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# Are Large External Imbalances in Central Europe Sustainable?

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Even in a world of remarkably large global imbalances, the Central and Eastern European countries (CEECs) stand out.<sup>1</sup> During 2001–06, these countries recorded some of the largest external current account deficits (relative to the size of their economies) of any emerging-market countries (figure 1.1). Because these deficits tended to reflect rather low domestic saving rates alongside high domestic investment rates, the CEECs were dependent on large inflows of foreign capital, often with sizable accumulations of external debt. Granted, not all have experienced such developments—both the Czech Republic and Poland have seen average current account deficits below 5 percent of GDP—but of the ten CEECs considered here, seven had average investment-savings (or equivalently external current account) imbalances in excess of 7 percent of GDP during 2001–06.

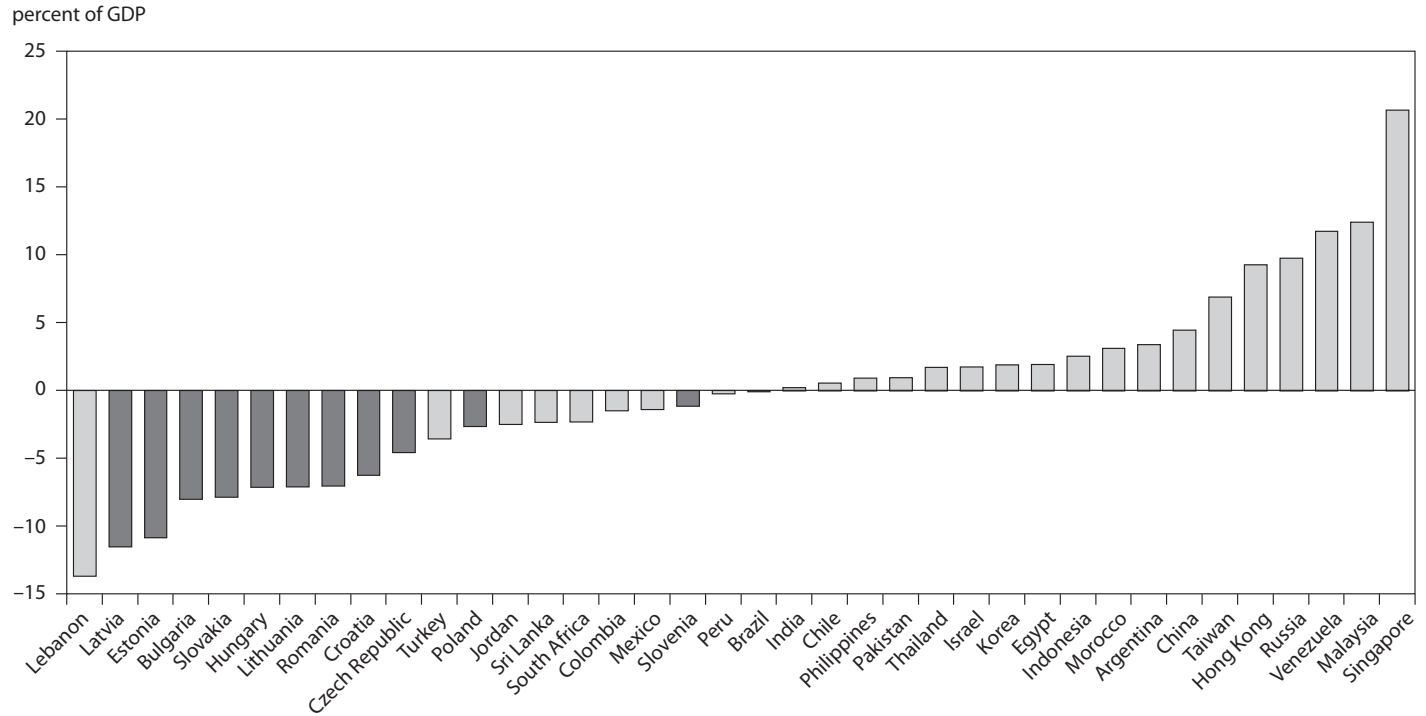
Should red flags go up? In general, the CEECs have engaged in little if any discretionary official foreign exchange intervention—almost all are inflation targeters with either floating exchange rates or actual or de facto currency boards with nondiscretionary, unsterilized intervention only. Therefore, concerns that apply to other countries about unsustainable manipulations of exchange markets (for example, by discretionary sales or

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1. The CEECs are Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Slovakia. All of these countries were centrally planned economies until 1990 and have now (with the exception of Croatia) acceded to the European Union, but they have not yet replaced their currencies with the euro.

**Figure 1.1 Current account positions of emerging-market countries, 2001–06 average**



Note: Dark bars indicate the Central and Eastern European countries.

Source: International Monetary Fund, *World Economic Outlook*.

purchases of foreign exchange to finance current account imbalances) are virtually nonexistent for the CEECs. Nevertheless, questions are growing as to whether the large imbalances leave these countries excessively vulnerable to sudden stops or reversals in capital inflows, and whether markets are being lulled into complacency by expectations that the European Union will come to the rescue should problems develop, that the EU Stability and Growth Pact will ensure sustainable policies, or that eventual euro adoption will provide a safe haven.

The aim of this chapter is to understand the origins and risks of large imbalances in the CEECs. The analysis indicates that such an understanding requires a broad perspective on the countries' adjustments to the pretransition distortions in their economies, their (at least implicit) strategies for catching up to Western European per capita income levels, and the dynamics of both these processes in countries with open markets in close proximity to wealthy Western European countries. In effect, the outcomes as they have evolved were inevitable, imbalances are likely to remain large or (in countries where they have been small) to widen, and governments formulating policies need to understand and take into account the risks of their adopted growth strategy.

This chapter is organized in five sections. The first reviews the stylized facts surrounding the emergence of external imbalances (typically accompanied by rapid output growth) in the CEECs and examines their resemblances to and differences from the experiences of other emerging-market countries. The second reports on the results of estimating a model examining the determinants of output growth. Building on this analysis, the third section examines the interaction between growth and current account imbalances to help establish whether the large-scale use of foreign savings is producing adequate returns in terms of higher output growth. And the fourth considers how markets view the risks of large current account imbalances. The final section presents conclusions.

## **Large Imbalances and Income Catch-Up: Stylized Facts**

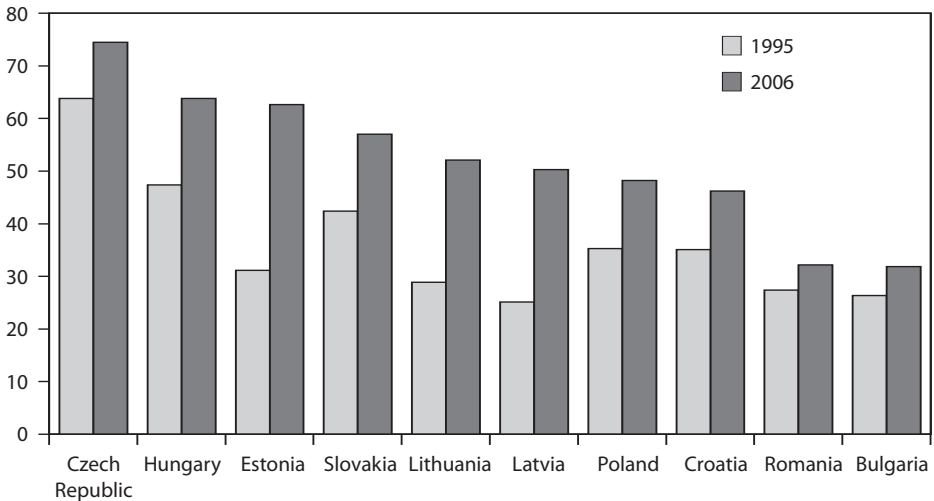
Emerging from the era of central planning, the CEECs had a formidable task to catch up with the income levels of their Western European neighbors. By 1995, when the worst of the posttransition shock had subsided, the range of per capita GDP (at purchasing power parity, or PPP, exchange rates) was 25 to 63 percent of the average level of the EU-12 (figure 1.2).<sup>2</sup> As daunting as such a catch-up may seem, it was a smaller gap than in most other emerging-market countries (see box 1.1 for a list of the 38

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2. Throughout the chapter, catch-up potential is measured relative to the 12 members of the euro area as of 2006 (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain).

