Oesterreichische Nationalbank

Eurosystem

Workshops

Proceedings of OeNB Workshops

Emerging Markets: Any Lessons for Southeastern Europe?

March 5 and 6, 2007

No. 12

Stability and Security.

Are European Emerging Markets Different?

Dimitri G. Demekas

International Monetary Fund[1]

There is no consensus today among analysts, investors, and policymakers on how to interpret the evolution and prospects of European emerging markets.[2] The choice seems to be limited to two opposing views, and developments in recent months have, if anything, polarized the debate further.

At the risk of oversimplifying, the first of these views is that, after a few disruptive years at the beginning of their transition from socialism to capitalism, these European emerging markets are now solidly on the path of growth and convergence with Western European economies. Though strewn with challenges, this path offers great benefits and even greater opportunities for the citizens of these countries and for foreign investors. The magnitude of these benefits and the prospects of EU accession propel these countries quickly but safely on a one-way street to prosperity. This view seems to have been in practice adopted by the majority of private investors in these economies, both domestic and foreign. Not surprisingly, it is also held by the governments of these countries.

The opposite view claims that the economic forces behind the process of convergence are generating mounting imbalances in these countries. Compared to

[1] This paper draws heavily on work done by colleagues at the European Department of the International Monetary Fund. I am particularly indebted to Ashoka Mody, whose advice and research – to which I refer frequently – provided the inspiration for this paper, and to Gerwin Bell for helpful comments. The views expressed here, as well as any errors, are nevertheless mine and do not necessarily represent those of the International Monetary Fund.

[2] There is always a degree of arbitrariness in the definition of country groups. For the purposes of this paper, the "European emerging markets" include the European transition economies that are current or prospective European Union (EU) Member States, in other words the ten Central and Eastern European new EU members (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia) and the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia, and the territory of Kosovo, currently under temporary UN administration). They do not include Russia, Ukraine, Belarus, Moldova, and Turkey. Although these countries have a fair claim to being both "European" and "emerging markets", they are distinct from the rest either because they do not have a firm EU perspective or – in the case of Turkey – because they are not transition economies.

other emerging markets, these imbalances look positively alarming. While all may still turn out well at the end, the risks are significant and growing, while policymakers are being irresponsibly complacent. Because the prospects of EU accession alone cannot defy economic laws, it will all probably come to grief sooner rather than later. This view is common among many academics and analysts, particularly those with a macroeconomic bend, and is supported by a thriving cottage industry of comparisons between European emerging markets today and Southeast Asian economies just before the crises of the late 1990s.

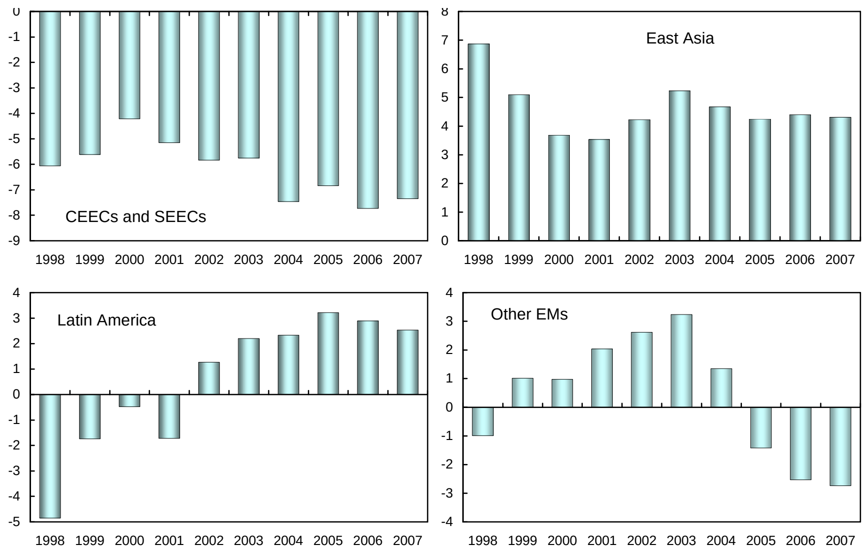
Who is right? And are these the only two possibilities?

