Development of international investment position in the selected new European Union member countries

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Abstract

In the following paper we examine the main aspects of international investment position development in the selected new European Union member countries since the year 1999, with an emphasis on their international financial assets and liabilities structure. We assess the extent of the Bulgaria's and Romania's international financial integration compared with the Czech republic and the Slovak republic ones. The aim is to examine the main implications of the different economic performances of the countries on the selected aspects of their international financial integration. We also observe the main trends in their external capital structure development in terms of the relative importance of foreign direct investments, portfolio equity and debt investments and external debt. Finally, we explore the implications of the accumulated stock of external capital for future trade and current account balances development.

Keywords: financial integration, external capital structure, trade integration, transition economies

JEL classification: F15, F36, F41

1. Introduction

Since the beginning of the 1990s the consistent capital flows liberalization has led to the significant foreign capital inflows to the transition countries from the region of the Central and Eastern Europe. The renewal process of the domestic capital base after the initial macroeconomic stabilization period in the first half of the 1990s has uncovered the imbalance between the domestic resources (national savings) a real capital requirements of the transition process. High growth potential of the transition countries together with the huge real investments demanded by the transition process has raised the attractiveness of the investment conditions for the foreign investors and related foreign capital inflows. Among the other investment incentives for the foreign investors besides low initial level of domestic capital base we consider relatively high initial level of human capital and institutional guarantees in a sense of future accession of the transition countries to the European Union (EU). In spite of the fact that the overall economic performance of the transition countries was and still remains affected by the initial economic shock, the rates of the real GDP growth in some new EU member countries still remains relatively high during the past decade.

Accumulation of the foreign capital stimulates transition countries to intensity the convergence process. It also enables transition countries to exploit potential investment opportunities and at the same time to increase the level of consumption expenditures and national income. In case of the countries that face the rapid increase in the foreign capital inflows it is necessary to point out two significant consequences.

First, repatriations of the profits (considering the profitability of the foreign equity

investments) and repayments of the interests and debts (considering the foreign loans and debt securities) increases the overall burden for the foreign investments target country to stabilize its foreign financial position through the surpluses in the foreign trade. The size of surpluses needed is determined not only by the overall volume of the accumulated foreign liabilities and the rate of the real GDP growth but also by the expected rate of return on the foreign assets and liabilities of the country[1].

Second, for the indebted country it is necessary to estimate the overall exposure to the financial shocks. For example, financial crisis in the 1990s (South-East Asia, South America, Russia) has turned attention of the economists to the potentially high sensitivity of the affected countries to the specific form of foreign debt financing - foreign short-term debt loans. From this point of view it is necessary to take into account the overall risk that is included in each form of the foreign capital flowing to the transition country.

In the paper we analyze the main aspects of the international financial integration of Bulgaria and Romania in the period 1999-2006[2] that became the EU members in 2007. At the same time we emphasize the overall structure of the foreign capital inflows to these countries. Results of the analysis we compare with the main features in the development of the international financial integration of the Czech republic and the Slovak republic for purpose of emphasizing the impact of the different economic performance of the countries on the selected aspects of their international financial integration. We also highlight one of the essential attributes of the foreign capital structure - relative importance of the FDI, portfolio equity investments, portfolio debt investments and debt (loans) in the overall foreign capital structure. We reveal the main implications of the accumulated stock of foreign liabilities to the future development in the foreign trade and current account balances.

2. Overview of the main trends

A. Exchange Rate Policy Framework

We consider that exchange rate policy is one of the key attributes related to the general macroeconomic decisions that the countries from the region of the Central and Eastern Europe have undertaken through the process of transition[3] from the central planning to the market economies and the process of convergence[4] toward the EU countries. In the table 1 we provide the actual overview of the main exchange rate policy features in Bulgaria, the Czech republic, Romania and the Slovak republic.

Table 1 Selected Transition Economies: Exchange Rate Policy Framework, 2007

	exchange rate system	exchange rate policy framework	international capital flows regulation
Bulgaria	Currency board (since July 1997)	exchange rate as nominal anchor (since July 1997)	low
Czech republic	managed floating (since May 1997), EUR as reference currency	flexible inflation targeting (since April 1998)	low
Romania	freely managed floating (since August 2005), EUR as reference currency	flexible inflation targeting (since August 2005)	low

[1] It is significantly determined by the structure of the overall foreign assets and foreign liabilities balance sheet.

[2] The selection of the period was determined by the availability of the official data about the international investment position of Bulgaria and Romania.

[3] Especially through first five-seven years after the year 1989, when the exchange rate policy helped to shape the general macroeconomic framework relating to the initial macroeconomic stabilization and form the background for the sustainable economic growth.