**Figure 1.2 Per capita income gaps of 10 CEECs relative to the euro area**

percent at PPP exchange rates



PPP = purchasing power parity

Source: International Monetary Fund, *World Economic Outlook*.

countries designated in this chapter as emerging-market countries). In fact, even in 1995, all but two (Bulgaria and Latvia) of the CEECs were in the most affluent half of the emerging markets, and three (the Czech Republic, Hungary, and Slovakia) were in the most affluent quarter.

Has output growth (and by extension the pace of catch-up) in fact been rapid, especially if viewed against the generally strong performance since 1995 of other emerging markets with a substantial catch-up challenge? Much depends on how the data are sliced. Looking at the period 1995–2006, the CEECs have seen growth spread over the higher half of emerging-market performance, with Poland and Estonia at the top of the spectrum and the (richer) Czech Republic and (poorer) Bulgaria at the bottom (figure 1.3). But for no country has growth been steady over the period. Rather, some countries (Poland and Hungary) were early rebounders but later laggards, and others (Bulgaria, Latvia, and Romania) struggled to escape the transition shock but rebounded strongly in the latter part of the period.<sup>3</sup>

The sources of growth—labor input, capital input, or total factor productivity (TFP)—have been similar among CEECs, but their pattern has been quite different from that of other emerging-market countries (figure 1.4). Broadly, with massive labor shedding in almost all the CEECs, at least

3. All per capita GDP data are measured at PPP exchange rates to ensure comparability across countries. See Schadler et al. (2006) for an explanation of this measurement.

**Box 1.1 Emerging-market countries**

<b>Region</b>	<b>Countries</b>
Central and Eastern Europe	Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia
East Asia	China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand
Latin America	Argentina, Brazil, Chile, Mexico, Peru, and Venezuela
Other	Egypt, India, Israel, Jordan, Lebanon, Morocco, Pakistan, Russia, South Africa, Sri Lanka, and Turkey

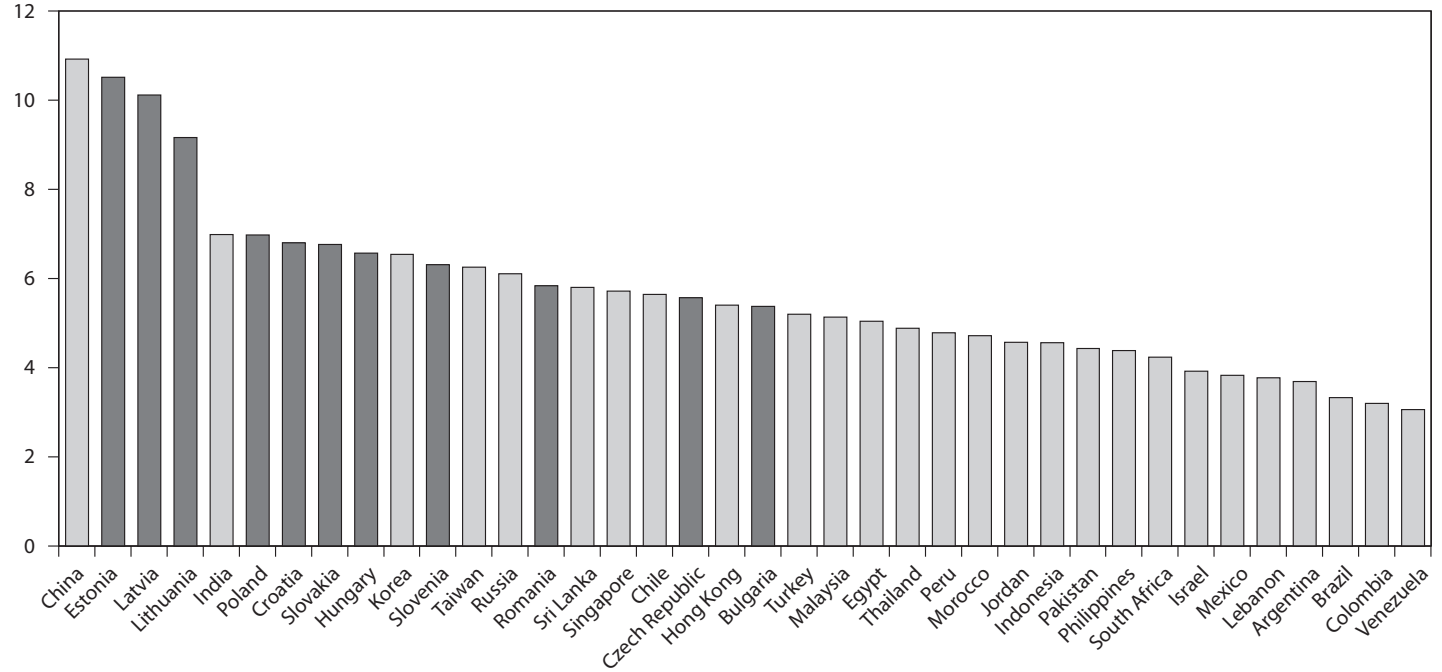
during the 1990s, the contribution of labor input to growth was substantially smaller in the CEECs than in other emerging-market countries. Although it is not possible to precisely measure the capital stock in countries where a large share of capital has been discarded as obsolete, the calculations that are available suggest that the contribution of capital to growth in the CEECs was more or less in line with that in other emerging-market countries—in the most recent five-year period (2001–05), greater than the average in Latin American emerging-market countries but smaller than the average in Asian emerging-market countries. What stands out for the CEECs is the contribution of TFP, which ranged from an extraordinary 6 percentage points in the late 1990s in the Baltic countries to a low of 2 percentage points in the four Visegrad countries (the Czech Republic, Hungary, Poland, and Slovakia) during 2000–2004. In no other group of emerging-market countries was this contribution so persistently large.

Notwithstanding the sizable contributions of capital and TFP to CEEC growth since 1995, gaps vis-à-vis the euro area countries in capital-labor ratios and levels of TFP remain large. Although employment rates in most of the CEECs were by 2004 roughly comparable to the (admittedly low) rates in the euro area, capital-labor ratios and especially TFP levels in the CEECs were still substantially lower than in the euro area. Available calculations suggest that average capital-labor ratios in the CEECs (excluding Bulgaria, Croatia, and Romania) were 15 to 44 percent and levels of TFP 36 to 64 percent of those in the EU-12.<sup>4</sup> These gaps, even after 15 years of convergence, reflected the enormous legacy of distortions—resource

4. See Schadler et al. (2006, 15) for a classification of income gaps vis-à-vis the euro area in employment, capital, and TFP components.

