011</td>
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<tr>
<td>Current account balance; in percent of GDP, four year average (CAB)</td>
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<td>0.055</td>
<td>0.053</td>
<td>0.032</td>
<td>0.044</td>
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<td>[0.046]</td>
<td>[0.042]</td>
<td>[0.053]</td>
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<td>EU-10 country dummy times CAB</td>
<td>-0.262</td>
<td>-0.245</td>
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<td>[0.094]</td>
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<td>EU candidates country dummy times CAB</td>
<td>-0.133</td>
<td>-0.124</td>
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<td>[0.055]</td>
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<td>[0.062]</td>
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<tr>
<td>EU neighborhood country dummy times CAB</td>
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<td>0.485</td>
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<td>[0.127]</td>
<td>***</td>
<td>[0.135]</td>
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</tbody>
</table>

Number of observations: 584
Number of countries: 88
Number of instruments: 30
Hansen test for over-identifying restrictions: 0.064 \[^B\]
Arellano-Bond AR(1) test (p-value): 0.000
Arellano-Bond AR(2) test (p-value): 0.812
And then, the European debt crisis hit emerging European economies...

... through the significant reduction of the external demand and nearly a sudden stop of foreign capital inflows.
Was the development through financial integration worth the risks?

- Apart from the benefits, excess financing was a problem before the global crisis, and it hurt some emerging European countries.

- The abrupt declines in real GDP must be recognized and included in any assessment of the effectiveness of financial integration. These declines raise the question of whether the positive dynamics are inherently unsustainable.

- A key challenge for policymakers is thus not to avoid financial integration, but to understand which policy mix contributes to turning this opportunity into a sustained growth dynamic and how the tail risks can be effectively mitigated.
The unique case of Latvia

Figure 9: Foreign capital inflows and real GDP growth in Latvia, 2000-2013

Source: World Economic Outlook Database, The International Monetary Fund, October 2012.
Back to the theory
An intertemporal perspective to the current account determination

- The intertemporal approach to current account analysis makes an important conceptual advance compared to traditional and modern approaches through its recognition that private savings and investment result from forward-looking dynamic decisions (Sachs 1981; Obstfeld and Rogoff 1994; Razin 1995).

- The underlying assumption of this New open-economy macroeconomics approach is the possibility for intertemporal trade, which is only possible with a high degree of capital account openness.
An intertemporal perspective to the current account determination (2)

- The liberalization of the capital account transactions is a necessary precondition for the validity of the intertemporal approach, not the stage of development of the country, although they can be highly correlated.

- The European transition countries, on average, substantially increased their capital account openness during the last decade.

- Financial integration progressed rapidly from the late 1990s. The sum of foreign assets and liabilities as a share of GDP - the financial equivalent of trade openness indicators - increased greatly.
An intertemporal perspective to the current account determination

Figure 10: De jure indices of capital account openness of selected European economies (1994-2009)

Aggregate consumption

The aggregate consumption $\bar{C}_t$ is constructed as a weighted average of the consumption by the non-Ricardian ($C_{tNR}$) and Ricardian consumers ($C_{tR}$):

$$\bar{C}_t = \lambda C_{tNR} + (1 - \lambda) C_{tR} \quad [4]$$

where $\lambda$ and $(1- \lambda)$ represent the weights of each type of consumers.

The distinction between the two types of consumers is an important one: it relaxes the assumption of homogeneity in consumption behaviour and provides analytical justification of the use of a dynamic specification for the model of current account determination.
The Ricardian consumption

Following the analytical derivation of the model, the final specification of the Ricardian consumption takes the following form:

\[
C_t^R = \frac{\gamma}{1+r} \bar{C}_{t-1} + \left(1 - \frac{\gamma(1-\lambda)}{1+r}\right) r B_t^p + \left(1 - \frac{\gamma}{1+r}\right) \frac{r}{1+r} E_t \sum_{s=t}^{\infty} \frac{Y_s - I_s - T_s}{(1+r)^{s-t}}
\]

[5]

where \( C_t^R \) is the consumption of Ricardian agents, \( \gamma \) is the fraction by which individual’s consumption exceeds past aggregate consumption (\( \bar{C}_{t-1} \)), \( r \) denotes the return on the net foreign assets (\( B_t^p \)) of the private sector, \( E_t \) is the expectations operator of the stream of future net output and \( \lambda \) and \((1-\lambda)\) represent the weights of non-Ricardian and Ricardian consumers, respectively.
After a set of transformations, the final empirical specification is:

\[
CA_t = (1 - \lambda)\gamma CA_{t-1} + \lambda (T_t + rB^G_t - G_t) + \frac{\lambda(1-\lambda)}{1+r} \Delta NO_t + (1 - \lambda)\left(1 - \frac{\gamma}{1+r}\right)(NO_t - E_t\tilde{NO}_t)
\]

