Assessing the sustainability of external positions in new EU members

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Motivation and Outline

Some questions:

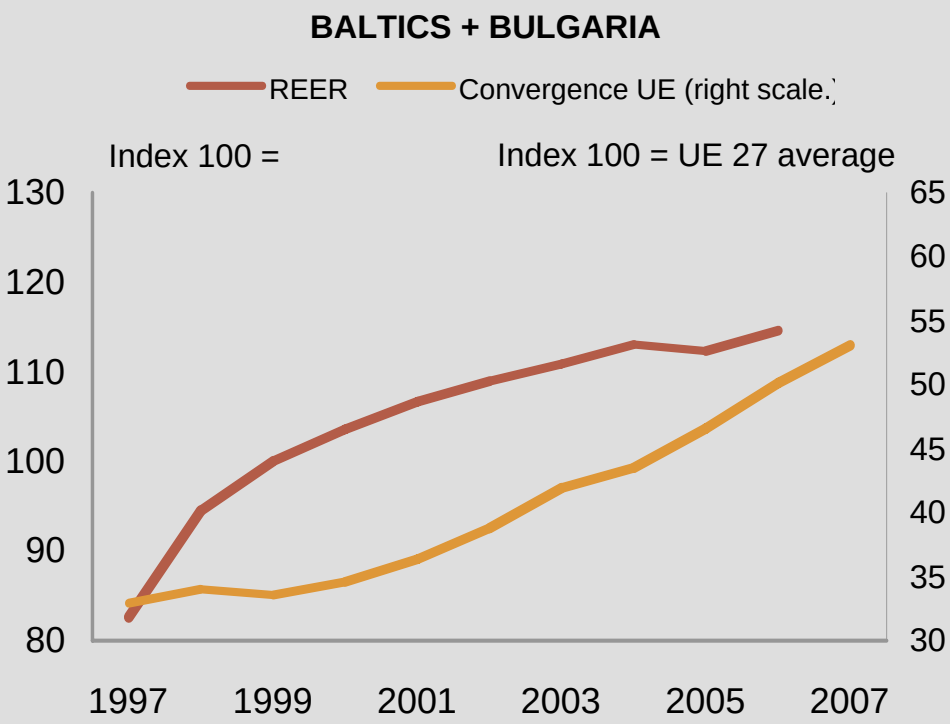
- **Are new EU members external positions sustainable after all?**
- **Which role plays the exchange rate (appreciation)?**
  - Cause or consequence of external positions?
  - Villain (competitiveness) or hero (adjustment-smoother in convergence)?
- **Work in progress…departing from REER equilibrium estimation (RDE)**

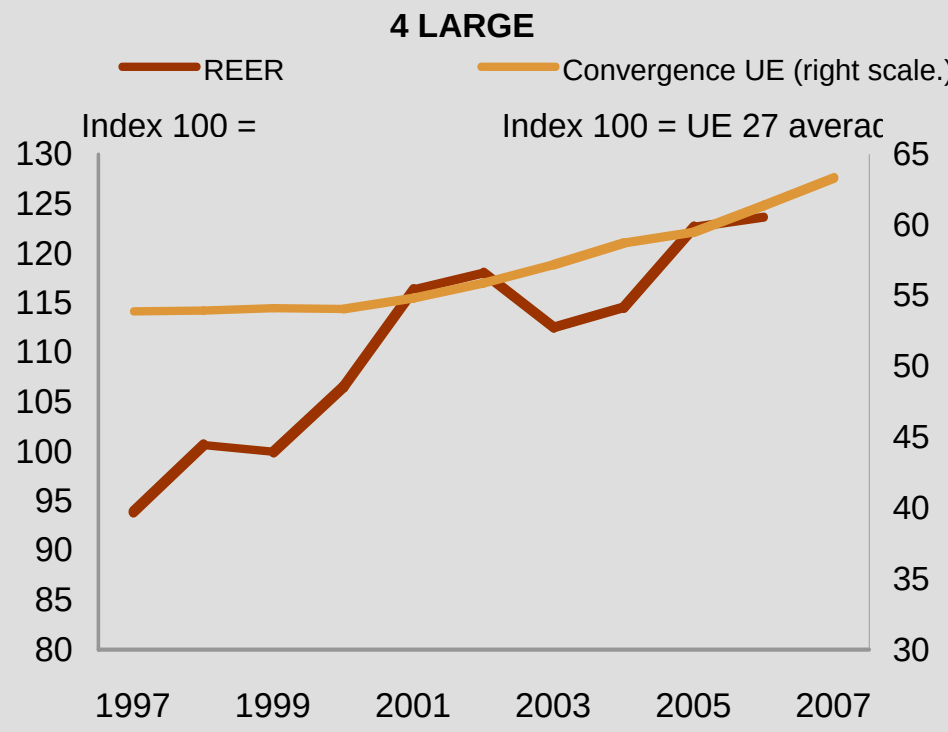
OUTLINE

- **NMS features**
- **Sustainability of external positions in new EU members and equilibrium exchange rate**
- **Caveats**
  1. Net debt as catalyser of productivity convergence
  2. Valuation effects and exchange rate role
  3. Cost of debt
- **Conclusions**