**Figure 1.3 Emerging-market growth performance, 1995–2006** (average growth rates)

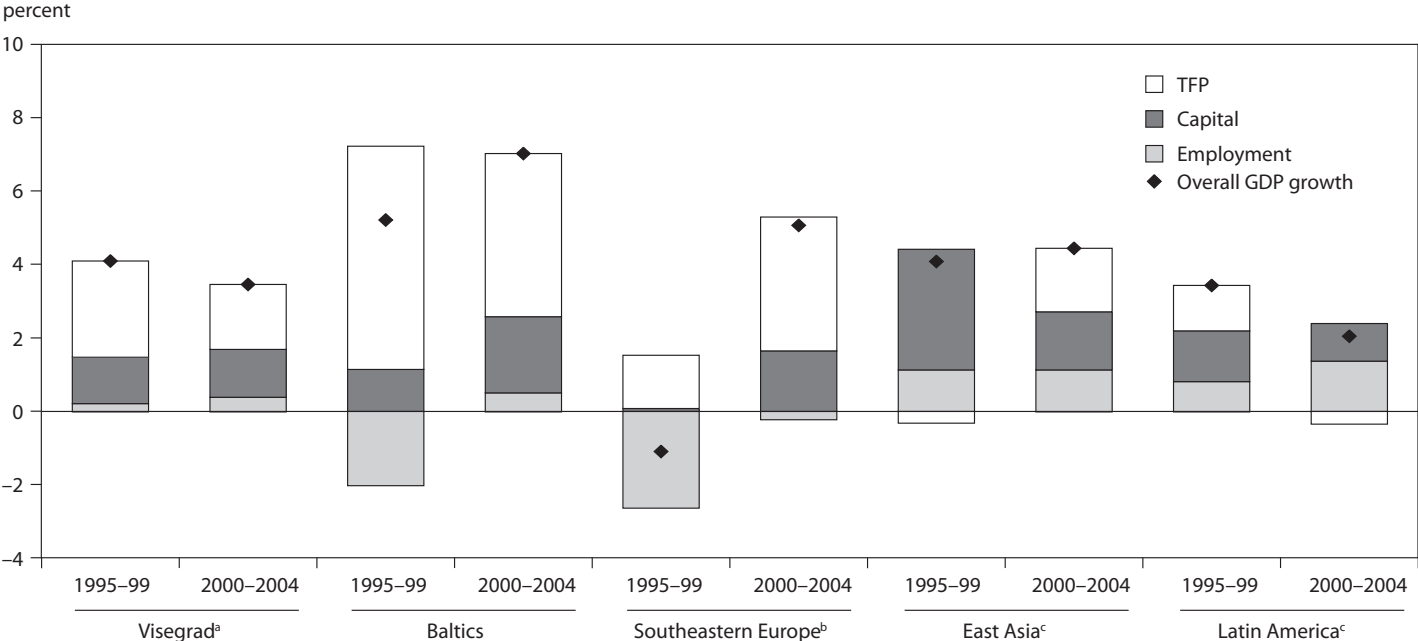
PPP per capita GDP



Note: Dark bars indicate the Central and Eastern European countries.

Source: International Monetary Fund, *World Economic Outlook*.

**Figure 1.4 Contributions to average GDP growth in emerging markets, 1995–99 and 2000–2004 averages**



TFP = total factor productivity

a. Czech Republic, Hungary, Poland, and Slovakia.

b. Bulgaria and Romania.

c. See box 1.1 for countries included in the East Asia and Latin America groups.

Source: Schadler et al. (2006).

misallocations and poor incentives to invest and work—from the central planning era.<sup>5</sup> Particularly insofar as the CEECs share borders and many cultural characteristics with Western European market economies, the remaining gaps presage a further surge in investment and growth of TFP as Western technology and managerial expertise spill over to the east.

In fact, this is just what has been happening. Investment-to-GDP ratios in the CEECs have been among the highest in emerging-market countries (figure 1.5). How have these been financed? Domestic saving has played a large role, of course. Recall, however, that just as distortions from central planning resulted in misdirected investment, they also thwarted the provision of consumer goods: Thus households' pent-up demand as central planning collapsed was enormous, and the shift to market economies was accompanied by a sharp drop in private savings to low levels by emerging-market standards. In these conditions, large inflows of foreign savings (reflected in current account deficits) were essential if investment rates were to be sustained at the levels necessary to support the closing of the gap in capital-labor ratios. Indeed, in the spectrum of emerging-market countries, large current account deficits in the CEECs stand in sharp contrast to average surpluses of other regional groupings of emerging-market countries. In other words, with expected high returns on investment in the low capital-labor ratio, both domestic residents of CEECs and foreigners saw strong attractions to investment.

But does such large-scale use of foreign savings create vulnerabilities to sudden stops or changes in market sentiments that make it fundamentally unsustainable? Is the recent record of CEECs a reflection of short-sighted borrowing that will not produce the needed returns for servicing obligations? These broad questions are best broken down into three smaller ones.

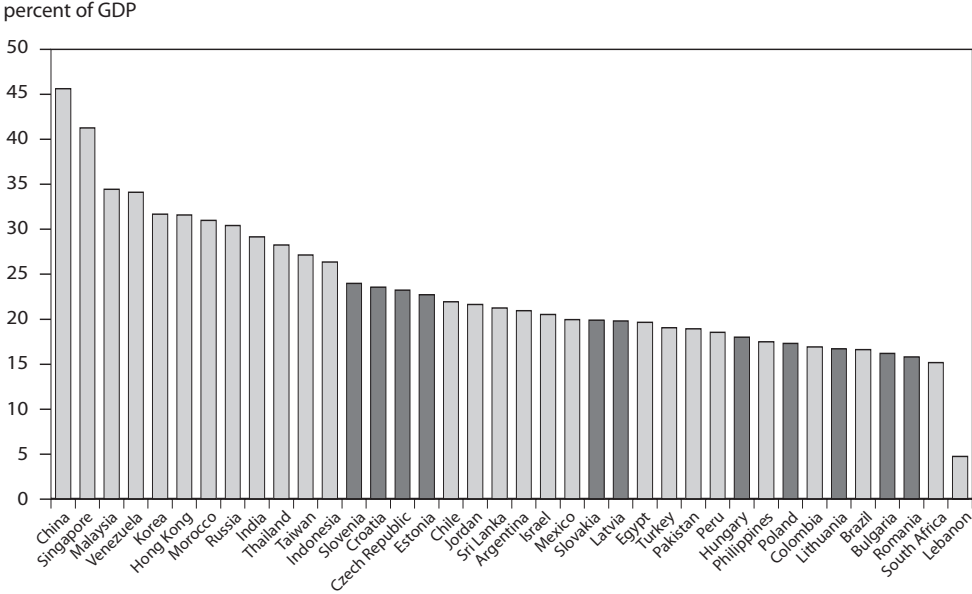
First, is it the private or public sector that is generating the investment-savings imbalances? The East Asia crisis taught us that private imbalances are not always safe: The unadorned Lawson Doctrine—investment-saving imbalances of the private sector reflect rational private decisions and are not a domain for public-sector concern or involvement—died. That said, it would be hard to refute—particularly when institutions and transparency are strong—that private imbalances are more likely to produce sustained growth than are public imbalances. And indeed, most current account deficits in CEECs reflect not a fiscal gap but rather private investment-saving gaps (figure 1.6). In other words, with high expected returns from technology transfer and increases in capital-labor ratios toward Western European levels, large capital inflows need not be disequilibrating. In fact, they should be equilibrating—responding to the profound disequilibria from the central planning era.