The coefficient on the lagged term of the current account reflects the weight of Ricardian (consumption-smoothing) agents in the population \((1-\lambda)\) and the degree of habit persistence \((\gamma)\),

The term \((T_t + rB^G_t - G_t)\) denotes the general government budget balance (taxes plus return on government's net foreign assets minus government consumption),

\(\Delta NO_t\) stands for the change in net output (present output minus investment minus general government consumption) and

The last term in the expression constitutes the core of the intertemporal approach, which indicates the deviation of the net output \((NO_t)\) from its permanent value.
Empirical specification

- For presentational convenience, the dynamic empirical specification is reformulated as:

\[
CA_{i,t} = \alpha_1 + \alpha_2 CA_{i,t-1} + \beta_1 fb_{i,t} + \beta_2 gr_{i,t} + \beta_3 \Delta inv_{i,t} + \beta_4 \Delta gc_{i,t} + \\
+ \beta_5 relinc_{i,t} + \beta_6 relinv_{i,t} + \beta_7 relgc_{i,t} + u_{i,t}
\]

- where \( i = 1, 2, \ldots, 30 \) (countries) and \( t = 18 \) years (1994, 1995, \ldots 2011).

- \( CA_{i,t} \) is the current account (normalized by GDP)

- \( \alpha_1 \) is the intercept

- \( \alpha_2 \) stands for the coefficient on the lagged dependent variable (\( CA_{i,t-1} \))
Empirical specification

The net output variables:

Real GDP growth rate

Changes in the investment ratio

Changes in the government consumption ratio

The financial integration variables:

Relative income

Relative investment

Relative government consumption

\[ gr_{t,t} = \frac{GDP_{i,t}}{GDP_{i,t-1}} \times 100 - 100 \]

\[ \Delta inv_t = \frac{i_t}{gdp_t} - \frac{i_{t-1}}{gdp_{t-1}} \times 100 - 100 \]

\[ \Delta gc_t = \frac{gc_t}{gdp_t} - \frac{gc_{t-1}}{gdp_{t-1}} \times 100 - 100 \]

\[ relinc_{i,t} = \ln \left( \frac{gdp_{pc_{i,t}}}{gdp_{pc_{sample \ average,t}}} \right) - \ln \left( \frac{gdp_{pc_{sample \ average,t}}}{gdp_{pc_{sample \ average,t}}} \right) \]

\[ relinv_{i,t} = \ln \left( \frac{inv_{i,t}}{inv_{sample \ average,t}} \right) - \ln \left( \frac{inv_{sample \ average,t}}{inv_{sample \ average,t}} \right) \]

\[ relec_{i,t} = \ln \left( \frac{gc_{i,t}}{gc_{sample \ average,t}} \right) - \ln \left( \frac{gc_{sample \ average,t}}{gc_{sample \ average,t}} \right) \]
List of country groups

- **EU-15**: Austria (AUT), Belgium (BEL), Denmark (DNK), Finland (FIN), France (FRA), Germany (DEU), Greece (GRC), Ireland (IRL), Italy (ITA), Luxembourg (LUX), Netherlands (NLD), Portugal (PRT), Spain (ESP), Sweden (SWE), United Kingdom (GBR).

- **EU-10 (The new EU member states)**: Czech Republic (CZE), Cyprus (CYP), Estonia (EST), Hungary (HUN), Latvia (LVA), Lithuania (LTU), Malta (MAL), Poland (POL), Slovak Republic (SVK), Slovenia (SVN).

- **South Eastern Europe (5)**: Albania (ALB), Bulgaria (BLG), Croatia (HRV), Macedonia (MKD), and Romania (ROM).
1. Fiscal balance ( + )

- The twin-deficit hypothesis attaches critical importance to country’s fiscal balance as a determinant of both short- and long-run current account behaviour.
- Standard representative-agent models assume complete Ricardian equivalence, or no impact of fiscal balance on the external accounts.
- Yet, this model is augmented by the inclusion of two types of consumers that provides formal justification for the fiscal policy impact on the external current account balance.
- The coefficient on the fiscal balance is therefore expected to be greater than zero.
2. Changes in net output (+)

- The net output is defined as present output (Y) minus investment (I) minus public spending (Cg).
- Different from the output gap! While the output gap indicates short-run excess or insufficient demand in an economy, the changes in net output refer to the dynamics of the present output minus investment minus public spending.
- Changes in net output are expected to display a positive correlation with the current account balance, because of the hypothesised consumption-smoothing effect and their partial translation into higher savings.
Expected signs

3. Output deviation (+)

- In theory, global shocks leave the current account position unaffected. Changes in per capita income matter as long as they differ from the average (or global) changes.