Intro.New EU members marked features

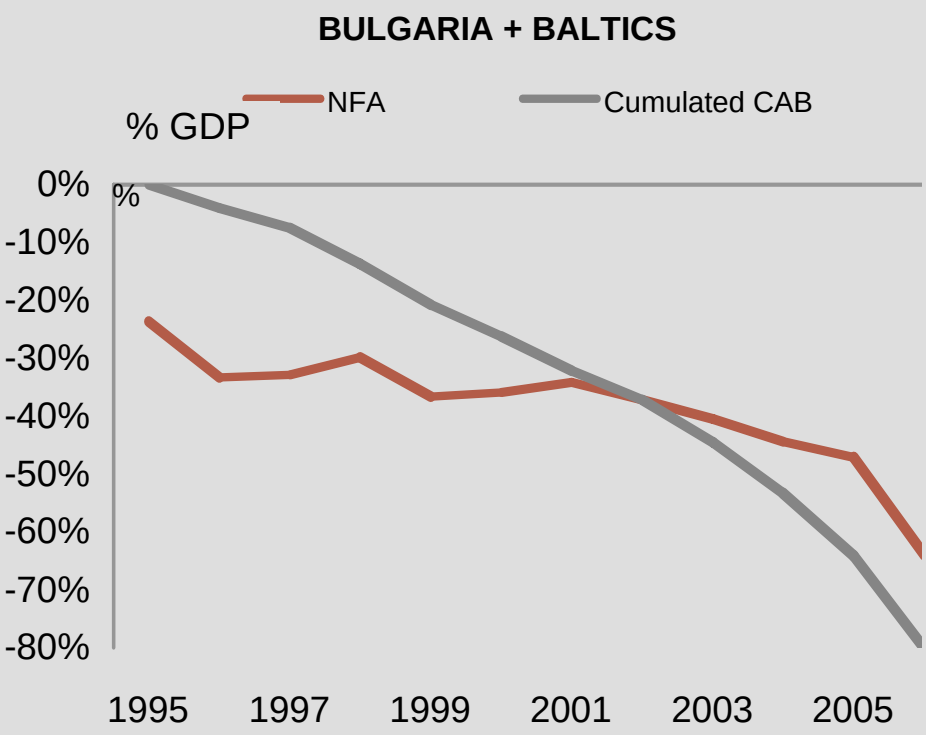
- **The optimistic view:**
  - rapid real convergence, improvement in per capita income and equilibrium real exchange rate appreciation (Balassa-Samuelson)