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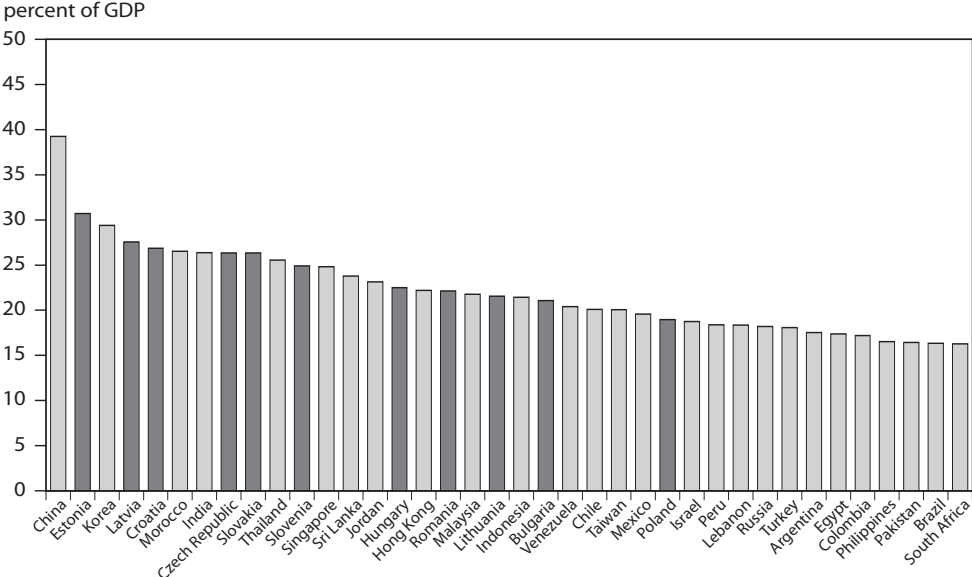
5. Eichengreen (2007) has an excellent account of the extent of the distortions and the contrast in growth performance between Eastern and Western Europe during the postwar/pretransition era.

**Figure 1.5 Emerging-market domestic savings and investment, 2001–06 average**

**a. Domestic savings**



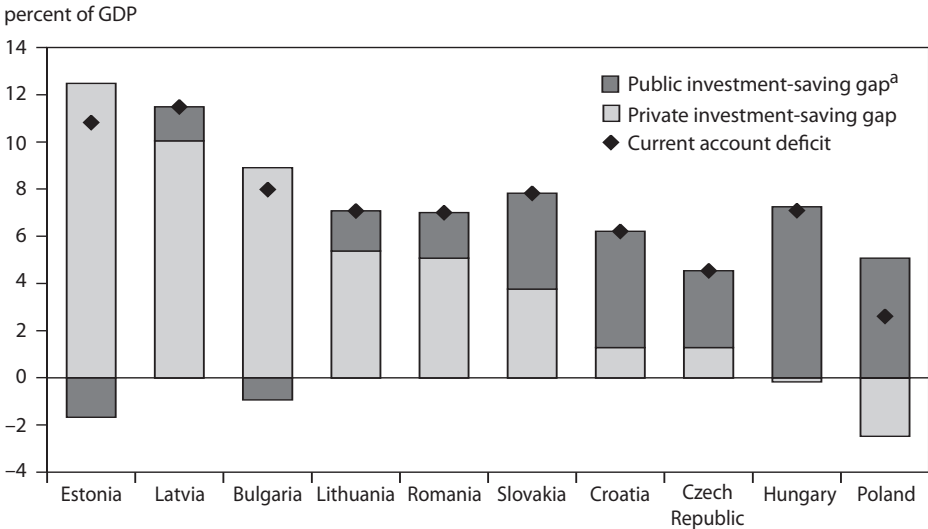
**b. Investment**



Note: Dark bars indicate the Central and Eastern European countries.

Source: International Monetary Fund, *World Economic Outlook*.

**Figure 1.6 Investment-saving gaps and current account deficits, 2001–06 average**



a. Negative numbers denote general government surpluses.

Sources: International Monetary Fund, *World Economic Outlook*; author's calculations.

Second, why have *net* private inflows to the CEECs been so much larger than to other emerging-market countries? Are they not all facing broadly similar catch-up challenges? One distinction is key: The CEECs, in the process of rapidly shifting to market mechanisms and meeting the requirements for accession to the European Union, almost fully eliminated restrictions on capital flows. Current account deficits were to a large extent *capital account driven*: They resulted from the perception, particularly among high-saving EU neighbors, that profit opportunities from technology transfer and rising capital-labor ratios would earn large returns. Indeed, in an environment of open capital accounts, large income gaps between the CEECs and their neighbors, and converging institutions, it would be hard to envision anything other than large capital inflows.

Third, who is bearing the foreign exchange risk underlying the large capital inflows? Even with relatively benign macroeconomic policies, such risk (in addition to the standard risks in investment of any sort) typically arises when capital flows across borders of countries with different currencies. Is financing FDI dominated, so that risks are borne largely by foreign investors? Or is it debt creating, so that the preponderance of risks—of lower-than-expected growth, rising interest rates, or exchange rate changes—are borne by domestic borrowers?

The financing story is mixed. FDI is indeed large in the region, for the most part exceeding (relative to GDP) that in other emerging-market countries. But private debt-creating inflows also stand out. Whereas these hover around balance in most other emerging-market groupings, in the CEECs they rose to over 4 percent of GDP by 2005, the last year for which comprehensive data are available. By 2007 they are likely larger still (figure 1.7a).

How are private debt-creating inflows working through the system? To a large degree they—together with domestic savings—are financing rapid credit growth, especially to households (figure 1.7b). Although stocks remain moderate, it is worrisome that for several countries (mainly fixed exchange rate countries) bank credit growth, especially to households, is largely denominated in or indexed to foreign currency. Households are taking on the risks of any weakening of growth and of changes in interest or exchange rates.

The obvious implication of the financing picture is high external debt relative to GDP by emerging-market standards (figure 1.7c). This is true for gross or net indebtedness (that is, adjusting for the accumulation of foreign assets mainly in commercial and central banks). Also, in contrast to most other emerging-market countries, where debt ratios are falling, external indebtedness relative to GDP in most of the CEECs has risen steadily, with only a brief leveling off in 2004.

In further contrast to most other emerging-market countries, official foreign exchange reserves are generally low (figure 1.7d). All of the CEECs have forgone reserve accumulation in the context of floating exchange rate systems or actual or de facto currency boards. While low reserves could be seen as a weakness relative to other emerging-market countries, the transparency of monetary policy frameworks with no discretionary or sterilized intervention in the CEECs is a major strength and probably precludes the need for holding sizable reserves.