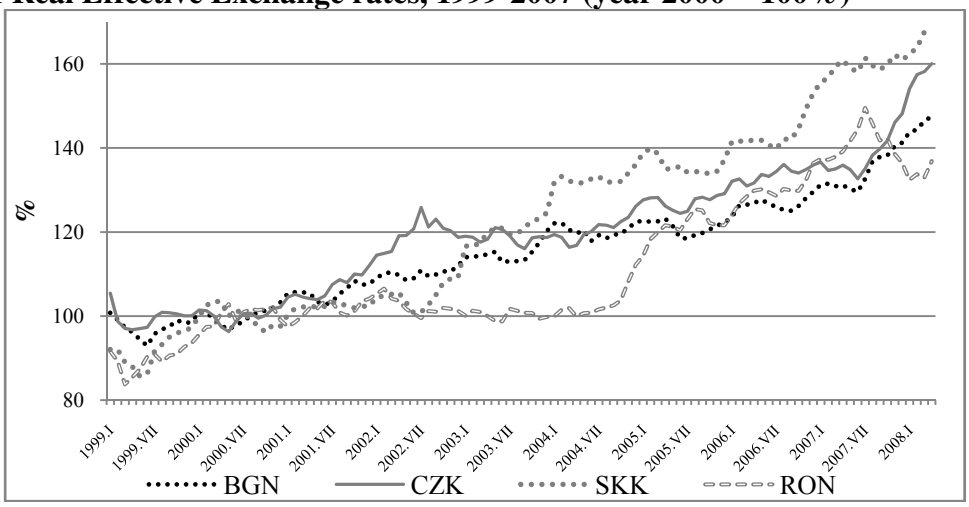
[4] Especially in the later years of transition when the process of the convergence was intensified.

Slovak republic	managed floating (since October 1998), EUR as reference currency	flexible explicit inflation targeting under ERM2 (since November 2005)	low

Source: Author.

Real exchange rate development represents one of the most important determinants of the external competitiveness of the economy. Transition countries have experienced a long trend of real exchange rate appreciation since the period of successful macroeconomic stabilization at the beginning of the 1990s. The overview of the real effective exchange rate (REER) development in Bulgaria, the Czech republic, Romania and the Slovak republic during 1999-2007 shows the figure 1.

Figure 1 Real Effective Exchange rates, 1999-2007 (year 2000 = 100%)



Source: Authors calculations based on [1].

Figure 1 shows the long trend of REER appreciation in the selected Central and Eastern European Countries (CEEC) during the period 1999-2007. The real appreciation especially in the beginning of the period was the result of higher persisting inflation differentials[5] and later it was the result of persisting appreciation of the nominal exchange rates. Among the other determinants of the REER appreciation process we emphasize high annual rates of the real GDP growth (see figure 2) and significant inflows of foreign capital (see figure 4). Another important source of REER appreciation in case of Bulgaria was fixing the central parity of BGN to EUR since 1997. Development of REER in Romania[6] was determined by the depreciation trend of RON nominal exchange rate till the end of 2004. Increased rates of the real GDP growth during the period of successful disinflation, together with the intensive foreign capital inflows (as a result of capital flows liberalization and persisting high interest differentials) and following appreciation of the ROL nominal exchange rate have contributed to the intensive REER appreciation of RON since 2005[7].

B. Real Economic Performance

Inflows of the foreign capital encourage the real output growth in the target economy. At the same time faster growth of the real domestic output stimulates the foreign investors to

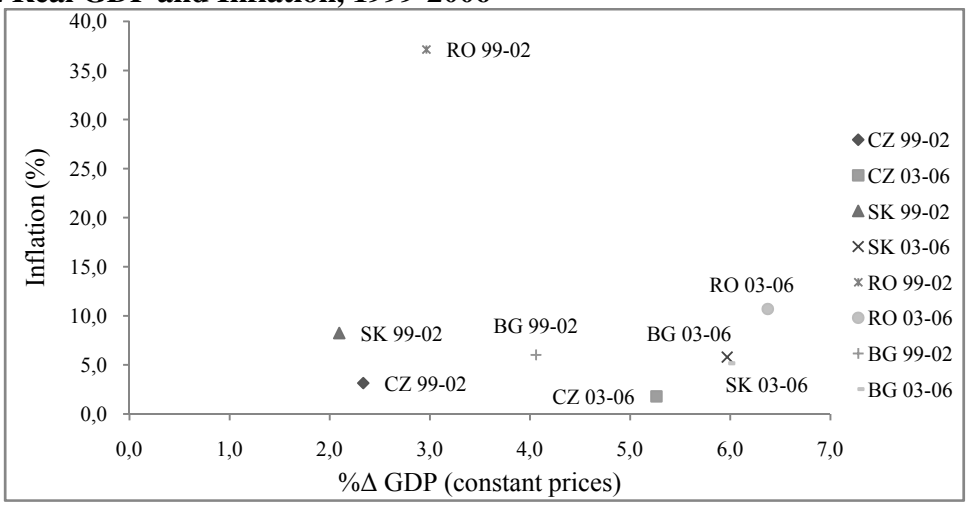
[5] See figure 2 to review higher inflation in the selected CEEC during especially earlier periods of the transition process.