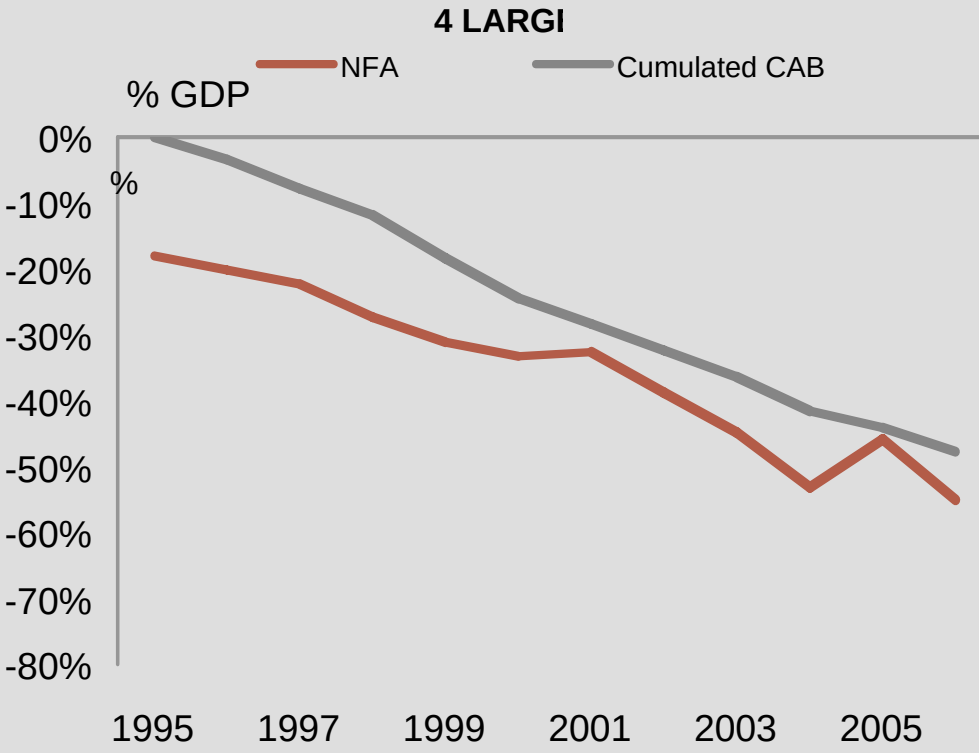




Intro.New EU members marked features

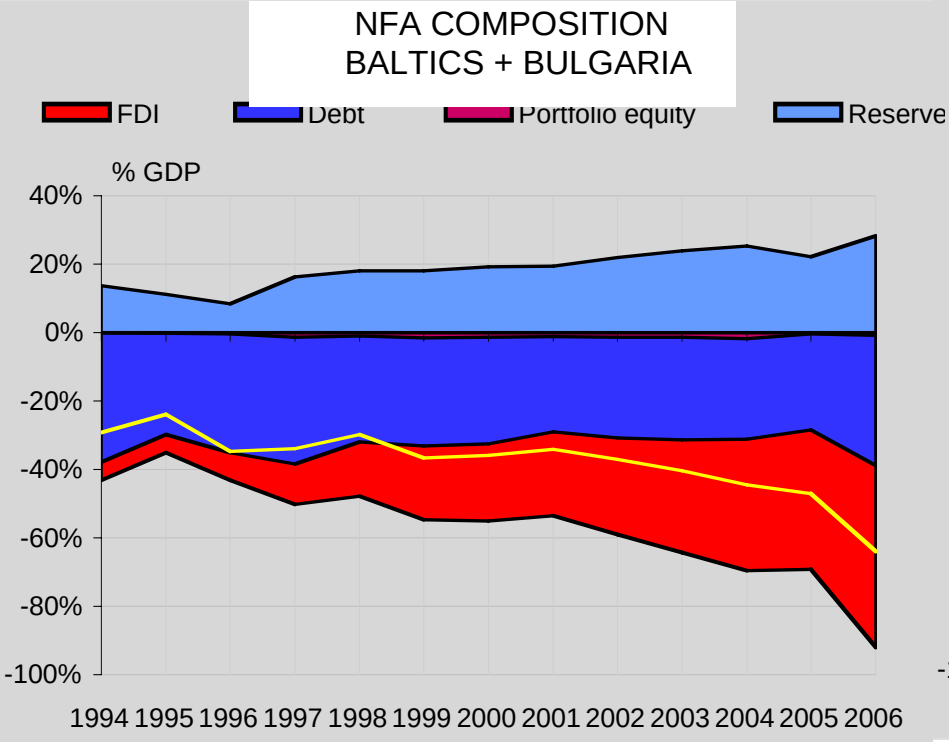
- **The alarming view:**
  - Large current account imbalances….leads to deterioration of external position NFA
  - …but quite less than cumulated c/a balance

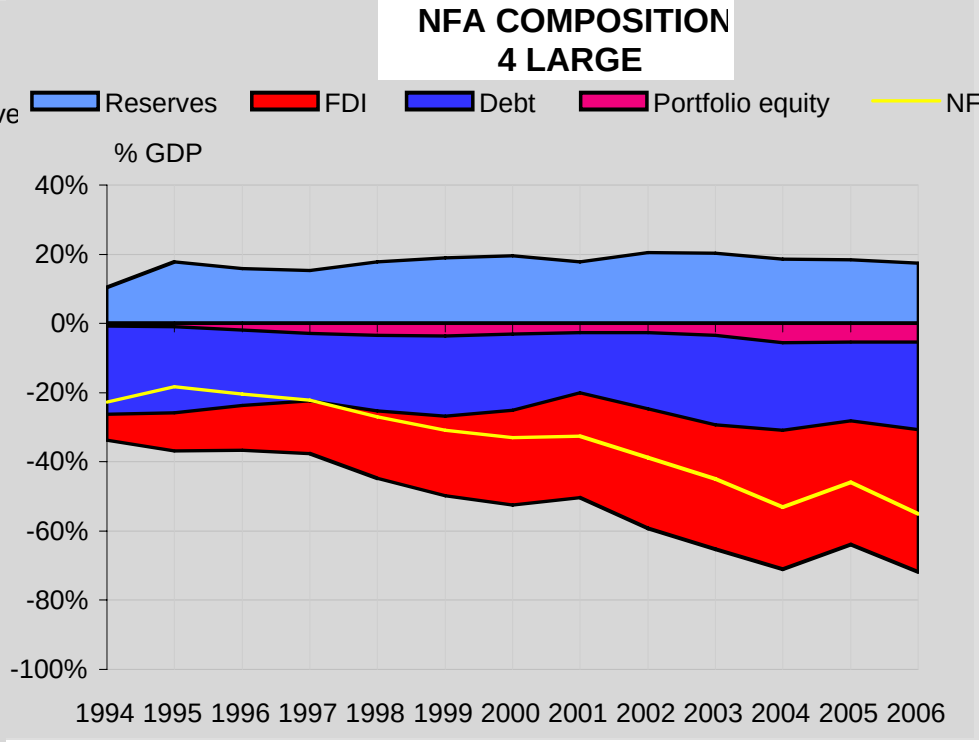




Intro.New EU members marked features

- **Decomposition of the NFA position**
  - Key to explain the consistency of deteriorating NFA with sustainability and e-r evolutions
- **Graph of debt composition**
  - Reserves offset by porftolio and debt
  - Controlling for that **FDI dominates** the picture





