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"ZAVISNOST" TEKUĆEG BILANSA PLAĆANJA OD STRANIH DIREKTNIH INVESTICIJA

THE "ADDICTION" WITH FDI AND CURRENT ACCOUNT BALANCE

Abstract: *Current account deficit, initially created by the stabilization policies during transition has become a distinct feature of CEE countries. The structure of the deficit has been gradually changing and the predominant role has been taken over by the investment account deficit. This is an inevitable outcome of CEE "addiction" to FDI.*

The linkage between FDI and current account balance is presented by a simple three equations model which relates FDI to the investment and trade accounts. The panel data for eight CEE countries in the 1996-2008 period are used. to estimate the rates of returns on foreign investments which determine outflows through the investment account and the effects of FDI on the trade account. The world financial crisis diminished both inflows of FDI and outflows of profits generated by FDI while severing the problems of enormous negative net financial position of the countries.

Key words: *current account, factors services, foreign direct investment*

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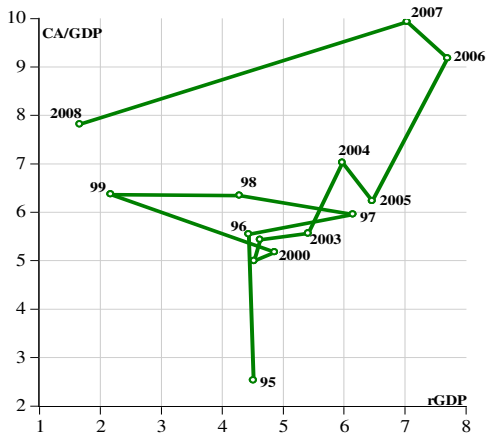
1. TRANSITION PATTERNS AND CURRENT ACCOUNT BALANCES

The current account deficit[1] and the corresponding escalation of indebtedness have been, besides unemployment, a marked feature of economic development in former socialist countries[2] in the period between "transformational depression" and current economic crisis. Namely, while average GDP growth in the period following "transformational depression" stabilised at approximately 5 percent a year, it was accompanied by a 12 percent unemployment rate and 6 percent current account deficit. One could therefore speak of "jobless" and "unsustainable" post-transitional growth. Joblessness can be easily explained by fundamental changes in the labour market mechanism during transition (Mencinger, 2000). The term unsustainable, as used here, concerns the dependence of the CEE countries on foreign savings, which is revealed by their current account deficits and growing foreign indebtedness.

Graph1

Sustainability of post-transition growth in CEE countries



[1] The current account is composed of four accounts, encompassing trade, services, incomes and transfers. The income account which is of interest here embraces compensation for labour services and compensation for capital services. The latter are further divided into: flows from direct investments, portfolio investments and other investments.

[2] The term CEE countries used here relates to Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia. i.e. the countries joining EU in 2004.

The size and the characteristics of current account deficits in a CEE country can be at least partly explained by the transition model shaped by the starting position of the country, prevailing ideology[3], stabilization policies, and restructuring patterns. Large current account deficit at the end of transformational depression can thus be traced to stabilisation policies suggested by Washington consensus[4]. The policies were to respond to the supposition according to which Aggregate Demand exceeds Aggregate Supply. Stabilisation was therefore understandably pointed to decreasing the gap by restrictive monetary and credit policy, anchoring wages, government spending and exchange rates on the demand side, and by rapid liberalisation of foreign trade and prices on the supply side. While the so-called "monetary overhang" and shortages which had existed in socialist economies disappeared overnight with high inflation or hyperinflation, the policy prescriptions remained unchanged. Rapid liberalization of imports was above all destroying the manufacturing sectors of CEE countries, contributed to the fall in measured output, augmented Kornai's "transformational depression" and pushed most domestically produced goods to the bunch of Balcerowicz's "pure socialist production goods". Indeed, only a few goods produced in CEE countries could be sold on the world market or could compete with foreign goods on the liberalized domestic market. Increased imports were therefore not matched by exports.

The current account deficit has become a steady feature of the CEE countries while the structure of the deficit has been gradually changing. Namely, the share of the large structural trade deficit caused by rapid liberalization of imports, which until 2002 was larger than the entire current account deficit, has been decreasing and the shares of transfers and services (both surpluses) have been diminishing as well. The predominant role in shaping current account balance of the CEE (as an entity) has been gradually taken over by the investment account deficit, which began to grow dramatically after 1999. In 2005, the deficit on the income account of CEE surpassed the entire current account deficit by nearly 10 percent and has since remained predominant. The income account deficit (the gap between GDP and GNP) grew from 0.96 percent of GDP in 1996 to 5.88 percent of GDP in 2007 and to 5.38 percent in 2008.

Variations among the countries are substantial; three different patterns can be distinguished. In Baltic countries enormous current account deficits have remained shaped by trade account deficits while growing deficits on the investment account have been offset by surpluses in services and net transfers. In Slovakia, Czech Republic, and Hungary the deficits on the investment accounts

[3] Observed, for example, by the ranking of the countries with regard to »economic freedom« index by Heritage Foundation where the three Baltic countries lead and Slovenia lags behind.

