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EU INTEGRATION, CAPITAL FLOWS AND CONVERGENCE

The countries of Central and Eastern Europe which joined the European Union in 2004 and 2007 (New Member States, NMS) have recorded – prior and after their accession – robust growth and were able to converge with the rest of the EU (Old Member States, OMS). Economic growth in the NMS has – to a large extent – been driven by external capital inflows, predominantly from the OMS. It is argued that both capital inflows to the NMS and their convergence with the OMS were underpinned by the advancing integration of the NMS with the EU. Capable to integrate, the NMS increased their credibility as perceived by international investors. Official EU funds, although dwarfed by private capital flows, are also instrumental in the process of convergence of the NMS. During the global crisis of 2007–2009 convergence of some individual NMS has reversed due to their inappropriate macroeconomic policy. In section 1 convergence underpinned by external financing is briefly put in a historical perspective. Section 2 includes stylized facts on capital flows into the NMS. In section 3 links from capital inflows to convergence in the EU are discussed. Section 4 concludes with policy recommendations designed to strengthen the process of convergence.

1. SOME EXPERIENCE ON THE CATCHING-UP PROCESS DRIVEN BY EXTERNAL FINANCING

The conventional theory predicts that the international flow of capital from rich to poor countries helps the latter group grow faster thereby allowing for an income convergence between the groups. This process is associated with the higher marginal productivity of capital in the poor economies and with the equalizing capital productivities among countries brought about by capital migration. Due to the inflow of external capital, the catch-up potential, under which poor countries tend to grow systematically faster than the rich ones, is thus better used [Barro–Sala-i-Martin 1992].

The process of the liberalization of capital accounts, which has been gaining momentum across the world towards the end of the 20th and at the beginning of the 21st century, is an important component of the – more or less successful – growth strategies in many catching-up economies.

Outside Europe, towards the end of the previous century several emerging economies in Asia have been increasingly receiving external capital and were visibly outpacing advanced countries in terms of growth. This process of convergence was stopped with the 1997 Asian crisis associated with abrupt and strong capital flow reversals. Albeit painful, the crisis turned out to be relatively short and the affected countries were able to turn back to recovery and growth, achieving growth rates higher than advanced economies. In the 1960/1970's major economies in Latin

America have been soaring and also hugely borrowing from international creditors. The deteriorating external environment of the 1980's as well as policy mistakes in Latin American countries have led to an acute external debt accompanied by the capital flight. The losses in terms of economic growth have been much more severe and protracted than in East Asia. Also the recovery in the aftermath of the crisis of the 1980's has been – on average – weaker and marked with more ups and downs than in Asia.

In Europe, Poland in the 1970's turned remarkably to a growth strategy driven by external financing. With some cushion in the form of low initial external indebtedness, policymakers decided to heavily borrow on external markets with the objective to modernize industry and to speed up both investment and consumption. This strategy ultimately failed for systemic reasons: an inefficient, centrally planned economy was not able to absorb external funds and to produce the desired growth effects. Similarly to Latin America, over the 1980's the country has been falling into a serious external debt crisis with the deteriorating GDP growth. In Western Europe, convergence has been occurring along with the deepening and enlarging process of the integration of the EU. In particular, four poorer catching-up economies of Spain, Portugal, Greece and Ireland have been showing a long term convergence with the average EU level between 1960 and 2000. It is remarkable, that growth accelerations in these countries followed – immediately or with some lag – their EU entry which was associated with increased inflows of the intra-EU funds, both private and official [Cuaresma et al. 2008]. Towards the end of the current decade the global crisis has severely affected these four countries and their convergence to the EU average.

2. CAPITAL INFLOWS TO THE EU NEW MEMBER STATES.

Over the last two decades the NMS (referred here as Hungary, Czech Republic, Poland, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Bulgaria and Romania) have implemented two strategic steps: the systemic transformation to a market economy and the accession to the EU. These processes were associated with huge increases of external capital flows to the NMS.