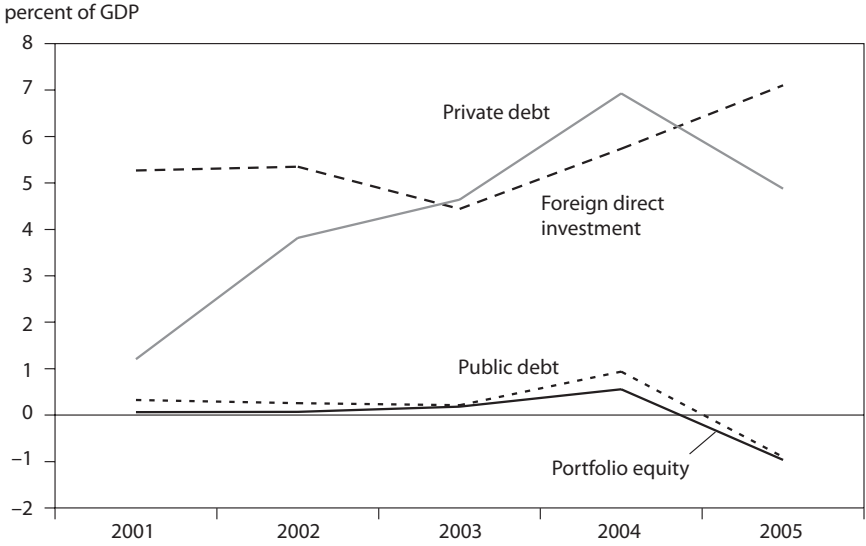
These stylized facts point to the complexity of assessing vulnerabilities stemming from large external imbalances. The principal question underlying such an assessment is whether the CEECs can produce sustained growth, even if not at the high rates of the past few years. This is the subject of the next section.

## **How Do the Influences on Growth Stack Up to Emerging Markets More Generally?**

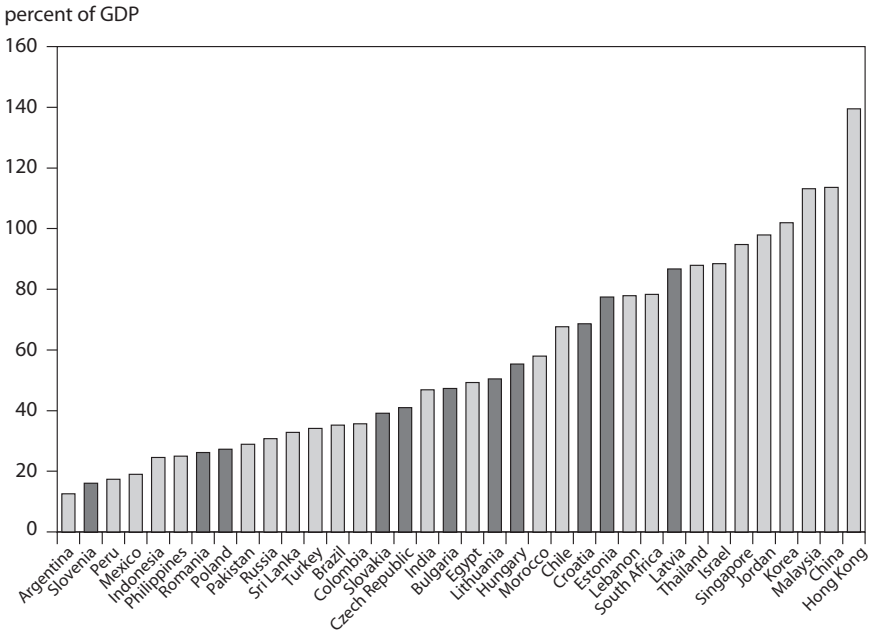
Understanding the determinants of economic growth remains a highly imperfect science. The growth accounting framework used in the last section reveals the mechanics of growth but does not explain why some

**Figure 1.7 Aspects of CEEC financial accounts**

**a. Net capital flows, 2001–05**

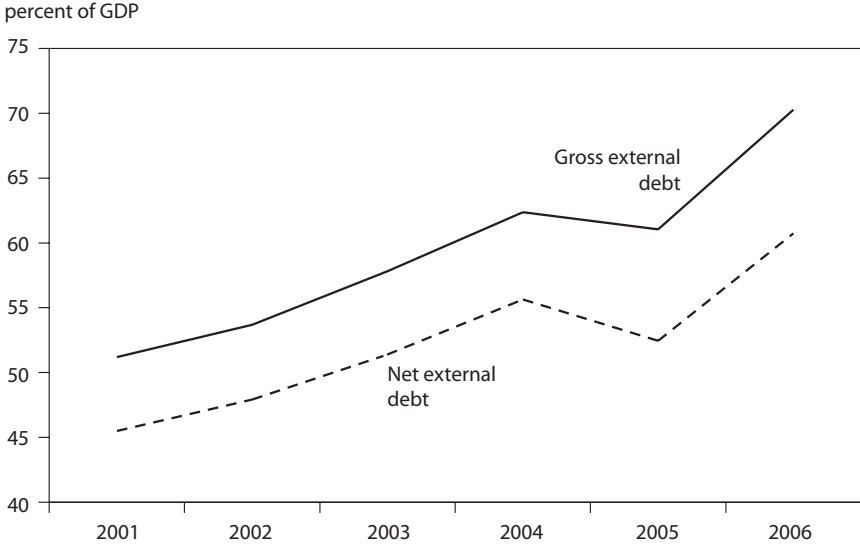


**b. Private credit, 2006**

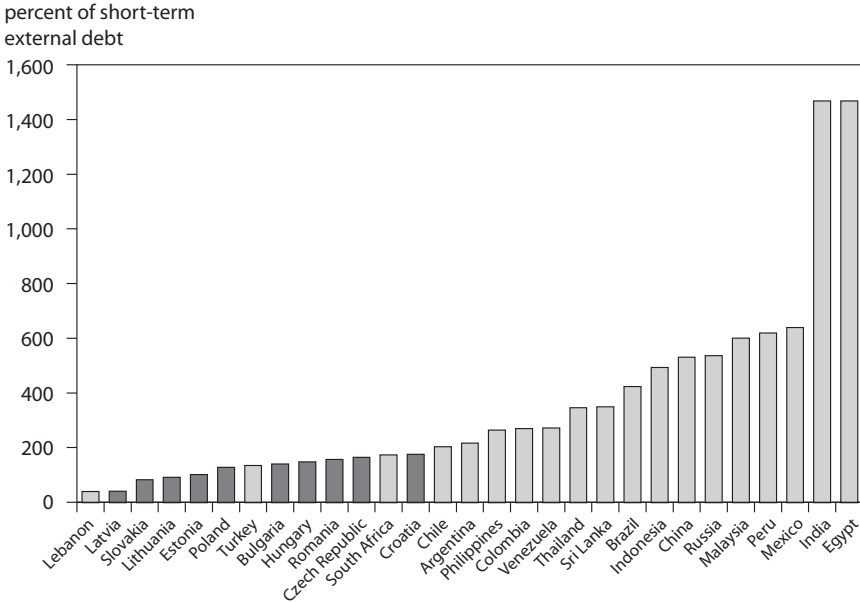


**Figure 1.7** (continued)

**c. External debt, 2001–06**



**d. International reserves, 2006**



Note: Dark bars indicate the Central and Eastern European countries.

Source: International Monetary Fund, *World Economic Outlook*; World Bank, *Global Development Finance* database.

countries grow faster than others. For this information, there are few alternatives to the growth regression literature, which uses the experiences of many countries to indicate through panel data regressions what conditions and policies best support growth. Of course, it is important to recognize the limitation of empirical exercises using panel data.