[6] As shown in figure 1 there was no depreciation trend of RON till the end of 2004.

[7] Until 2005 the currency code for Romanian currency was ROL. Since the July 2005 till the December 2006 the National Bank of Romania has accomplished a redenomination of the Romanian currency.

allocate the capital in the dynamically growing economy. In the figure 2 we compare the growth of the real GDP and inflation in the selected CEEC. It is clear that high rates of the real GDP growth were combined with the inflation decrease during the selected period.

Figure 2 Real GDP and Inflation, 1999-2006



Source: Authors calculations based on [2],[15].

One of the most crucial determinants of the successful disinflation process in case of Bulgaria was fixing the central parity of BGN to EUR together with the currency board system implemented by the National bank of Bulgaria in 1997. On the other hand the rate of inflation in Romania was still considerably high in 2000 (45.7%) and even in 2004 (11.9%). Because of unsatisfactory inflation development and high volatility of foreign capital inflows (as a result of capital flows liberalization) the National bank of Romania has implemented the system of flexible inflation targeting. Implementation of the strategy had the positive influence on the future disinflation development in Romania.

International trade integration[8] is stimulated by the international division of the labor that is based especially on the comparative competitive advantage assumption. The extent and the dynamics of the international trade development are the key determinants of the overall openness of the economy. We assume, considering the relation between the positive and negative aspects of the overall economic integration, that the international trade integration is more prominent in relation to the international financial integration. International trade integration reduces the expectancy of the financial crisis (especially in the small open economies) and in case the financial crisis arises it eliminates the overall costs of the crisis. Overall impacts of the economic integration are determined by the interactions between the international trade integration and the international financial integration. In case the financial crisis arises the international trade integration reduces the negative impacts of the crisis on the real GDP growth of the country and it also accelerates the recovery from the crisis. The country may experience the international trade integration deepening even if it is low financial integrated economy. On the other hand the international financial integration deepening without the adequate international trade integration stimulates the unacceptable reallocation of the resources. In such a case the foreign capital may flow to branches in which the target economy doesn't have the foreign comparative advantage. Table 2 summarizes the overview of the international trade integration development in the selected CEEC.

Table 2 International Trade Integration, 1999-2006 (% of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006

[8] International trade integration is calculated as a share of annual exports and imports in the GDP.

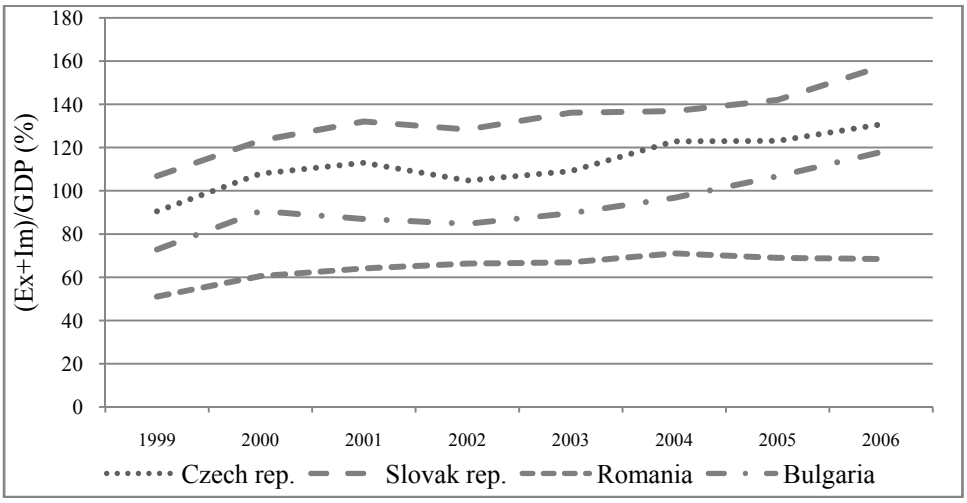
Bulgaria	73	91	87	85	90	97	107	118
Czech rep.	91	108	113	105	109	123	123	131
Romania	49	59	64	71	73	77	63	69
Slovak rep.	107	123	132	128	136	137	142	157

Source: Authors calculations based on [2],[3],[15].
Note: International Trade Integration: (export + import)/GDP (%)

All selected CEEC have experienced the dynamic increase in the international trade integration during the period 1999-2006. In situation when all selected CEEC have experienced high rates of the real GDP growth their exports and imports have been increasing at higher rates than the real GDP.