Table 1. Dynamics and composition of capital flows to NMS (billions of dollars)

	1998–2000	2001	2004	2006	2007	2008	2009
Total private flows	28.8	16.1	52.3	118.8	185.5	154.7	6.4
Foreign Direct Investment	15.6	17.7	31.7	64.4	77.1	69.3	31.8
Portfolio flows	2.3	2.2	17.0	–0.4	–2.9	–9.9	–7.5
Other	10.9	–3.7	3.5	54.7	111.3	95.3	–18.0
Official flows	1.0	–4.2	9.8	3.8	–6.4	21.1	34.5

Source: IMF

As shown in table 1, Private flows which – except for 2009 – have dwarfed official ones - were increasingly dominated by foreign direct investments (FDI) and by the bank lending (other flows). The NMS witnessed an increase of capital inflows already in the early 2000's, in anticipation of their EU accession. This increase was visibly stronger after 2004 when eight out of ten countries joined the EU.

The ratio of FDI to GDP jumped in the NMS from 6% in 2000-2006 to 10% in 2007 and of bank lending – respectively – from 0-3% to 7%; individually – in Latvia to 31%, Estonia to 21%, Lithuania to 12%. Western, mainly European banks control the bulk of total bank assets in the NMS: nearly 90% in Estonia, around 75% in Lithuania, Romania and Slovakia, over or around 50% in Czech Republic, Hungary, Poland, Latvia and Bulgaria [MacFarquhar–Pinder 2009].

Among foreign investors and lenders in the NMS, Western European businesses clearly dominate. Depending upon individual NMS, investors and lenders from Western Europe represent, in terms of total stocks/liabilities/locations: around 90% of FDI; 50–70% of portfolio equity investment; around 90% of portfolio debt investment and over 90% of foreign bank assets [Lane–Milesi-Feretti 2006].

Capital flows form Western to Eastern Europe are fuelled by pull and push factors of structure and policy nature. The NMS represent a catch-up potential, i.e. they have higher potential and actual economic growth which attracts foreign resources. Relatively poor physical capital and relatively good human capital endowments offer high returns from those resources. The NMS have structurally higher, although converging to EU levels, interest rates encouraging investors to shift from Western European safe, low-yield to more risky, high-yield investments in Eastern Europe. The latter group has a potential for real appreciation of local currencies. On the policy side, two major processes in NMS attract capital inflows: strategies of speeding up economic growth and smoothing consumption as well as of opening up and integrating with the global economy. The privatization, particularly of the financial sector, is instrumental in acquiring local banks by Western European financial institutions. The NMS strongly compete for attracting FDI.

Structural characteristics as well as policies pursued in Western Europe help push capital outside, including to the East of the region. Economies of Western Europe are relatively well endowed with physical capital and have relatively high labor costs. Several countries show current account surpluses vis-à-vis the NMS. Relatively low interest rates push Western European investors out to the East.

To these pull and push usual factors fuelling capital flows to the NMS another factor is added: it is the EU integration which helps increase private flows and adds EU official flows. The channels through which EU integration affects capital flows to the NMS, are shown in figure 1.

Basic elements of the EU integration, i.e. single capital market, monetary and financial integration, institutional frameworks as well as EU official funds affect capital flows to the NMS directly or indirectly, through credibility of these economies. Single capital market eliminates formal obstacles to capital flows within the EU. Some NMS, e.g. Poland, Slovakia, have liberalized their capital accounts prior to the EU membership, in compliance with the OECD requirements. For other NMS, it is the EU-related perspective of the single market which has put in motion the liberalization of capital accounts in the pre-accession period and allowed for increased

inflows. Monetary union brings in price transparency and eliminates costs associated with capital transfers such as transaction costs and exchange rate risks. Highly volatile exchange rates usually discourage foreign investors except those, however, whose portfolios are oriented towards exchange rate fluctuations. Among the NMS, Slovenia and Slovakia have so far progressed in monetary integration adopting the euro. Financial integration is expected to significantly expand the supply of capital available for the whole integrating area, including for the NMS. Along with increasing financial integration, geographic segmentation of markets tends to become less important. The banks of the OMS can increase their cross-border loans to the firms in the NMS. The latter group can access capital markets of the former one more easily by listing shares on foreign stock exchanges. The process of EU financial integration is not yet completed and it differs from market segment to market segment [ECB 2007]. It is worth emphasizing, that under two major integration programs, i.e. Financial Sector Action Plan and the Lamfalussy Process, the NMS score increasingly closely to the OMS.