In this paper, I argue that European emerging markets are different than other emerging markets, and therefore superficial comparisons with Southeast Asia are off the mark. I discuss two hypotheses that may explain these differences in terms of economic fundamentals. And I argue that, while these factors alleviate some of the traditional macroeconomic risks, they underscore a different set of policy challenges. These challenges are more micro- than macroeconomic and have a longer-term time horizon. This may make some macroeconomists uncomfortable, but does not render these challenges any less real or urgent. I conclude with some lessons for Southeastern European countries, in particular, which are in some ways the least advanced European emerging markets.

1. Recent Trends in European Emerging Markets

The growth record of the European emerging markets during the last decade has been good, matching broadly that in East Asian emerging markets and exceeding that in Latin American and other emerging markets (the latter group includes Russia, Turkey, and African and Middle Eastern emerging markets). But a combination of relatively high domestic investment with relatively low domestic savings rates has pushed their current account deficits to levels that are extraordinarily high by international standards. And this at a time when the other emerging markets as a group are generating current account surpluses (chart 1).

Chart 1: Average Current Account Balance, 1998–2007, (Unweighted average; % of GDP)



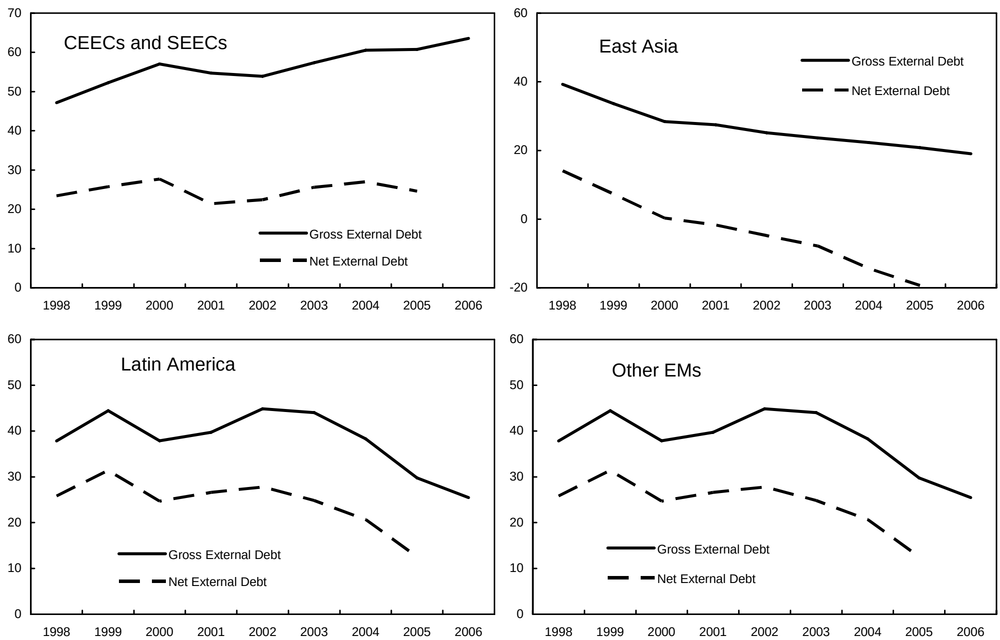
Note: CEECs = Central and Eastern European countries; SEECs = Southeastern European Countries.

Source: IMF, World Economic Outlook.

The counterpart of these large current account deficits has primarily been foreign direct investment (FDI) inflows. But debt-creating inflows, though much lower, are also substantial, and have been on an upward trend since 2003. This is again in contrast to the experience of other emerging market groups. As a result, European emerging markets are the only ones whose external indebtedness has not declined since the beginning of the current decade: their gross external debt has kept climbing, surpassing the 60% of GDP mark last year; and their net external debt has remained broadly stable in the 20–25% of GDP range. In contrast, gross and net debt-to-GDP ratios in all other emerging market groups have fallen significantly since the beginning of this decade and are now much lower than in European emerging markets. Indeed the average net external debt ratio of East Asian emerging markets has recently turned negative, as this region has become a net creditor to the rest of the world (chart 2).