- In empirical terms, the output deviation is constructed as natural logarithmic deviation of country’s per capita income from the permanent level of this variable.

- The permanent level is defined as the annuity value of the variable at the prevailing interest rate or “hypothetical constant level of the variable with the same present value as the variable itself” (Obstfeld and Rogoff, 2002, p. 74).
Expected signs

• But what is the empirical counterpart of the permanent level of a variable, as defined by Obstfeld and Rogoff (2002)?

• The empirical literature proxies this by the time-varying cross-country average of the sample. This is one of the most serious deficiencies of the model.

• If the country-specific income is above the global-average income, then the country is expected to run current account surplus, and vice versa, that is, a priori expectations favour a positive sign on the output deviation variable.
Expected signs

(4) Relative investment ( - ) and (5) Relative government consumption ( - )

• The relative investment and relative government consumption are constructed as the difference between actual values from the time-varying cross-country average of the sample.

• Any spending beyond the levels observed in the other countries is expected to deteriorate the present current account position, and thus, the expected signs on both variables are negative.
Words of caution

• The weakness of the permanent level assumption
  – individual countries are assessed through the lens of their deviation to the permanent level.
  – if all the countries are deviating from the average then the standard deviation has actually more information than the average. For instance, when we consider the relative government consumption, we would assume it has a negative relationship with the current account.
  – however, a stable country in terms of government consumption will see the relative government consumption measure increase if the rest of the sample decreases its government consumption. This means that the deviation between the country’s government consumption and the sample average is increasing.
### Estimation results:

What drives the external current accounts?

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>ENTIRE SAMPLE</th>
<th>System</th>
<th>Beck-Katz</th>
<th>Parks-Kmenta</th>
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<td>Lagged current account (in % of GDP)</td>
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<td>0.831 ***</td>
<td>0.829 ***</td>
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<td></td>
<td>[0.099]</td>
<td>[0.052]</td>
<td>[0.026]</td>
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<tr>
<td>Fiscal balance (in % of GDP)</td>
<td>0.036</td>
<td>0.065 *</td>
<td>0.028</td>
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<td>[0.056]</td>
<td>[0.037]</td>
<td>[0.025]</td>
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<tr>
<td>Real GDP growth rate</td>
<td>-0.141</td>
<td>-0.192 ***</td>
<td>-0.095 ***</td>
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<td></td>
<td>[0.097]</td>
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<td>Change in investment ratio</td>
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<td>-0.093 ***</td>
<td>-0.119 ***</td>
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<td></td>
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<td>Change in government consumption ratio</td>
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<td>Relative income</td>
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<td>Relative investment</td>
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<td>Relative government consumption</td>
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The empirical results suggest that during the observed period, on average, the current accounts of the European economies were strongly driven by recent developments.

They produce evidence of pronounced persistence of the current account balance, given that the lagged current account coefficient estimate is around 0.8.

It captures the partial adjustment of the current account and can be rationalized by habit formation in the behaviour of private agents.
Estimation results

- The coefficient on the fiscal balance for the reference group suggests incomplete Ricardian equivalence.

- 6.5 percent of a change in the fiscal surplus is immediately reflected in an increase in the current account position.

- A rise in budget deficits would not be fully offset by corresponding increases in private saving, as a response to expectations about higher future taxes.

- While the impact of the fiscal surplus on the current account may appear somewhat small, it should be emphasized that the implied long-run effect is more than twice as high.
Estimation results

• Higher **real GDP growth** is also associated with larger current account deficit.

• The positive coefficient on **relative income** indicates that a per capita income below the average, will be associated with a current account deficit.

• The rationale is that poorer countries are assumed to grow faster than the average and are thus borrowing against future income.
Concluding remarks

• While foreign savings at times might substitute for national savings, we find that the channel to high growth in emerging Europe is through making possible the pursuit of investment opportunities that would otherwise remain unfunded.

• The increase of the investment demand, as SEE economies speed up the European integration process, contributes to a significant deterioration of their current account positions.
Concluding remarks

• Other empirical studies also find evidence that the announcements during the EU integration process have raised the expected future path of aggregate demand and thereby further stimulated domestic capital formation in the prospective EU member states.

• EU membership (actual or prospective) acts as an anchor for expectations of improved institutional quality even if actual change on the ground improves more slowly.
Concluding remarks

• The type of capital coming into a country matters!

• Financial openness might support growth, but also contributes to vulnerability.

• Foreign capital is an enviable development opportunity with tail risks. However, if FDI is one of the elements of the capital flowing into the country, then it is less likely to increase a country’s vulnerability and more likely to support its growth.