Comparing the trade openness of the selected CEEC (see figure 3) we have observed that in the period 1999-2006 Bulgaria and Romania were less opened than the Czech republic and the Slovak republic.

Figure 3 International Trade Integration, 1999-2006



Source: Authors calculations based on [2],[3],[15].

Considering the current rates of the real GDP growth[9] we expect the consistent increase of the Bulgarian and Romanian overall international trade openness.

C. Main Trends in the Current Account and Net International Investment Position Development

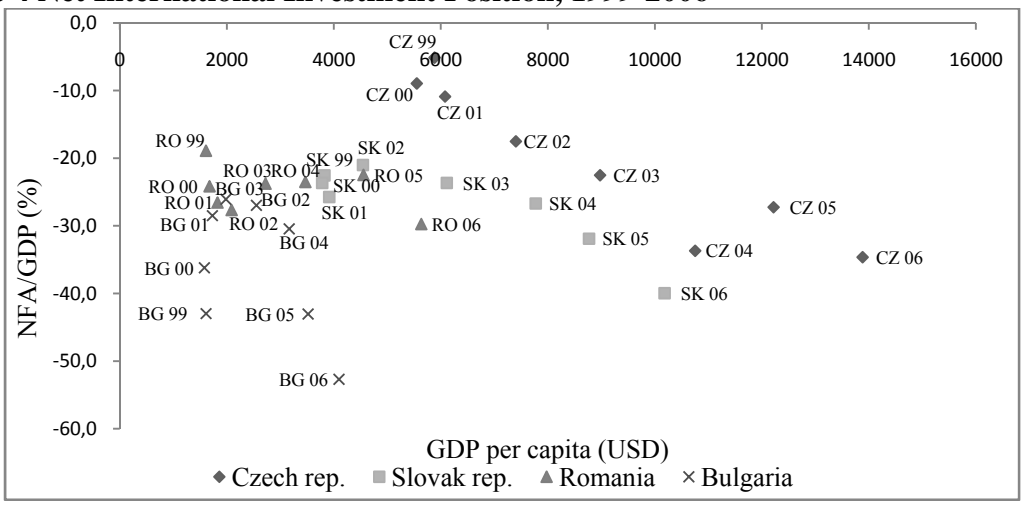
High trade openness together with the specific conditions typical for the beginning of the transition process has determined the overall development of the international investment position of the selected CEEC. Initial low level of the domestic capital base, high capital requirements of the transition process and consistent capital flows liberalization have contributed to the intensive increase of the international financial integration of the selected CEEC via the high foreign capital inflows.

In the figure 4 we summarize the overview of the net international investment position development of Bulgaria, the Czech republic, Romania and the Slovak republic in the period 1999-2006 by comparing the net foreign assets and real GDP per capita development. It is clear that the net international investment position was negative in all four countries during the selected period. At the end of the period the share of the net foreign liabilities in the GDP

[9] In order to maintain the current high rates of the real GDP growth the selected CEEC should reduce high current account deficits, stimulate the competitiveness of the domestic private enterprises and maintain the low inflation environment.

in Bulgaria was around 53%. In three remaining countries the share of the net foreign liabilities in the GDP didn't exceed 40%.

Figure 4 Net International Investment Position, 1999-2006



Source: Authors calculations based on [2],[3],[4],[9],[15].

Considering the initial conditions at the beginning of the transition process the high foreign capital inflows were well expected assuming higher rates of the return on the capital allocated in the transition countries and expected higher rate of convergence toward the Western European economies.

Together with high foreign capital inflows the selected group of the countries has also experienced the negative trend in the current account development (see table 3). The current account deficit for the whole group of countries was on average around 5.7% of the GDP (with the maximum at around 7.3% of the GDP in case of Bulgaria and with the minimum at around 4.3% of the GDP in case of the Czech republic). We suggest that the well known safe limit for the current account deficit recommended by the International Monetary Fund is around 3% of the GDP.

Table 3 Current Account, 1999-2006 (% of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	-5,0	-5,6	-5,6	-2,4	-5,5	-6,6	-12,0	-15,8
Czech rep.	-2,4	-4,7	-5,3	-5,7	-6,3	-5,2	-1,6	-3,1
Romania	-4,1	-3,7	-5,5	-3,3	-5,8	-8,4	-8,7	-10,3
Slovak rep.	-4,8	-3,3	-8,3	-8,0	-6,0	-7,8	-8,6	-8,3

Source: Authors calculations based on [2],[3],[15].