Exchange rate determination. Portfolio model

- **External debt dynamics equation**

$$\mathbf{cab} = \Delta nfa = \mathbf{pcab} + \mathbf{(r - g)nfa}$$

  – Pcab= cab net of interest payments: trade balance and others

- **Narrow view of competitiveness (rer driven)**

$$\mathbf{pcab} = -\gamma \mathbf{q}$$

(increase in real exchange rate **q (CPI defined)** is appreciation)

- **Equilibrium**

$$\Delta nfa = 0$$

$$pcab = -\frac{(r-g)nfa}{}$$

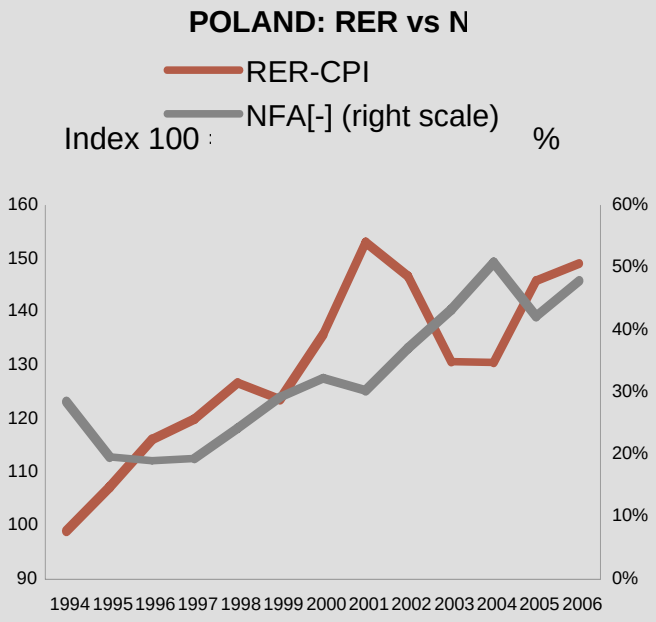
- **Stabilization of external position**
- **Generate trade surplus if nfa <0**

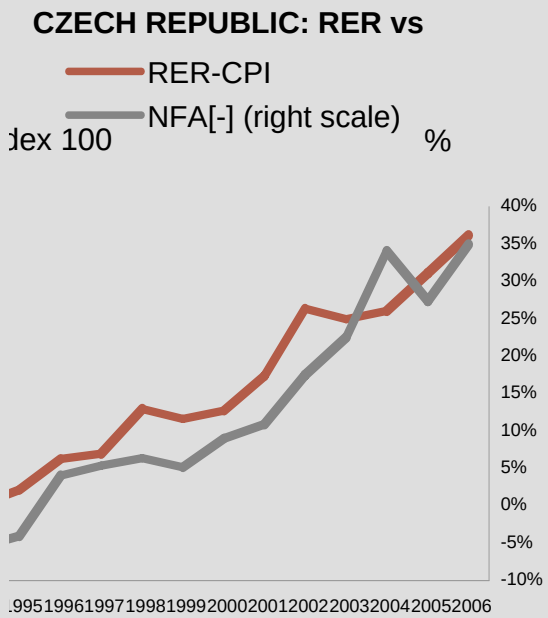
$$eq = \frac{(r-g)nfa}{\gamma}$$

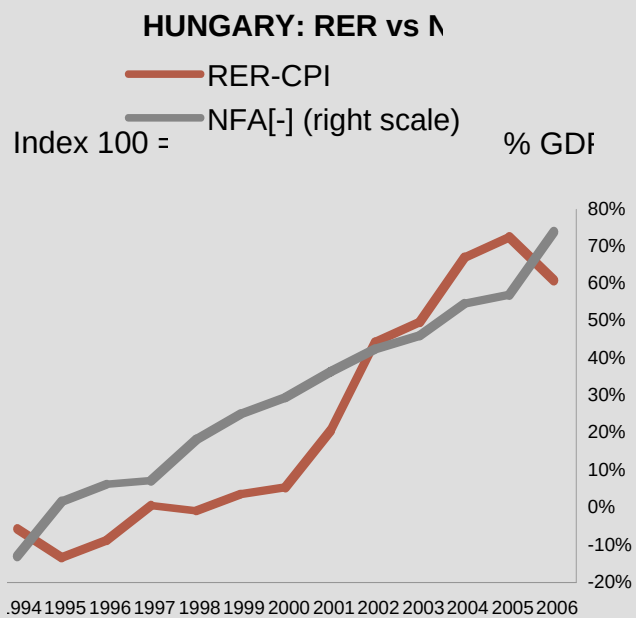
- **Eq q is depreciating with nfa <0**

Exchange rate determination. Portfolio model

- **Estimation Alberola & Navia (2007) RDE**
  - POL/CHE/HUN-'93-'04
  - Test link between external position and real exchange rate
  - The cointegration approach says <u>just</u> the opposite.