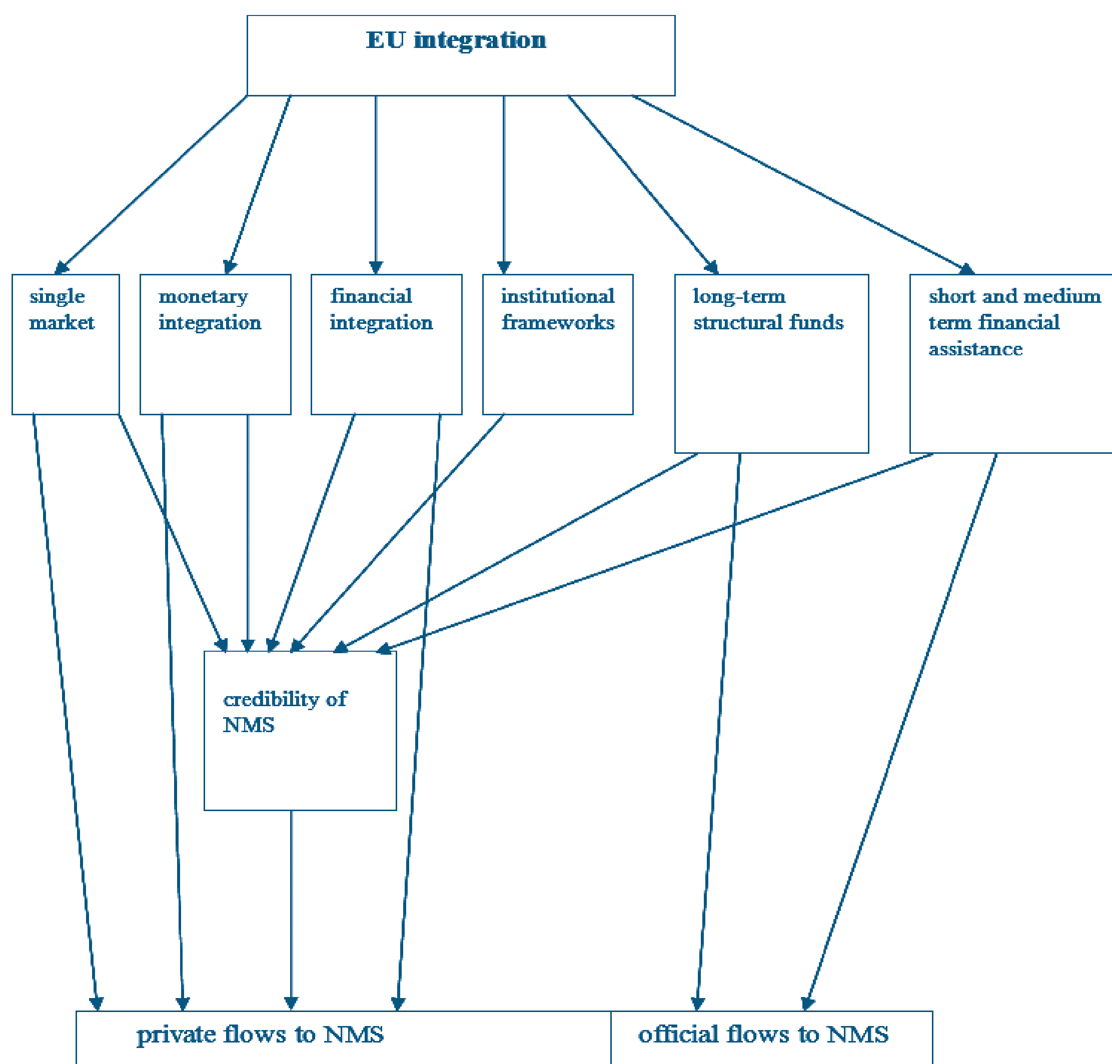

Figure 1. EU integration "adds" to capital flows to NMS

The credibility of the NMS in the eyes of risk and yield sensitive investors is a significant factor affecting capital inflows. Compliance - actual or prospective - with the procedures of the single market, with monetary and financial integration and with other EU institutional frameworks helps raise the international credibility of the NMS. In particular, EU integration implies strengthened macroeconomic discipline due to a single monetary policy and common fiscal rules. International capital markets promptly and strongly reward good policies but also promptly and severely punish bad policies. Markets also believe that EU institutional, legal and regulatory frameworks linked to the acceptance of the acquis communautaire reduce the risk of the discretionary and poor policies in the future.

The increased international credibility of the NMS remains instrumental in attracting more and cheaper external funds. In 2004–2008, as compared to other economies with similar fundamentals, the NMS have been enjoying the advantage on spreads of sovereign bonds issued internationally. In parallel to sovereign bonds, the NMS – to varying degrees – have been outperforming other emerging economies also on other asset markets, such as equities or currencies [Luengnaruemitchai– Schadler 2007]. Advancing monetary integration may help increase sovereign credit ratings of the NMS by rating agencies towards the level enjoyed by the whole euro area and therefore lead to an increased access to foreign capital by companies from the NMS.

The spread advantages related to EU integration enjoyed by the NMS have been reduced, and almost disappeared, due to the global financial crisis in 2008-2009 as investors turned out to put more emerging economies in one basket. These developments led some authors to view the earlier advantages of the NMS as temporary rather than permanent issue [IMF 2009].