As a result of the consistent current account deficits in the selected CEEC the net international investment position development has changed rapidly. While in case of Bulgaria the share of net foreign liabilities in GDP has exceeded 50%, Romania has managed to keep the ratio of net foreign liabilities to GDP below 30%. Considering the negative trend in the net international investment position development in the selected CEEC we suggest that these countries were able to cover high current account deficits due to dynamic foreign capital inflows as a result of the international financial integration deepening.

D. International Financial Integration

High current account deficits in Bulgaria, the Czech republic, Romania and the Slovak republic were the result of high capital inflows (at average 2.5% of the GDP for all countries) and negligible capital outflows (at average 0.2% of the GDP for all countries).

As a result the level of the international financial integration[10] of the selected CEEC has increased from 115% in 1999 to 142% in 2006. The overview of the international financial integration development in Bulgaria, the Czech republic, Romania and the Slovak republic during the period 1999-2006 shows the figure 3.

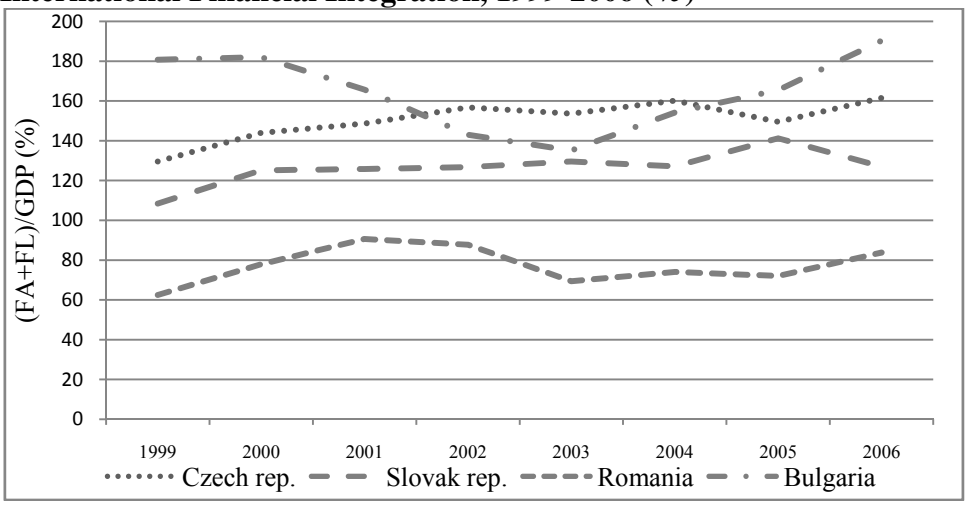
Table 4 International Financial Integration, 1999-2006 (% of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	181	182	166	143	135	154	165	190
Czech rep.	130	144	149	157	154	160	150	162
Romania	63	78	91	88	69	74	72	84
Slovak rep.	108	125	126	127	130	127	141	127

Source: Authors calculations based on [2],[4],[15].
Note: International Financial Integration: (foreign assets + foreign liabilities)/GDP (%)

We assume that the international financial integration development in the selected CEEC is the result of an increased cross-border financial assets allocation global trend. Financial account liberalization together with the financial sector deepening and the structural reforms has stimulated this trend in the transition countries. The international capital flows in comparison with the international good flows are much more sensitive to the changes in the potential target country economic development. From the figure 5 we may observe almost the permanent trend in the international financial integration deepening in the Czech republic and the Slovak republic.

Figure 5 International Financial Integration, 1999-2006 (%)



Source: Authors calculations based on [2],[4],[15].

In Romania and especially in Bulgaria the trend in foreign financial assets and liabilities development was not positively correlated with the GDP development. As one of the most essential determinants of the negative trend we consider an increased international financial markets uncertainty[11] and following decreased incentives of the foreign investors to allocate the capital to the less developed regions.

In Bulgaria the decrease in the international financial integration was partially the result of the government actions in official debt rescheduling[12] in the period 2002-2003. As a

[10] International financial integration is calculated as a share of total foreign financial assets and liabilities in the GDP.
[11] Especially as a result of bombing attacks in the U.S.A. in September 2001.
[12] Government actions have induced the decreased involvement of the foreign investors in financing the country's official debt.