The practical question addressed here is twofold: First, what has contributed to the relative strength of growth in the CEECs, and second, are conditions in the CEECs right for continued strong growth that would support adequate returns to the high investment rates funded by both domestic and foreign savings?<sup>6</sup> Analysis of many previous studies resulted in selection of the sparest list of variables likely to capture the key influences on CEEC growth. Then, estimating parameters using five-year overlapping averages of data from 146 countries (advanced, emerging-market, and low-income) during 1985–2004, the key strengths and weaknesses of the conditions for growth were identified and the results used to examine how growth rates are likely to evolve in the next five years.

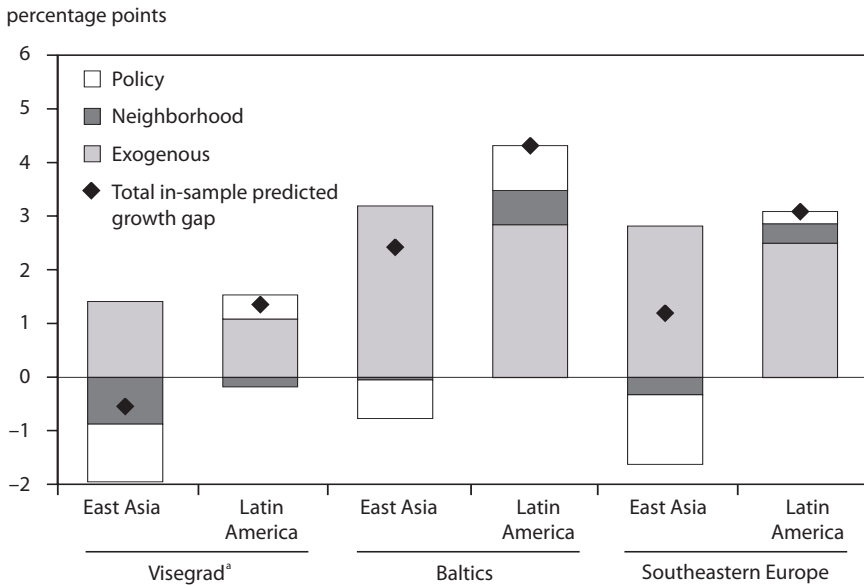
Broadly, the results support evidence from other studies that three types of influences play a key role in growth. The first group can be called exogenous variables—historical or demographic variables over which policy has little control except in the very long run; these are initial GDP per capita and population growth, both negatively related to GDP growth. A second key influence is partner country growth: Countries that have trade relationships with faster growing countries tend to grow faster themselves. And a third group comprises policy variables—simple proxies for the cost of investment, labor force education, openness to trade (which provides growth-stimulating competition), the ratio of tax receipts to GDP (after a critical point, larger governments impede efficiency), and institutional quality (assessment of the latter is based on indices compiled for the *International Country Risk Guide* encompassing measures of government stability, democratic accountability, law and order, quality of bureaucracy, and corruption).

The model predicts in-sample growth rates reasonably well (see Schadler et al. 2006 for full reports on estimates and in-sample predictions). More to the point for this chapter, the results indicate a number of strengths and some weaknesses of the CEECs relative to the other groupings of emerging-market countries. Figure 1.8 presents average differences (indicated by the black diamond) between in-sample predictions of growth rates for each of three CEEC groupings and for the East Asian emerging-market group on the one hand and the Latin American emerging-market group on the other. It also classifies each of these differences in growth rates into the three clusters of underlying determinants—exogenous factors shown in light grey, the neighborhood factor shown in dark grey, and policy factors shown in white.

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6. The empirical work presented in this section derives from Schadler et al. (2006).

**Figure 1.8 Differences in contributions to growth: CEEC groupings relative to Latin America and East Asia, 1999–2004 average**



a. Czech Republic, Hungary, Poland, and Slovakia.

Note: Contribution to average growth in CEEC grouping less contribution to East Asia or Latin America as labeled. Positive numbers indicate stronger contributions in CEEC grouping.

The clear message here is that the CEECs generally and the Baltic and Southeastern European countries in particular have experienced a sizable boost to growth since 2000 from exogenous factors—primarily low population growth rates relative to both East Asia and Latin America. The neighborhood effect has been mixed—generally negative relative to the East Asian countries but positive (and in some cases strongly so) relative to Latin America.<sup>7</sup> Differences in the policy environment, while smaller than differences in exogenous influences, are on average positive vis-à-vis Latin America but negative vis-à-vis East Asia. These differences are dominated by size of government (smaller in East Asia than in most of the European countries), openness (East Asian countries tend to be more open than those in Europe), and schooling (European countries have higher levels of educational attainment than Latin America).

7. The much better neighborhood effect since 2000 in the Baltics than in the Visegrad or Southeastern countries reflects the Baltics' important trade relations with the relatively rapidly growing Scandinavian countries and Russia, in contrast to the more important role of the core euro area in the Visegrad countries.

Looking ahead, conditions for continued strong growth in the CEECs are rather good. The out-of-sample predictions suggest that per capita GDP growth through 2009 could range from about 5 percent for the Baltics to about 4 percent for the Visegrad countries. To a large extent, this relatively favorable outlook reflects improvements during the past five years in some policy areas (notably, size of government, openness, relative price of investment, and educational attainment). These improvements broadly offset the reduction in growth prospects stemming from the smaller gap in per capita income in advanced countries—in other words, diminishing catch-up opportunities. Nevertheless, the current policy environment in the CEECs is set to continue to exert a (small) negative effect relative to that in East Asia, indicating the continuing need for more growth-oriented policies (particularly by cutting the size of the government relative to the economy) to narrow the growth gap vis-à-vis emerging Asia.

## **Are Growth and Current Account Positions in Sync?**

This generally reassuring picture of growth in the CEECs has sidestepped the question of whether the relatively heavy reliance on foreign savings to support investment will itself become a negative influence on growth. In other words, will vulnerabilities associated with large current account deficits and rising indebtedness (even if the debt is held by the private sector) constrain growth? There are two related components of this question: First, has the use of foreign savings been inefficient or wasteful so that future growth will not meet the expectations of investors, and second, are there indications that markets might be spooked by large current account deficits and (what might be seen as) associated vulnerabilities? This section addresses the first of these concerns and the second is taken up in the next section.

There is no straightforward method to determine whether the large capital inflows to the CEECs are going to productive or sustainable uses. There is a temptation to assume that FDI is sustainable and even efficient, while flows through the banking systems (at least some of which find their way into borrowing by households and small businesses) are less reliably so. Buying into this assumption of course entails many leaps of faith: that entrepreneurship in the host countries is poor, that consumption-smoothing does not allow adequately for downside risks to income growth, and that accumulation of consumer durables does not have a sufficiently strong effect on productivity, to name a few.

An alternative to such a simplistic approach, taking into account the lack of data for a micro examination of the efficiency of foreign capital-financed spending, is the use of a macro model to examine the link between growth and current account deficits using annual data on all European countries (during 1975–2004 for advanced countries, 1995–2004 for

others; Schadler et al. 2006). The intuition is that European integration may make Europe different from other regions: It may make capital flows more responsive to growth opportunities and, conversely, growth more responsive to capital inflows.