Although dwarfed by private flows, EU official capital flows to the NMS remain significant in relative terms. Total EU funds amounted to 3–3.5% of GDP of the NMS in 2000–2006, and increased slightly to 3.5–4% under the new financial perspective in 2007–2013. Out of that, structural and cohesion funds increase respectively from 40% to 60–70% of total EU funds (except for Bulgaria and Romania), mainly at the costs of funds for agriculture [Sierhej 2007]. Apart from long term capital flows in the form of the structural and cohesion funds, the EU provides non-euro NMS with short and medium term financial assistance for balance of payments support: either precautionary – designed for crisis prevention – or non-precautionary – for crisis resolution. In 2009 the total amount appropriated for balance of payments support was doubled to 50 billion Euros. By improving long term growth perspectives of the NMS and making these economies more crisis-resilient, the EU official flows help also strengthen their credibility and therefore attract private capital.

3. CAPITAL INFLOWS, ECONOMIC GROWTH AND CONVERGENCE OF THE NMS

Theoretical considerations regarding the impact of international capital flows on economic growth go, generally, in three directions [Ostry 2007]:

- emphasizing that international capital flows bring a number of benefits associated with the improved allocation of funds between market participants; in par-

ticular, economic growth is enhanced when external capital is used to finance efficient projects, implies transfer of technology (e.g. through FDI), or capital flows lead to larger international risk sharing;

- emphasizing the volatility of international capital flows. Large capital inflows amplify vulnerability of the country to abrupt and strong reversals, to a possible contagion, with the effects disrupting economic growth. The wave of financial crises in capital-receiving emerging economies in 1995–2001 as well as recessions in many financially open economies during the global crisis of 2007–2009 are examined to provide support for the negative growth effects;
- recognizing thresholds needed to achieve benefits from capital inflows and to reduce associated costs referred to above. These thresholds include: development of the domestic financial sector; macroeconomic discipline; quality of institutions and of governance.