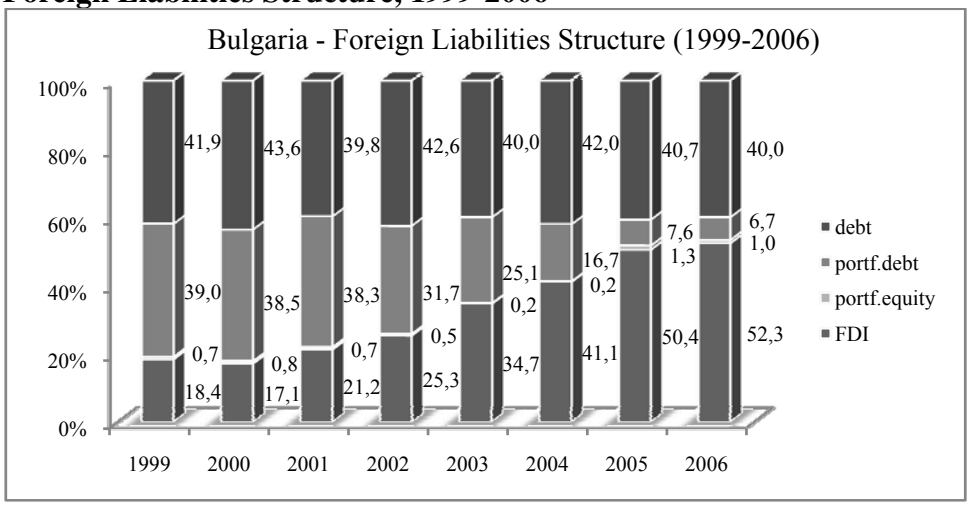
result the total foreign financial assets of the domestic banks have decreased while the domestic financial assets (especially government securities) of the domestic banks have increased.

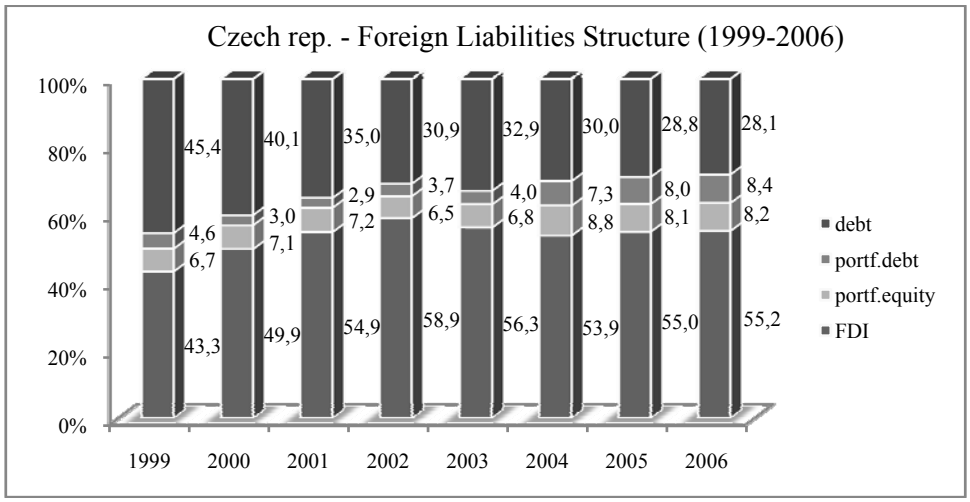
In Romania the decrease and following international financial integration stagnation has reflected the slump in the stock of the FDI (2002) and the foreign debt investments (2002-2003). The decrease in the long-term foreign debt investments was the result of an increased securitized debt share[13] in the total foreign financial liabilities.

E. Foreign Capital Portfolio Structure

At the beginning of the transition process the highest share in the foreign financial liabilities in the selected CEEC was in a form of foreign debt. In 1999 the share of the foreign debt in the total foreign financial liabilities was still 66% on average, while the share of the equity investments was only 34% on average. During the period 1999-2006 the share of the equity investments in the selected CEEC has increased[14] so that at the end of the period it has achieved around 54% in the total foreign financial liabilities (figure 6).

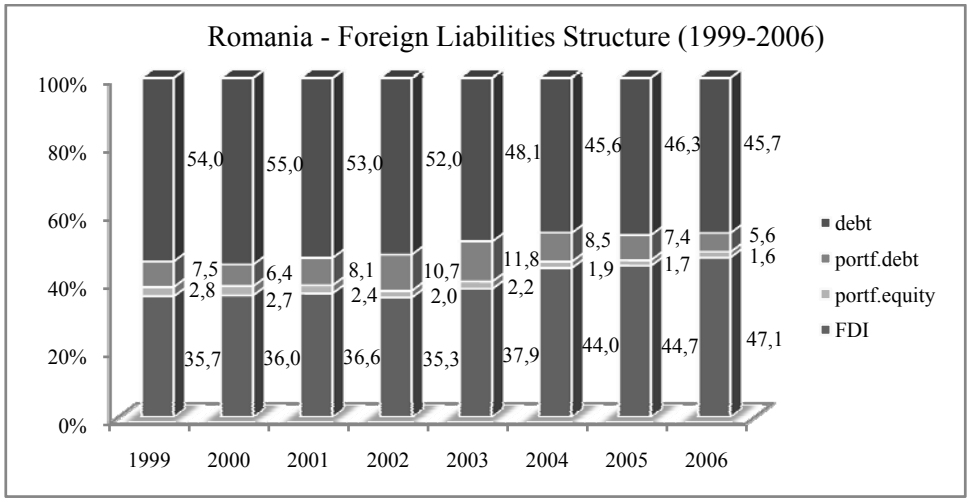
Figure 6 Foreign Liabilities Structure, 1999-2006