Chart 2: External Debt

(% of GDP)



Sources: IMF, World Economic Outlook and International Financial Statistics.

Notes: Net external debt is the gross external debt net of foreign assets in central banks and the banking sector.

Large capital inflows and rising external indebtedness give rise to a litany of macroeconomic concerns. Capital inflows can cause real exchange rate overvaluation, the more so when the nominal exchange rate is inflexible. They can fuel asset price bubbles. The resulting foreign currency liabilities generate balance sheet risk for borrowers without natural or financial hedges. Debt-creating inflows, in particular, are subject to rollover risk, sudden stops, or reversals as a result of an abrupt shift in market sentiment. And reliance on foreign borrowing exposes the borrower to the risk of contagion, i.e., the possibility that market access may be severely disrupted because of adverse developments affecting another emerging market or a generalized shock affecting all emerging markets, regardless of where it originated. The risk of contagion is particularly pronounced in European emerging markets because a large part of debt-creating flows into the region are intermediated by a relatively small number of Western European banks.

Even more alarming for those who worry about the macroeconomic risks of large current account deficits and capital inflows is the fact that we may not have sufficient policy tools to contain them. Fiscal policy is rather a blunt instrument, and there are limits to the speed and degree to which it can be adjusted. And at a more fundamental level, it is not clear whether fiscal policy could or indeed should be used to mitigate risks arising from excess private sector demand. Monetary and exchange rate policy is severely constrained in emerging markets by a combination of "fear of floating" considerations (Calvo and Reinhart 2000), institutional weaknesses (shallow money markets and weak transmission channels), or currency substitution. And needless to say, using monetary and exchange rate policy is not even an option for countries with currency boards. On top of it all, in addition to the constraints affecting individual policies, Calvo (2005) has argued that domestic policies *in general* are fundamentally insufficient to manage what he termed "globalization risk", i.e., the risk arising from opening up the economy to the global financial market.

Beyond the "traditional" or garden variety macroeconomic risks, the sustained current account deficits of European emerging markets raise deeper questions about the sustainability of their recent growth. In a recent paper, Prasad, Rajan and Subramanian (2006) showed that, contrary to the prediction of the standard theory, since the mid-1990s capital has stopped flowing "downhill" and started flowing "uphill", i.e., not from rich to poor countries but vice versa. It is not the emerging markets that run current account deficits financed by capital inflows from advanced economies, but the advanced economies who finance their current account deficits with surplus savings generated in the emerging markets. Moreover, current account deficits are not associated with higher growth, as one might expect. On the contrary, a simple correlation between current account balances and growth shows a statistically-significant positive relationship in the global sample: the countries that grow faster are those with higher current account surpluses (or lower deficits).

So what is going on in European emerging markets? Why is their recent experience so different than that of other emerging markets? It is tempting to conclude that this difference is an aberration: ample international liquidity, irrational exuberance, and exaggerated expectations about the benefits of EU accession have flooded European emerging markets with foreign capital and given them a burst of growth. But this cannot last. Sooner or later these countries must revert to norm, this argument goes, and behave like all other emerging markets. Either there will be a current account correction or growth will run out of steam – or possibly both. Indeed the longer this aberration goes on, the closer the day or reckoning and the greater the pain it will bring.