Exchange rate determination. Portfolio model

- **Miserable failure of the portfolio model**

- **Why?…rest of the presentation**

a) How do e-r interact with external position and its sustainability

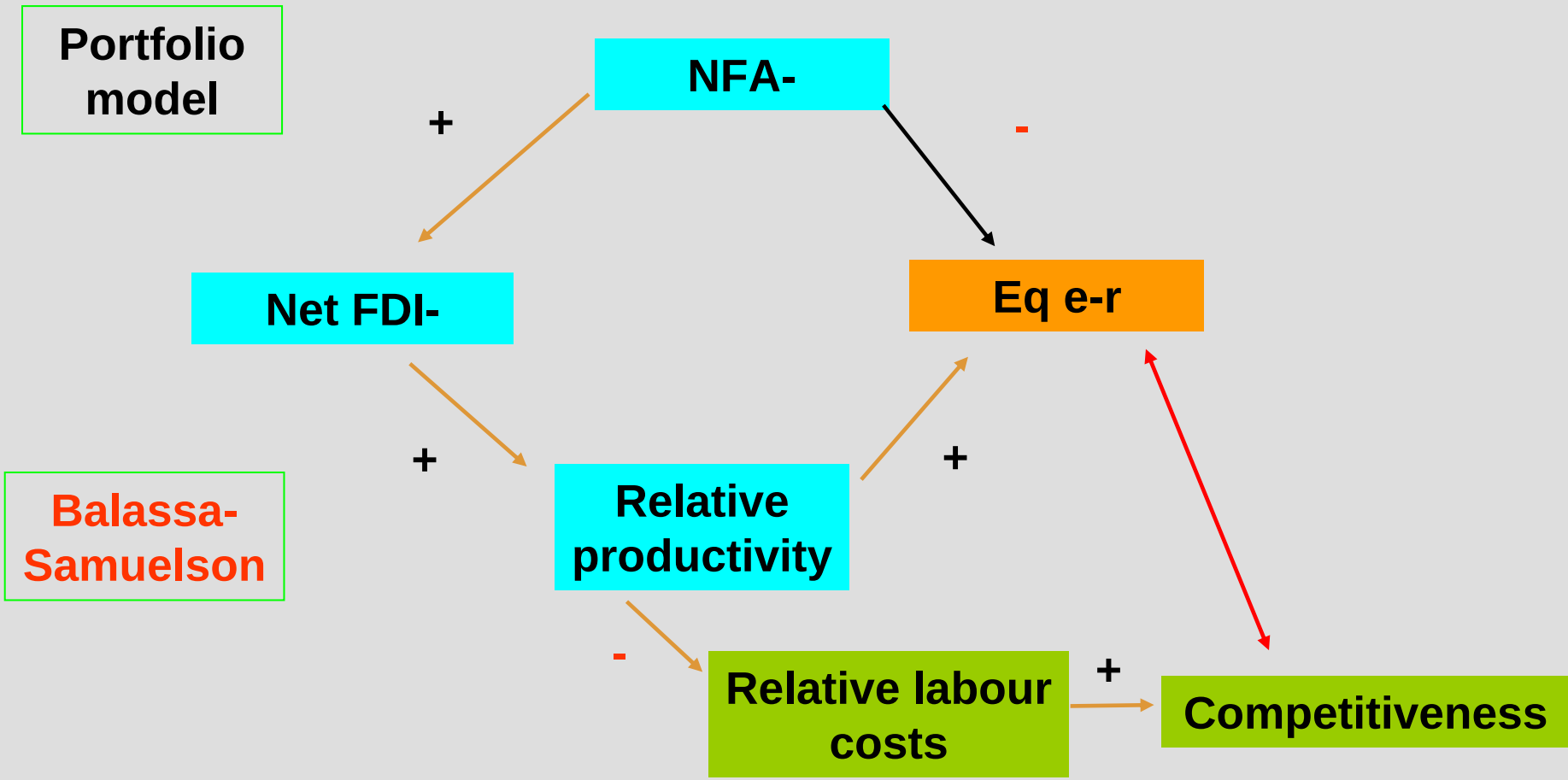
-Debt as productivity-convergence-competitiveness enhancing

-E-r appreciation as improving NFA position (valuation effects)

b) NFA dynamics are twisted

– Cost of debt relative to return-growth from debt

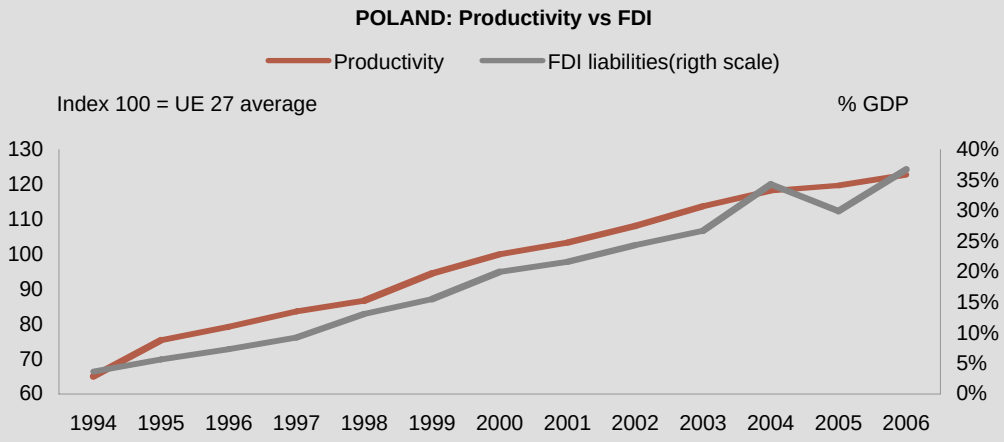
I-Debt as productivity-competitiveness enhancing