Figure 1.9 provides some evidence for this intuition. It shows the relationship between initial per capita income levels (horizontal axis) and the growth of per capita GDP (vertical axis). The negative relationship represents the familiar empirical regularity that, as they exploit catch-up opportunities, poorer countries grow faster than richer ones. Now the question is, do countries that use foreign savings more have faster growth for any initial income level—in other words, do higher current account deficits make the negative slope steeper? Grouping observations by quartiles of current account deficits (lower quartiles are smaller deficits) suggests they do. In Europe, larger current account deficits produce a steeper downward sloping line, suggesting that over time, foreign savings have indeed fueled growth. In addition, Europe's economic and financial integration is advanced and deepening, and the flow of foreign savings into relatively poor countries (such as the CEECs) seems actually to hasten the speed of the catch-up. Would this heuristic observation hold up in the estimation of a full model—thus providing *prima facie* evidence of efficient use of foreign savings?

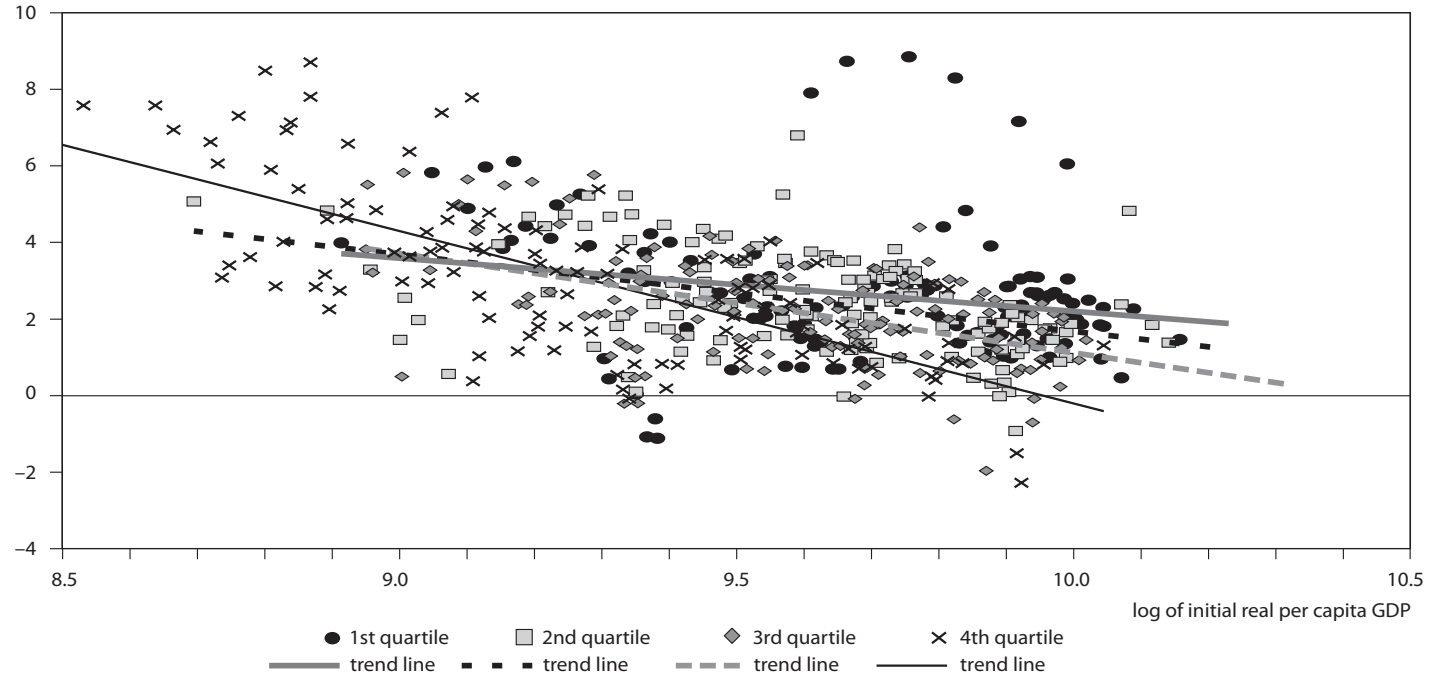
To test this intuition, a stripped-down growth model was augmented by incorporating a term representing the interaction between the current account deficit and the initial per capita GDP along with an equation representing the current account deficit as a function of initial GDP per capita, the growth of GDP per capita, and a demographic variable. Estimating this two-equation system jointly on data from all European countries permitted two inferences from this macro approach: First, within Europe, the use of foreign savings has a positive effect on growth, and second, the effect is stronger the lower the initial level of GDP (table 1.1). Preliminary tests of whether the nature of the inflows (as between FDI and other inflows) makes a significant difference to the growth impact suggest that it does not.

## How Do Markets View the Risks?

Thus far, the assessment of vulnerabilities has appealed to macroeconomic principles and models, but in many ways the perceptions and behavior of financial markets are the acid test. No matter what the models say, if financial markets have a different take, theirs will likely prevail. True, financial markets have periods of myopia, but over time they also reflect the views of investors with their money on the line. So this section examines how markets see the high-growth, high-imbalance strategy of CEECs.

**Figure 1.9 Current account deficits and speed of convergence in the European Union, 1960–2004**

growth in real GDP  
per capita



Note: Scatter plot observations are grouped by quartiles of the current account deficit, with the smallest deficits in the lowest quartile.

Source: Schadler et al. (2006).

**Table 1.1 Europe: Growth and current account deficit regressions**  
(using annual data 1975–2004)

Variable	Growth regression	Current account deficit regression
Log of GDP per capita <sup>a</sup>	–4.76 (4.17) <sup>***</sup>	–10.52 (4.86) <sup>***</sup>
Schooling	0.25 (2.59) <sup>***</sup>	
Population growth	–0.06 (0.22)	
Current account deficit	3.68 (3.25) <sup>***</sup>	
Log of per capita GDP * current account deficit	–0.39 (3.31) <sup>***</sup>	
Old-age dependency ratio		0.08 (2.02) <sup>**</sup>
Growth of GDP per capita <sup>a</sup>		0.12 (0.51)
Number of observations	503	503
R-squared	0.49	0.52

a. The coefficients on income and on growth are time-varying. For these variables, the table shows the parameter estimates for 2004.

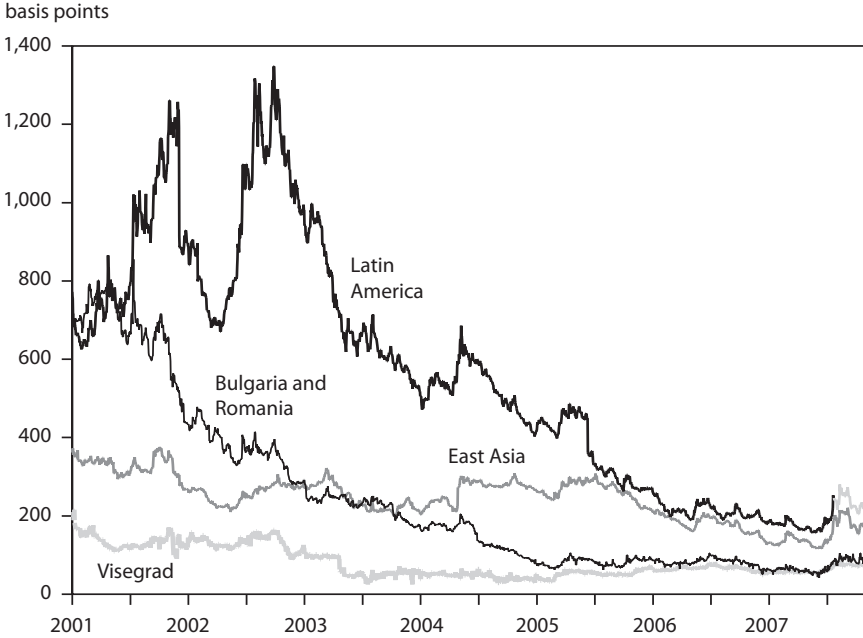
Note: For ease of exposition, the table presents results in terms of the current account deficit rather than the current account balance. Absolute value of z-statistics in parentheses. \*\*, \*\*\* show significance at the 5 and 1 percent levels, respectively.