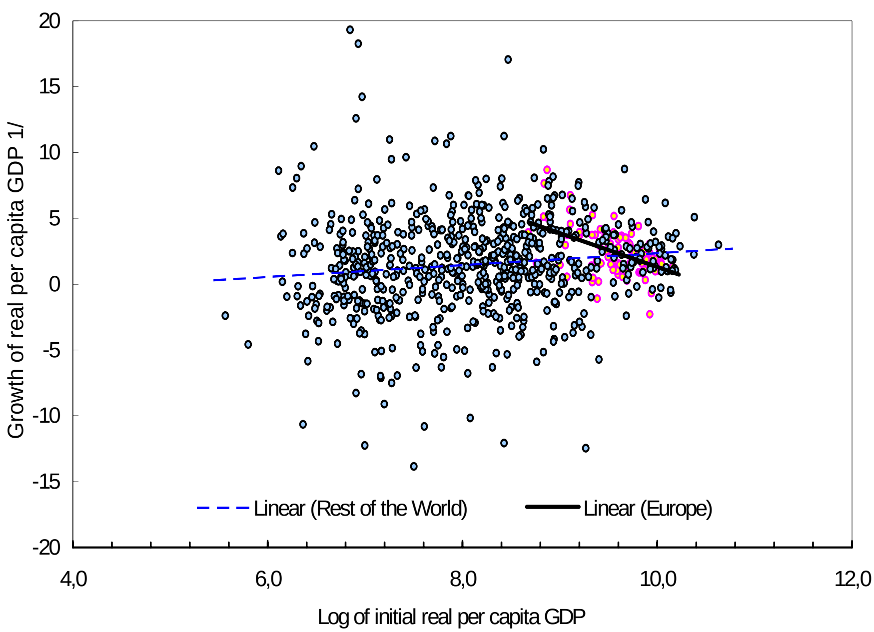
2. Europe is Different

While this gloomy conclusion is certainly plausible, it is far from compelling. Indeed there are good reasons to believe that Europe is different in a number of fundamental respects, and this could generate a sustainable divergence in economic outcomes between European and all other emerging markets that is consistent with the predictions of standard economic theory.

What are the differences?

First, Europe is a convergence story. In contrast to the rest of the world, in Europe per capita incomes of poor and rich countries have been converging. Indeed Europe is the only region where there is evidence of convergence even after controlling for other factors that influence growth in individual countries ("unconditional convergence"). Chart 3, showing the simple correlation between the level and growth rate of GDP per capita in a global sample for the last 30 years, illustrates this point.

Chart 3: "Unconditional" Convergence, Europe vs. Rest of the World, 1975–2004

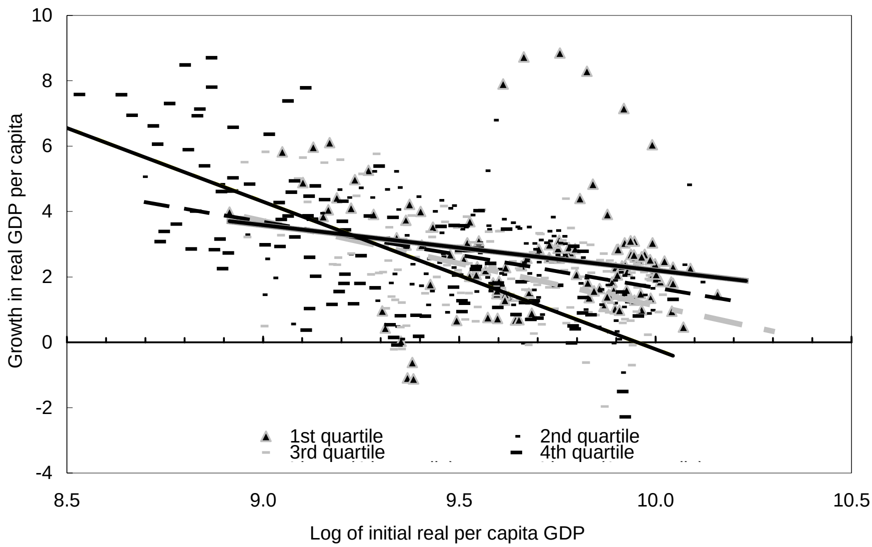


Note: 1/ Average annual growth over subsequent 5-year period (%).

Source: Abiad, Leigh and Mody (2007).

Secondly, in European countries foreign savings are associated with higher growth, just as theory predicts. Chart 4 shows the same correlation as before but with the sample now split in quartiles depending on the size of the current account deficit. The shift in the slope of the correlation line as we move from lower to higher quartiles suggests that higher current account deficits are associated with faster convergence. Prasad, Rajan and Subramanian (2006) also note that Europe is the exception to their puzzling finding that capital tends to flow "uphill". For some reason, the European continent seems to be less bound by the Feldstein-Horioka puzzle.

Chart 4: EU Current Account Deficits and the Speed of Convergence from 1960 to 2004



Note: 1960–2004 for EU-15 (excl. Luxembourg); 1995–2004 for New Member States (excl. Malta and Cyprus). 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).