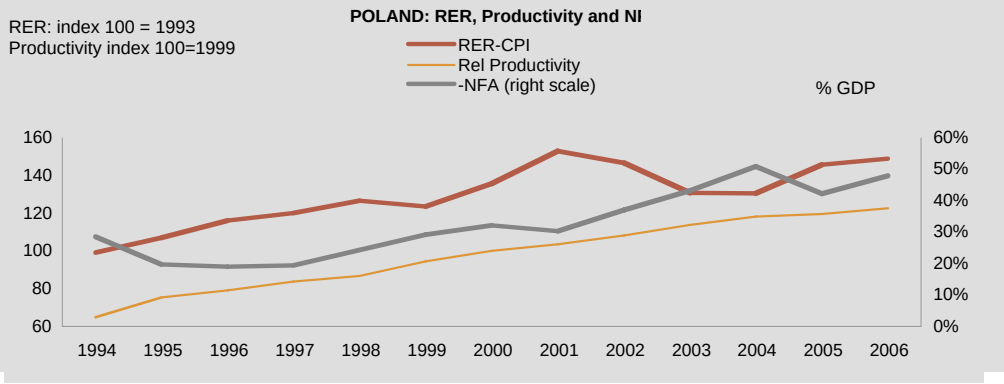


I-Debt as productivity-competitiveness enhancing

- **Conventional view: convergence leads to exchange rate appreciation**
- **…tested in unconventional way: extending model**
- **COINTEGRATION RELATIONS AND SIGNS**

REER	+	+
	NFA	RELATIVE PRODUCTIVITY
NFA		?
NFDI	+	-





II- Exchange rate valuation effects

$$\mathbf{cab} = \Delta nfa = \mathbf{pcab} + \mathbf{(r-g)nfa}$$

$$\mathbf{nfa} = \mathbf{nfa`} + \mathbf{nfa\,*}$$

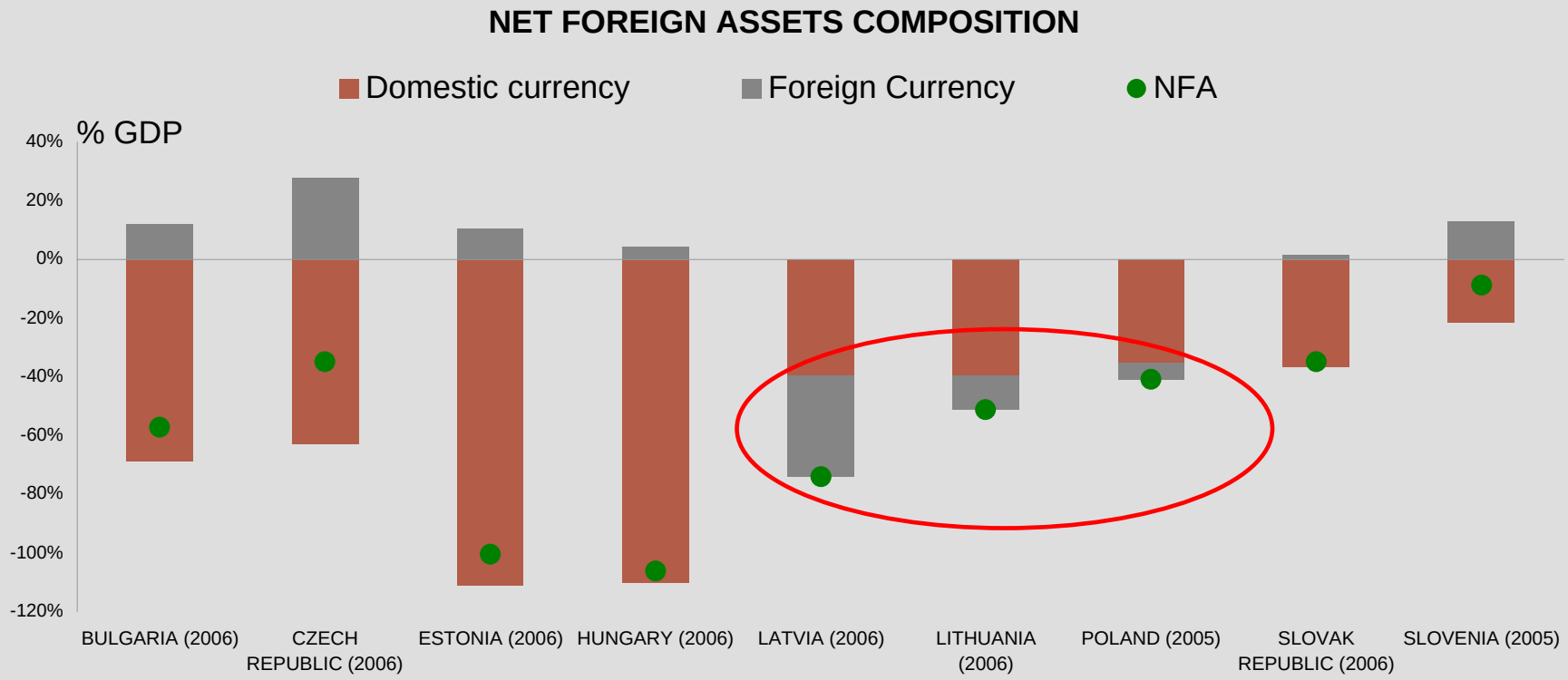
$$\mathbf{cab} = \Delta nfa = \mathbf{pcab} + \mathbf{(r-g)nfa} + \Delta e\ \mathbf{nfa\,*}$$