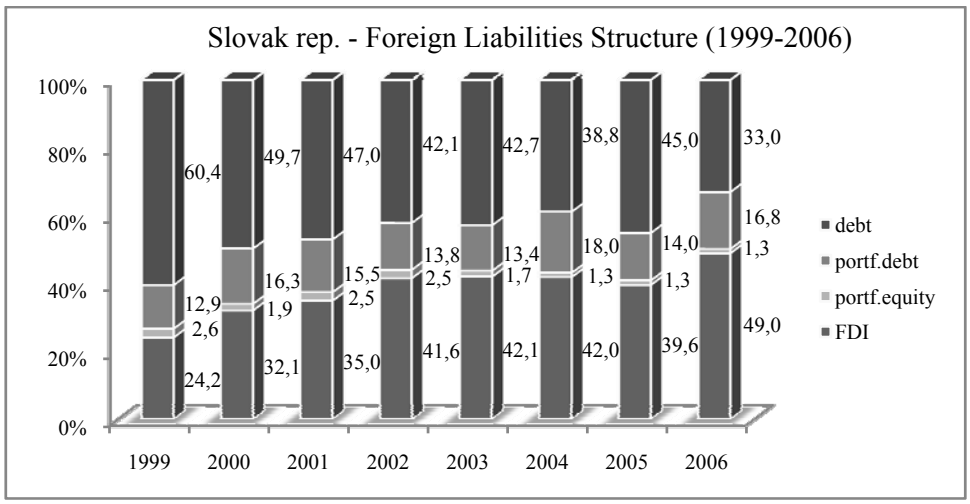




[13] The share of the securitized (domestic and foreign) debt is directly affected by the level of the domestic financial system.

[14] Especially as a result of the dynamic FDI inflows.





Source: Source calculations based on [2],[4],[15].

The selected CEEC (except Bulgaria[15]) have experienced the obvious decrease in the foreign non-securitized debt during the period 1999-2006. In case of Bulgaria we emphasize the relatively high share of the portfolio debt investments[16] in its foreign financial liabilities at the beginning of the selected period as a result of high interest of foreign investors to allocate their resources to the debt securities with higher interest yields in the country experiencing disinflation trend and macroeconomic stability guaranteed by the currency board.

Gradually increasing and relatively high share of the FDI in the foreign financial liabilities that the selected CEEC have experienced during the period 1999-2006 brings few interesting implications. First, the FDI enables domestic companies to share the business and investment risk with the foreign investor. The FDI returns for the foreign investor are not fixed but determined by the overall profitability of the capital allocated in the target economy. The risk transfer from the domestic to foreign investors enables target economies to cover relatively higher current account deficits that on the other hand stimulate the process of the convergence toward the Western European economies. Second, the inflows of the FDI to the selected group of the CEEC stimulate the transfer of the new technologies that contribute to

[15] The share of the foreign debt in the total foreign financial liabilities in Bulgaria remained almost the same during the period 1999-2006.

[16] One of the key assumptions necessary to stimulate an increase in the foreign portfolio investments share in the total foreign financial liabilities we might consider the advanced and liquid domestic financial market. Filling this condition in case of Bulgaria was also necessary for the adoption and successful operation of the currency board.