Thirdly, although the inflow of foreign savings into emerging Europe has already been sizeable, the potential for additional inflows appears to be still very significant. In a slightly older paper, Lane, Lipschitz and Mourmouras (2002) attempted to estimate the capital flow that would be required to equalize the return to capital between Western and Eastern Europe. They calculated that the potential cumulative capital inflow into European transition economies could add up to six or seven times annual GDP during the first five years of transition. That actual inflows so far have been much lower led them to conclude that there was still a huge potential for continued inflows in the period ahead. In a more recent study focusing specifically on FDI, Demekas *et al*. (2007), after estimating an explanatory relationship for FDI, calculated the potential FDI for each emerging European country based on the actual values of gravity variables, which are exogenous to policymakers, and the "best" values of the policy variables that are found to have a significant influence on foreign investment. While the more successful European transition economies are now close to their potential, the gap between potential and actual FDI is still positive everywhere and, for Southeastern European countries in particular, quite large: for instance, if Serbia or Bosnia and Herzegovina get their policies right, they could expect at least half as much FDI in the near term as they have already received. These findings suggest that, far from having run their course, capital inflows into emerging Europe could continue for several years.

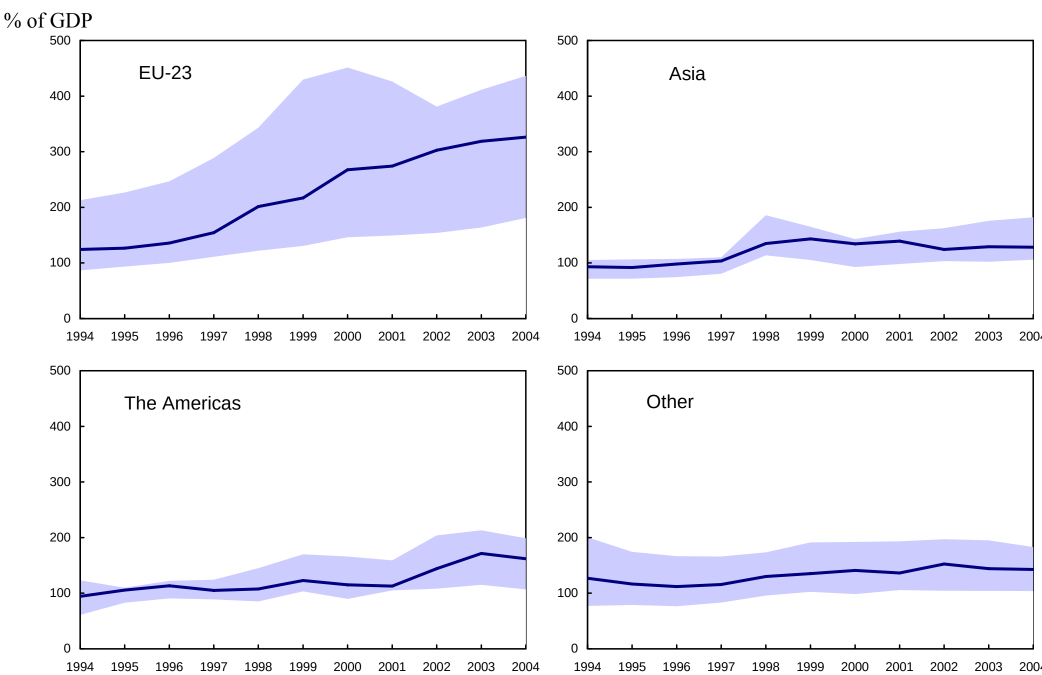
These differences indicate that the divergence between the recent experience of European emerging markets and the rest may not be an aberration but may reflect economic fundamentals. What could these fundamentals be? I want to discuss two hypotheses that could help explain why Europe is different. They are not mutually exclusive, and there may certainly be additional factors at play, but there is already some evidence that lends support to these two.