- **Decomposition of debt and currency denomination**

	Assets	Liabilities
FDI, portfolio	*Nfa** ...small	*Nfa'*
Reserves	***Nfa****	-
Debt	*Nfa** ...small	***Nfa****

II- Exchange rate valuation effects

- **How is the picture in NMS?**
  - FDI liabilities (in domestic currency) dominates
  - Net positions in foreign currency are relatively low in NET terms:
    - *Reserves (assets) offset debt (liabilities)*
  - Valuation effects of appreciations are not very relevant: exceptions LAT-LIT-POL



III- Is the net cost of debt positive?

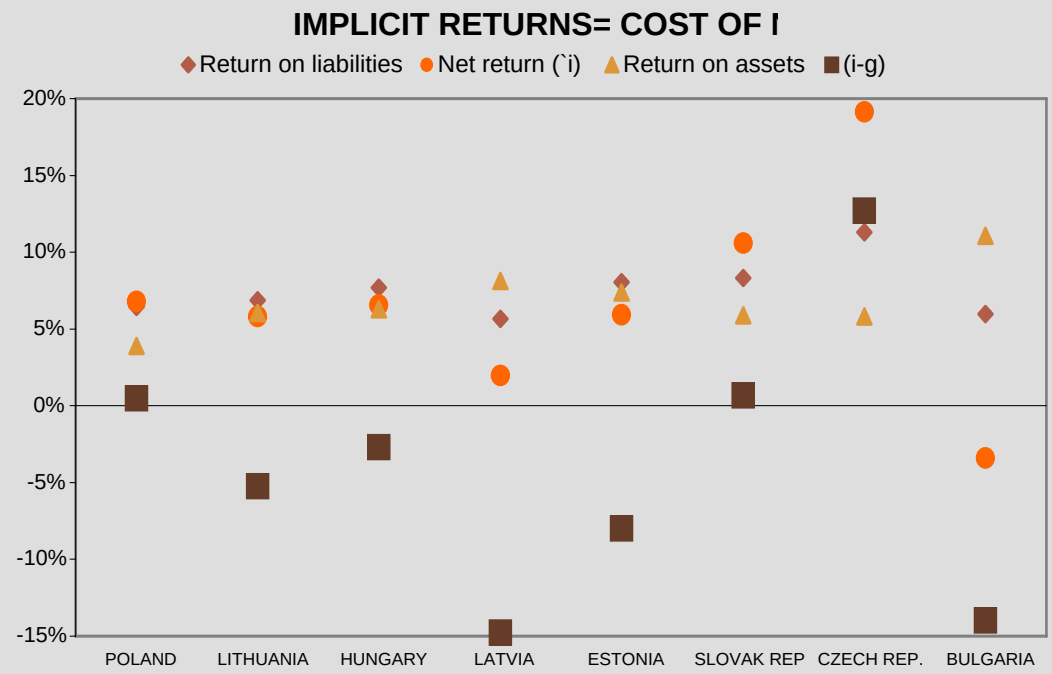
$$cab = \Delta nfa = xn + \boxed{(r - g)}nfa$$

- **An intriguing possibility. Dynamics reversion**

  Convergence play:

  – financial (low financing cost)

  – Real (high real growth)