Empirical studies on the subject bring no consensus. On the one end, no correlation between capital inflows and economic growth is found. On the other, there is significant correlation as well as, both direct and indirect, impact of capital inflows on growth, controlling for other variables affecting growth and discriminating between particular types of flows. Finally, some studies conclude that positive effects of capital inflows depend on "collateral benefits" or "thresholds" which in turn have been found growth-enhancing [Arvai 2005]. Mixed empirical results are due not only to differences in theories but also to varying methodologies (including variables and their measurements, timeframes, country samples etc.).

In the current decade, until 2008 the EU NMS have been enjoying - on average - robust economic growth and receiving large amounts of capital in many different forms. They have been able to converge with the OMS: in PPP terms, on average the NMS have reduced the gap to the OMS in GDP per capita by around 10 percentage points. In 2009 and probably in 2010, the convergence in broad groups of countries slowed down but did not stop. There is, however, some discontinuation on the individual level. Among the NMS, the Baltic countries are very severely affected by the global crisis and record recession over 17% in 2009. Among the OMS, in 2009 Ireland fell into a recession of 7.5%. Perspectives for 2010 are very pessimistic for Greece, Portugal, Spain and Italy. The convergence process for individual EU member states is illustrated *in table 2*.

It is remarkable that until 2008 the fastest progress in convergence has been observed in the Baltic countries, Romania and Bulgaria. Those economies were also experiencing strongest and fastest capital inflows as well as largest current account deficits. These developments reversed in 2009 and, most likely, in 2010. The Baltic countries and the Eastern Balkans are particularly strongly affected by the sudden stop in external capital inflows turning even into capital flight and by recession. Towards the end of the decade the convergence of these countries and of Hungary to the EU average is reversing.

It is argued that a certain portion of the convergence between the NMS and the OMS can be attributed to capital flows and, in particular, to flows enhanced by the EU integration. A number of studies go beyond simple correlations and try to assign more precisely shifts in convergence to shifts in capital flows to the NMS.

Table 2. GDP per capita based on PPP terms in EU member states, 2001–2009 (EU average = 100)

	2001	2004	2006	2008	2009
Bulgaria	29	33	36	40	40
Romania	29	34	37	41	39
Latvia	37	45	54	56	48
Lithuania	41	50	56	62	53
Poland	47	50	53	57	61
Estonia	48	59	67	67	61
Slovakia	52	58	63	72	72
Czech Rep.	69	74	79	82	82
Hungary	57	62	64	64	62
Ireland	135	143	144	137	133
Germany	119	115	115	116	115
France	118	115	113	112	114
UK	118	121	120	119	118
Italy	112	108	104	100	99
Spain	103	102	102	100	100
Portugal	81	76	74	72	73

Source: author's calculations based on data from the IMF

Behms and Schellekens [2007] apply a dynamic general equilibrium model of convergence and conclude that for the NMS output and consumption paths in case of capital flows are above the paths for the case without flows. Credit constraints slow down convergence more binding in an economy without capital flows.

Several cross-country regressions assign convergence to capital flows to the NMS and to the advancing process of the EU integration. Abiad et al. [2008] found that capital flows speed up convergence in the EU, after controlling for other variables that are typically thought to be robust correlates of growth as well as for the time lag, reverse causality and institutional framework. 20% of total sigma convergence (decline in the dispersion of GDP per capita) can be attributed to capital flows. In case of the beta convergence (towards the level of GDP per capita of Germany) it is around 10% in case of the NMS with relatively small capital inflows and 20-40% in case of economies with relatively large inflows.

Fabrizio et al. [2009] conclude that subsequent stages of the integration of the NMS with the EU (i.e. membership application; negotiation; EU accession; ERM II entry and the Euro adoption) are statistically significant predictors of growth accelerations in theses economies. The same holds true for financial openness and the presence of foreign banks. They consider the access to external capital and advancing integration are strong advantages of the NMS.