The first hypothesis is that the fundamental difference between European emerging markets and emerging markets elsewhere is the prospect of the former for membership in the EU and, eventually, in the euro area. Central, Eastern, and Southeastern European countries are part of an unprecedented historic experiment in economic, financial, and political integration that holds out the prospect of political stability and institutional convergence, large EU transfers and, eventually, adoption of the common currency. This implies a boost in future consumption – relative to emerging markets that are not prospective EU members – which consumers in these countries smooth by borrowing today. This is not reckless risk-taking behavior but sound economics: for the same reason, Ivy League undergraduates find it easier to get larger student loans than other students without paying a higher risk premium.

There is some indirect evidence for this hypothesis. European emerging markets have long been enjoying systematically lower external debt spreads (risk premia) in international capital markets than other emerging market economies. Although this difference has declined since 2004, it still remains positive. An econometric analysis of the debt spreads suggests that part of this bonus enjoyed by European emerging markets is not explained by economic fundamentals but reflects some non-quantifiable influence on markets' perception of risk. It is commonly assumed that the key factor behind this influence is the prospect of EU membership and euro adoption.

The second hypothesis has to do with the role of financial integration and has been advanced by Abiad, Leigh and Mody (2006). Europe is more advanced than any other region in terms of cross-border financial integration (chart 5), largely as the result of the expansion of the EU: the free movement of capital is one of the basic four freedoms that are the pillars of the Single Market. And as Blanchard and Giavazzi (2002) have shown, financial integration facilitates consumption smoothing and allows capital to flow "downhill". According to this hypothesis, the fundamental difference between European emerging markets and others is that financial development and integration in the former is more advanced, allowing them to leverage foreign savings more effectively in order to grow faster and converge. Moreover, since we saw earlier that lower initial per capita incomes and higher current account deficits are associated with faster convergence, this process is transitory and self-correcting: as European emerging markets converge, growth will moderate and current account deficits will decline.

Chart 5: Financial Integration in Different Regions, 1994–2004



Note: Financial integration measured as the sum of foreign assets and liabilities.

Sources: Lane and Millesi-Ferretti (2006); Abiad, Leigh and Mody (2007).

A variant to this hypothesis is based on the notion that the growth process is subject to nonlinearitities. Aghion and Howitt (2005), for example, have argued that these nonlinearities reflect the interaction of technological, institutional, and financial variables. Taking their analysis of financial integration in Europe a step further, Abiad, Leigh and Mody (2006) have suggested that financial sector development may be such a variable. In such a case, the difference between European emerging markets and others is not just that the financial sector is more developed in the former but that, having reached a critical mass, its role is now qualitatively different: it enables the Europeans to utilize foreign savings for economic growth and convergence in ways that are not (yet) possible for other emerging markets. The European emerging markets are therefore not just an exception – much less an aberration – but a bellwether: their recent experience is the shape of things to come in all other emerging markets once they pass the same threshold value of financial development and integration.

3. Lessons for Southeastern Europe

If the recent experience of European emerging markets is not an aberration but an equilibrium phenomenon reflecting fundamental differences from other emerging markets, it is tempting to dismiss the Cassandras and conclude that all is well.

This would be premature.

While the preceding discussion attenuates the concern about the sustainability of the European emerging markets' recent growth performance, as well as the "traditional" concerns about external imbalances, it does not completely eliminate them. To be sure, some of the risks associated with high external current account deficits and capital inflows (sudden stops, contagion, reversals, or exchange rate overvaluation) appear to be less pressing in European emerging markets than elsewhere. But they are still present, especially where the nominal exchange rate is not flexible, and should not be overlooked.