Source: See Schadler et al. (2006) for full explanation.

To get a handle on this question, we look at interest rate spreads on sovereign foreign currency–denominated bonds. This measure of the market’s perception of risk is reasonably comparable across countries where such issues exist.<sup>8</sup> Over the past few years, spreads on foreign currency sovereign debt have fallen for virtually all emerging-market countries; figure 1.10 shows averages for the regional groupings of countries used earlier in this chapter. Starting in 2001–02 (differing by group), spreads have had a general downward tendency—Latin America quite rapidly from 2003 and East Asia much more gradually. Notably, the Visegrad

8. In fact, only eight of the ten CEECs covered in this chapter have outstanding sovereign bond issues in euros in quantities large enough to constitute a market. Estonia and Latvia have small or no sovereign bond issues.

**Figure 1.10 Emerging markets: External sovereign debt spreads, 2001–07 (unweighted average, log scale)**



Visegrad = Czech Republic, Hungary, Poland, and Slovakia.

Source: Bloomberg market data.

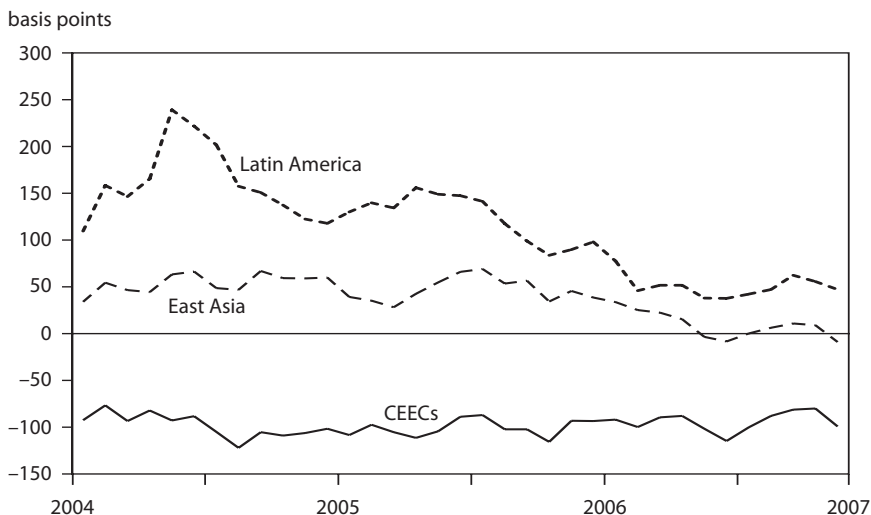
countries have had the lowest spreads among the various groups for several years, while Bulgaria and Romania saw their spreads fall below those of Latin America and East Asia in 2004–06.

How can these differences in the behavior of spreads be explained? The first step is to identify common influences on spreads and see how they differ across countries. The starting block is a panel regression of spreads for all emerging-market countries for which comprehensive data are available for a variety of economic, political, and financial “fundamentals” as well as for proxies of global liquidity conditions.<sup>9</sup> With these estimates, it is possible to separate each country’s spread into two components: the part that can be explained by the variables listed above and the part that cannot be explained (equivalent to the country fixed effect and the residual for each observation for each country).

What does this exercise reveal? By and large, the panel regression does a good job of explaining spreads—that is, the part of the spreads not re-

9. Luengnaruemitchai and Schadler (2007) has a full exposition of the empirical work.

**Figure 1.11 Emerging markets: Gap between actual and “explained” spreads (residuals including country fixed effects), 2004–07**



Source: Luengnaruemitchai and Schadler (2007).

lated to fundamentals tends to be small.<sup>10</sup> The main exceptions since 2004 are Latin America (where more recent debt crises create sizable positive country fixed effects) and the CEECs (where, since approximately 2003, spreads have been 50 to 100 basis points lower than can be predicted on the basis of fundamentals) (figure 1.11). That is, since 2003, markets have viewed the risks in the CEECs as substantially and consistently lower than in other emerging-market countries with comparable fundamentals.

Although it cannot be explained, the coincidence of the drop in the country-specific risk premia and the market’s growing perception that the CEECs would enter the European Union in 2004 is striking. In other words, the benefits of integration in the EU may have put the CEECs in a risk class different from that of other emerging-market countries. Several considerations could have influenced the link between EU entry and the reassessment of risk: These range from a possible perception that the European Union would bail out CEECs should they have difficulty servicing their debt to a relatively benign view that greater integration would help growth prospects and motivate better macroeconomic policies. The findings are equally compatible with the conclusion.

10. The panel regression is carried out with daily data for each emerging-market country. Aggregates shown in figure 1.11 are averages of the parts of the spread explained by fundamentals for each group of countries.

## Conclusion

By conventional standards, the external imbalances of many of the Central and Eastern European countries are large enough to justify serious concern. While most have substantial FDI financing, most also make use of sizable debt-creating inflows. At the same time, these countries stand out among emerging markets for having relatively small official reserves compared to their short-term external debt.

But the analysis in this chapter suggests that it may also be important to view the implications of these large imbalances in the context of the unusual circumstances of the CEECs. They have all emerged from a long period of distortive central planning and face immense opportunities for catch-up, especially in light of their proximity to Western Europe and rapid absorption of EU institutions and policy frameworks. Indeed, if the large benefits of globalization are to fully rebound to emerging-market countries—with the implied coordination of savings-rich and capital-poor economies—they must be expected to produce the kinds of imbalances seen recently in the CEECs. Obviously there are speed limits on the absorption of foreign savings (and at least Latvia has certainly reached them), but testing the limits on imbalances is likely to be a continuing feature of this unique group of countries.

This pushes to the center of the policy debate the question of how countries should manage the risks in large-scale transfers of saving. Thus far, as shown in this chapter, markets have been quite forgiving in assessing these risks, but this benevolence cannot be taken for granted indefinitely. Periods of greater stress on the markets are sure to occur. In effect, the high-growth/high-imbalance strategy of most CEECs is inherently a risky one and leaves little room for policy mistakes. Policies—macroeconomic, structural, and financial—must be geared toward anticipating the risks of sudden changes in market sentiment. This means that fiscal policy must avoid adding to the national financing burden and even generate net savings so as to make room for private investment and protect against the need for wrenching adjustments in the event of a change in market sentiment; in addition, monetary policy must be cast in a clear and transparent framework that anchors expectations of inflation or the exchange rate and ensures rapid responses of money market conditions in the event of shocks to expectations or market conditions. Structural policies must focus on completing the transition from the distortive legacies of central planning, including large roles for government in the economy and disincentives for workers in restructuring industries to find employment in rising parts of the economy. Financial policies must ensure that banks, which are increasingly intermediating foreign savings, are sound and able to assess and manage risk safely.

While rough patches are inevitable, the historically large shift of savings into the CEECs can be managed to the benefit of overall growth performance—an example for other emerging markets to emulate.

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