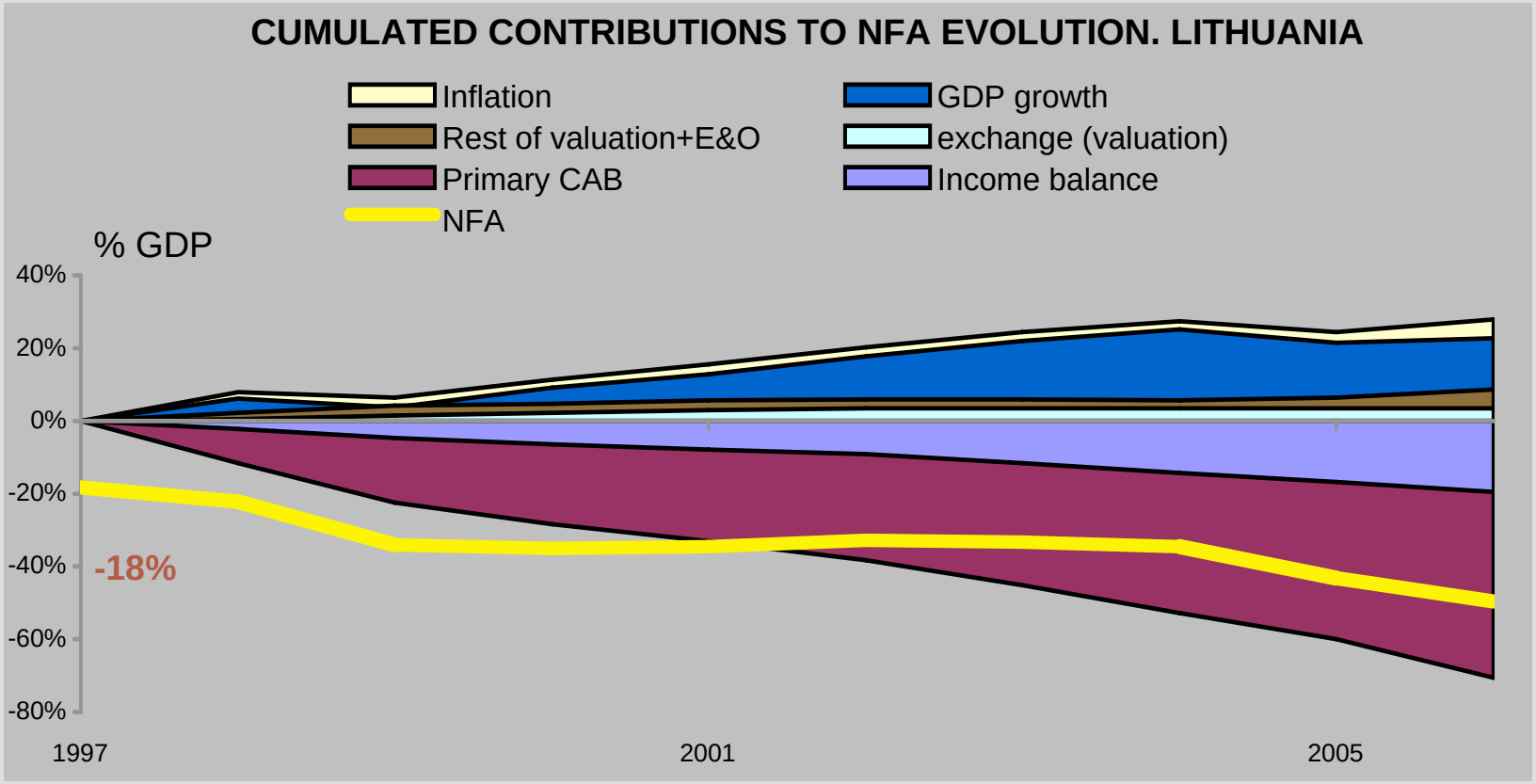


avg. 02-06	POLAND	LITHUANI	HUNGAR	LATVIA	ESTONIA	SLOVAKIA	CZECH r	BULGARIA
Assets	30,1%	35,0%	48,6%	64,8%	73,2%	52,9%	65,0%	64,7%
Liabilities	74,3%	75,7%	137,0%	119,7%	158,3%	81,9%	92,2%	100,2%
NFA	-44,3%	-40,8%	-88,4%	-54,9%	-85,1%	-29,0%	-27,3%	-35,6%
Income b.	-3,0%	-2,4%	-5,8%	-1,1%	-5,0%	-3,1%	-5,2%	1,2%

Sumup and conclusions

$$\mathbf{cab} = \Delta nfa = \mathbf{pcab} + \mathbf{(r-g)nfa} + \Delta e\ \mathbf{nfa}\ *$$

- **Dynamics are contained**



Sumup and conclusions

- **External sustainability assessment depends on NFA position**
  - Ratio of indebtedness
  - Composition: types of net debt and currency
- **Exchange rate as key variable**
  - Appreciation identified with deterioration of external accounts
  - Adjustment variable in portfolio models

- **Challenges to this view**
  - Exchange rate appreciation compatible with external sustainability
    - *Debt favours productivity convergence, e-r appreciation*
    - *With no competitiveness loss,*
  - E-r appreciation favour NFA stabilization through valuation effects
    - *…in some countries, to some extent, less than expected*
  - Cost of debt lower than return from debt in most countries
    - *contains unsustainable dynamics through income balance*
    - *Favoured by EU/EMU convergence play*

Wrapup and conclusions

- **Overall: Benign view of external sustainability in NMs**

- **BUT**
  - –Current account imbalances widening in several countries:
    - *•excess domestic demand rather than competitiveness loss*
  - –Burden on NFA increasing
    - *•Own dynamics*
    - *•Increasing returns in FDI as they mature*
  - –What matters is not so much stock but flow sustainability (financing availablility)
    - *•Solvency v. liquidity*
    - *•Ability to cover financing needs, which are large*
    - *•NFA dynamics are in any case negative, ever increasing financing needs*
  - –Hinges on success of convergence play
    - *•Incentive to hurry into euro adoption*
    - *•Sustainable convergence?*

- **Might exchange rate appreciations bring relief to pressures? (hero not villain)**
  - –Contain demand + inflation