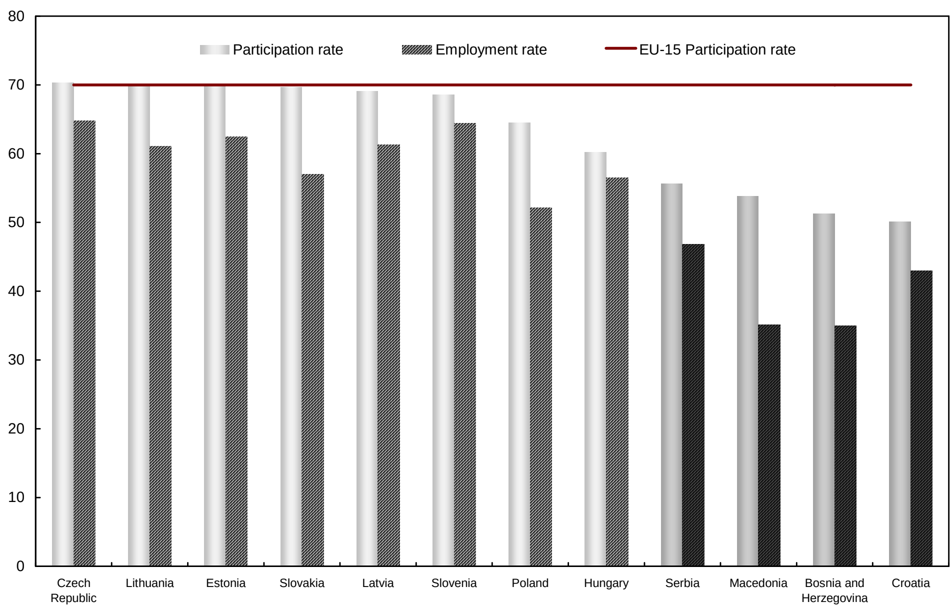
More importantly, the preceding analysis illuminates a new set of challenges. To validate investors' expectations, these countries must maintain high growth rates for years to come. And to secure the prospects for EU accession, as well as take advantage of possible threshold effects, they must keep the momentum in institutional progress. These are not the traditional macroeconomic concerns: they are more micro than macro, and their time horizon is considerably longer. Disconcertingly for macroeconomists, they also touch upon areas that we understand relatively little: the determinants of growth, the relationship between institutions and growth, and the political economy of institutional reform. But they are challenges that policymakers in European emerging markets – and those who advise them – cannot afford to disregard.

Elaborating a comprehensive policy agenda that would help European emerging markets tackle these challenges lies outside the scope of this paper. But in closing, I would like to highlight two points that I believe are particularly relevant for Southeastern Europe.

–One key factor for economic growth is labor force participation and employment rates. As chart 6 shows, the Central European and Baltic countries have already reached participation and employment rates that are close to those in the EU – although Poland and Hungary are somewhat behind the rest. Relatively little additional mileage can be expected in the future from raising these rates further. Southeastern European countries, however, lag significantly behind. Whether low participation and employment rates reflect socio-cultural factors (for example, as regards female participation), skills mismatches, discouraged worker effects, or a combination of the above, there is clearly a major growth payoff to be had by raising these toward Central or Western European levels.

Chart 6: Participation and Employment Rates, 2001–2005

(% of working age population)

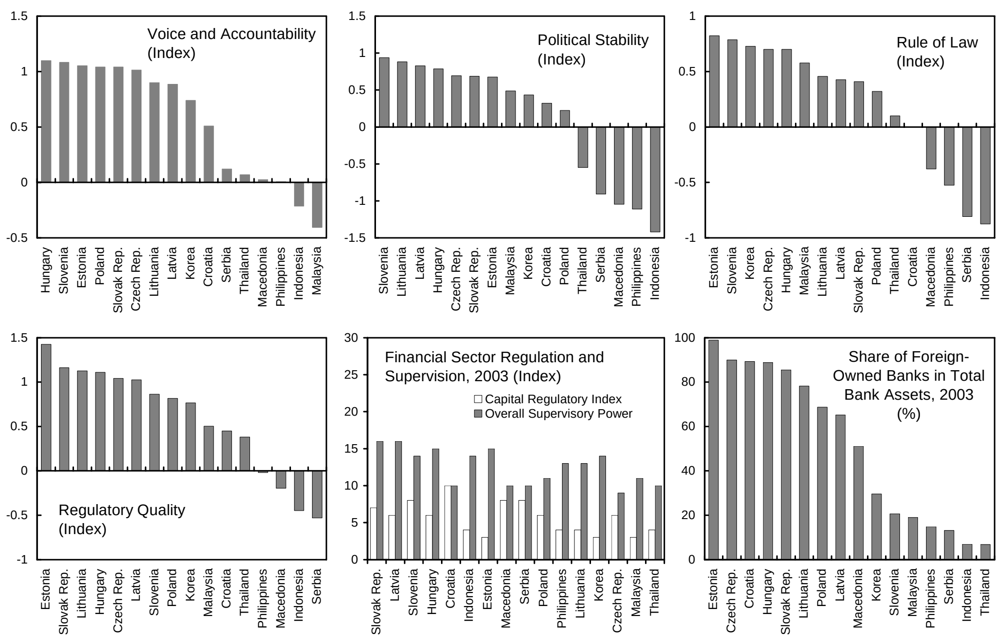


Sources: Eurostat and National Labor Force Surveys.