The progressing convergence driven by external capital inflows may, however, have its reversal. Such a strategy is exposing the NMS to the risk of growing imbalances which may disrupt growth and convergence. Growing imbalances may be caused either by fluctuations on capital markets due to inherent market failures (such as asymmetry of information, herd behavior, irrational exuberances) and/or by policy failures inducing excessively risky decisions on the side of companies and households. A deterioration of the overall external economic and financial environ-

ment as observed since 2007 is – obviously – reinforcing risks to growth of the NMS. These economies have experienced a crisis of investors' confidence and faced the risk of an abrupt capital withdrawal leading to a vicious circle of recession, losses and further capital outflows.

External imbalances have indeed been growing, although to a different degree, in individual NMS. Excessive current account deficits have been recorded in the Baltic countries, Romania and Bulgaria. In Hungary fiscal balance has strongly deteriorated. The external solvency ratio (i.e. the ratio of the sum of short term debt and the current account balance to reserves) was lowest in the Baltics and in Bulgaria, amounting to the range of 27–50 (the optimum protection level is 100). However, some other NMS, e.g. Poland and Czech Republic turned out to be relatively resilient to a global crisis and were able to continue their convergence to the OMS. Such developments reflect, to a large extent, country-specific factors (like macroeconomic policies) rather than external factors as the major reason for the slowing down convergence across the group of the NMS.

The inflow of official capital to the NMS may also foster their economic growth and convergence. The growth-enhancing effects of EU funds are channeled through following factors:

- like private flows, EU funds add to domestic capital accumulation in the NMS and increase investment and growth opportunities;
- EU funds attract private capital flows to the NMS;
- EU funds mitigate risks to economic growth associated with private flows.

Theoretical works suggest that EU funds positively affect economic growth of the NMS, particularly through their impact on infrastructure and on human capital. Cross-country regressions and model-based simulations assessing growth effects of EU funds make strong case in favor of funds designed to finance infrastructure, either public or private (Allard et al. 2008). Improved infrastructure and increased human capital are critical for attracting external private capital, particularly FDI. Unlike private flows, EU funds represent a stable and predictable source of financing. Regarding mitigating impact on volatilities of flows, the EU has created Medium Term Financial Assistance (MTFA) - a vehicle designed to resolve or prevent balance of payment crisis of the non-euro NMS. The financial support under MTFA is provided in a close cooperation with the IMF and in the context of its stand by arrangements (SBA); in this way the amount of funds available to the NMS is amplified. Among the NMS, Latvia, Hungary and Romania have recently called the EU and the IMF for MTFA and SBA. Within the EU short and medium term financial assistance is also provided bilaterally (e.g. by Poland and Czech Republic to Latvia).

4. CONCLUSIONS

In the current decade the NMS have strongly benefited from opportunities offered by their catch-up potential. They experienced high growth rates and were able to visibly converge to the EU average. The process of their convergence has - to a large extent - been driven by external capital inflows, predominantly from the OMS. Capital flows and their growth-enhancing effects were underpinned by the advanc-

ing integration of the NMS with the EU, the process which helped anchor investors' expectations towards macroeconomic discipline, institutional convergence and an improved quality of governance. In parallel to flows of private capital, official EU funds have improved opportunities to finance investment, attract more private investors and strengthen stability of external financing. With "an umbrella" provided by the integration with the EU, the NMS were offered opportunities to grow faster and with larger external imbalances than otherwise.

However, several NMS, mainly those converging most rapidly, found the counterpart to their growth in excessive external imbalances which stopped and reversed growth and convergence. The adverse effects of the volatility of international capital flows have been amplified by the global crisis of 2007-2009. As some NMS were affected less than others, specific policy factors were largely responsible for shifts in growth and convergence. Policy recommendations for the NMS and to the EU candidates that could be useful for their successful convergence underpinned by capital inflows include:

- orderly and prudent liberalization prior to the accession;
- sound macroeconomic policies (designed, among others, to prevent excessive debt and current account deficit accumulation);
- directing capital towards productive investment, mainly to a tradable sector;
- strengthening financial regulation and supervision as well as cross-border cooperation in these areas;
- improving financial transparency;
- improving risk management of financial institutions and of supervisory institutions;
- an active participation in the international initiatives designed to strengthen financial stability.

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