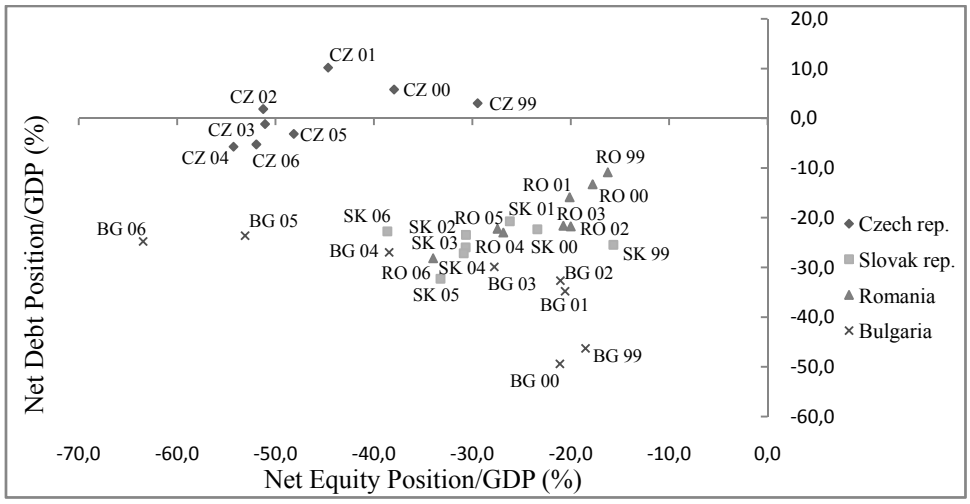
the overall productivity and national income growth. On the other hand we suppose that significant part of the profits from the projects financed by the FDI flows back to the foreign investors domicile.

The relatively low contribution of the portfolio equity investments is still an open question. The low quality of the corporate governance still remains a typical feature of the selected group of the CEEC. This might be the reason why the foreign investors are still facing the risk of cutting-down the profits caused by the insider-trading or due to the political changes (i.e. changes in legislation).

The share of the portfolio investments in the total foreign financial liabilities in the selected CEEC remains rather low in spite of the generally expected convergence of the foreign financial liabilities structure toward the Western European countries. Due to the persisting international financial integration and domestic financial markets deepening as well as increasing quality of the corporate governance we expect an increase in the weight of the foreign portfolio equity and portfolio debt investments in the selected CEEC.

Figure 7 shows the overview of the net international investment position structure in Bulgaria, the Czech republic, Romania and the Slovak republic during the period 1999-2006. All countries have experienced an increase in the share of the equity forms of the foreign capital.

Figure 7 Net Equity and Debt Position, 1999-2006



Source: Authors calculations based on [2],[4],[15].

Due to the persisting high rates of the real GDP growth as well as the increasing trade openness we expect an increased intensity of the FDI and portfolio investments outflows from the selected CEEC. As a result the net international investment position of the selected countries would improve.

3. Conclusion

Bulgaria, the Czech republic, Romania and the Slovak republic are an interesting example for understanding the potential outcomes of the international financial integration in the transition countries with a relatively different economic performance. At the beginning of 1990s the high current account deficits in the selected group of the transition countries have intensified the real convergence process by sharing the positive implications of the foreign capital inflows. Among the other aspects of the international financial integration in the transition countries we have highlighted the international risk and technology sharing. The international financial integration deepening stimulates other potential outcomes like lower

perceived risk, higher demand for exports, higher labour remittances from workers migrating to Western European countries, etc.

On the other hand the accumulated stock of the external capital gradually increases the necessity of the selected CEEC to make adjustments in the trade balance over the medium term. At the same time FDI represent the necessary channel of the technology transfer so that especially at the primal period of FDI inflows the transition economies may experience even current account deficit deepening. As one of the most suitable opportunities to change the negative trend in the current account development we consider an increased involvement of the selected CEEC in the international division of the labour process especially through the increased competitiveness of the domestic export branches, domestic production diversification, increased quality of the domestic production, higher product specialization in the higher value added products, etc.

Bulgaria, the Czech republic, Romania and the Slovak republic have gained from favourable external financing especially in the period when the demand for the external capital in other developing countries have reduced as the result of the current account surpluses, interest rates and risk premium decrease in the emerging markets. The only country from the group of the selected CEEC that was able to reduce high current account deficits in the recent years was the Czech republic. Bulgaria, Romania (from 2002 onwards for both countries) and the Slovak republic (from 2003 onwards) have experienced large current account deficits and the negative trend persists till the present. That is the reason why any sudden adjustments in the external balance development in the selected group of countries are simply hard to be expected in the near future.

As the main determinant of the international investment position development in case of the Czech republic and the Slovak republic we consider the trade balance pressures. We assume these countries may experience the relative decrease in the financial account surpluses as the result of the foreign investors' investment strategy diversification and related reallocation of the capital flows to the less developed regions in the EU (i.e. Bulgaria and Romania). That is the reason why we suggest the Czech republic and the Slovak republic to stop the negative trend in the current account development and take the actions necessary to stimulate the export efficiency of their economies. The future development of the trade balance in the selected group of the selected CEEC is significantly determined by the rates of the return on FDI - the higher is the profitability of FDI, the larger surplus in the trade balance is necessary to stabilize the external investment position of the country.

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