The other key factor for economic growth is total factor productivity (TFP). There is a considerable body of literature on the determinants of TFP, and I do not plan to summarize it here. One point of consensus is that institutions matter for productivity and growth. The channels through which institutions affect growth are manifold and not well understood. Strong institutions promote social peace; they stimulate innovation and efficiency in production; they attract foreign direct investment, which has positive spillover effects on the domestic economy and they facilitate and amplify the effect of macroeconomic stabilization policies. Finally, their impact may be nonlinear: the benefits of strong institutions may become apparent only after institutional development has surpassed a threshold value.

European emerging markets as a group are more advanced than other emerging markets across a number of different institutional dimensions: democracy, rule of law, protection of property rights, quality of regulations, financial sector development. If we look at the individual country level, however, it becomes clear that this reflects the progress in the Central European and Baltic countries; Southeastern European countries, in contrast, do not stand out relative to other emerging markets (chart 7). To ensure continued high TFP growth and take advantage of possible institutional threshold effects, policymakers in Southeastern Europe need to make institutional development a high priority on their agenda.

Chart 7: Selected Governance Indicators 2005



Note: Higher index numbers indicate better governance.

Source: World Bank Governance Database; World Bank Financial Regulation/Supervision Database.

Of course, raising labor force participation and accelerating institutional reform are not new ideas. They have long been part of the standard policy prescription of donors and international financial institutions to policymakers in European emerging markets. But the message is often drowned by the volume of concern expressed about the traditional macroeconomic risks of high external current account deficits and capital inflows. I have argued that there are good reasons to believe that these risks, while present, may not be very urgent in European emerging markets. It is to be hoped that by lowering the volume of these concerns a notch would allow policymakers – especially in Southeastern Europe – to focus more on microeconomic and institutional priorities.

References

Abiad, A., Leigh, D. and A. Mody (2007), "International Finance and Income Convergence: Europe is Different", *IMF Working Paper*, forthcoming, International Monetary Fund.

Aghion, P. and P. Howitt (2005), "Appropriate Growth Policy: A Unifying Framework", The 2005 Schumpeter Lecture delivered at the 20th Congress of the AEA, Amsterdam, August 25, 2005. http://www.economics.harvard.edu/faculty/aghion/papers.html.

Blanchard, O. and F. Giavazzi (2002), "Current Account Deficits in the Euro Area: The End of the Feldstein-Horioka Puzzle?" *Brookings Papers on Economic Activity*, Vol. 2002, No. 2, pp. 147–209.

Calvo, G. and C. Reinhart (2000), "Fear of Floating", *NBER Working Paper 7993*, National Bureau of Economic Research.

Calvo, G. (2005), "Crises in Emerging Market Economies: A Global Perspective", *NBERWorking Paper 11305*, National Bureau of Economic Research.

Demekas, D.G., Horvath, B., Ribakova, E. and Y. Wu (2007), "Foreign Direct Investment in European Transition Economies – The Role of Policies", *Journal of Comparative Economics*, doi:10.1016/j.jce.2007.03.005.

Lipschitz, L., Lane, T. and A. Mourmouras (2002), "Capital Flows to Transition Economies: Master or Servant?", *IMF Working Paper WP/02/11*, International Monetary Fund.

Prasad, E., Rajan, R. and Subramanian, A. (2006), "Patterns of International Capital Flows and Their Implications for Economic Development", mimeo, International Monetary Fund.

Schadler, S., Mody, A., Abiad, A. and D. Leigh (2006), *Growth in the Central and Eastern European Countries of the European Union*, Occasional Paper 252, International Monetary Fund.