[4] Slovenia appears to be the only country which explicitly refused the suggested policy and opted for gradualism; this is most evident in exchange rate policy with a floating exchange rate regime from the very beginning.

began to dominate their current account deficits while trade account deficits decreased or even turned to surpluses. In a large Polish economy investment account deficit shared the importance with trade account deficit. Slovenia exhibited a rather specific pattern. Namely; until 2004, one of the distinctive characteristics of the country was more or less balanced current account; the deficit on the trade account was matched by the surplus on the services account, while the income account and transfers account were nearly balanced. The situation changed abruptly afterwards with rapid growth of trade account deficit (amounting to more than 7 percent of GDP in 2008) accompanied by expansion of the income account deficit.

2. FOREIGN INVESTMENTS AND CURRENT ACCOUNT DEFICITS

Systemic changes brought substantial net capital inflows mainly in the form of FDI, particularly acquisitions. Empirical literature reveals mixed evidence on the existence of positive spill-over effects of FDI for a host country.[5] Yet, according to the conventional wisdom and mainstream economics, positive spill-over effects of FDI have acquired the status of unquestionable fact. Sales of state-owned companies to foreign owners were also an important component of privatisation and restructuring in the CEE countries and a significant part of FDI was cheap cash sales of productive assets. Most studies on FDI have been concerned with how to attract FDI and not with the short- or even their long-term consequences. The benefits of FDI have been considered confirmed by actual behaviour which "ignores inconclusive academic literature" (Lipsey, 2006, 1), positive externalities have remained to be publicised by international financial organisations, and FDI has remained a pillar of the development strategies in the CEE countries. Indeed, to attract FDI, the CEE countries have been willing to use various forms of subsidy: tax vacations, adaptation of the legal system or even direct financial assistance to multinationals, by which they have replaced contemptible sales of their assets in the period of speedy, often ideologically and politically inspired privatisations during which the "family silver" in most of the CEE countries was sold. Within a decade, foreign ownership of productive assets has become major and in some sectors (financial services, telecommunications, retail trade) predominant or even exclusive. Average yearly FDI inflow into CEE in the period 1996–2008 was approximately EUR 20 billions, with the exception of 2003, when it halved. The FDI inflows therefore resulted in the growth of foreign owned productive assets and correspondingly in enhanced investment income outflows. Though average inflows of FDI in the 1996-2008 period exceeded average outflows of

[5] See Blomstrom and Kokko (1998), Carkovic and Levine (2006), Gorg and Greenway (2004), Lipsey (2002, 2006), Mencinger (2003).

investment income amounting to EUR 16 billions yearly the situation was rapidly changing. Outflows of capital were namely growing from EUR 2.5 billions in 1996 to EUR 42 billions in 2008.

Table 1

The structure of the current account balance in the 1996–2008 period (average shares in GDP)

Country	Current account	Investment account	Trade account	Services, Transfers, Remittances	FDI
Czech R.	-4.09	-3.30	-2.26	1.39	6.15
Estonia	-9.66	-4.33	-16.63	11.67	8.59
Hungary	-6.57	-5.72	-3.59	5.31	5.56
Latvia	-9.98	-2.21	-17.81	10.53	5.28
Lithuania	-8.92	-2.21	-11.37	4.81	3.86
Poland	-3.43	-2.10	-4.27	2.70	3.33
Slovenia	-1.62	-1.13	-4.09	3.60	1.99
Slovakia	-6.05	-2.54	-5.65	2.33	4.62
CEE	-5.86	-2.49	-8.37	4.99	4.92

Source: own calculations from Eurostat yearly data

The overall short- and long-term effects of FDI on current account balance vary over time and may differ from country to country; they depend on the effects that FDI has on domestic savings and economic growth. Thus, though acquisitions of existing assets were the predominant type of FDI in the NMS, FDI was accompanied by deterioration rather than by improvement in the current account balance. A large share of the financial means obtained by selling existing capital stock to foreigners was namely used to increase consumption and imports rather than capital formation. This explains why there is no positive relationship in the CEE countries between the share of FDI in GDP and the share of gross fixed investments in GDP, why there is a strong contemporaneous negative relationship between FDI and current account balance, and, at least partly, why there is a negative relationship between the share of FDI and growth (Mencinger, 2003).

Let us observe the structure of the current account as shares in GDP and break up the current account balance **CA** into three parts: **CAG, CASTL** and

CAI. **CAG** represents trade balance, **CASTL** is composed of balance of services, net current transfers, and net compensations for labour services – remittances while **CAI** consists of the returns on the stock of direct investments, earnings on portfolio investments and interests on loans. By such partitioning **direct** and **indirect** effects of FDI on the current account balance can be delineated; the direct effects being the effects of FDI through the investment account, and the indirect effects being the effects of FDI through the trade account.

The investment account balance in period "**t**" is determined by the returns on foreign owned assets in the host country and by the returns on the assets owned by citizens of the host country abroad. $\mathbf{B_t}$ - net foreign asset position in period **"t"** is thus the sum of net FDI flows $\sum \mathbf{FDI}_{t-i} * \mathbf{(1-d)}^{i}$, with **d** being depreciation rate[6], net stock of portfolio investments $\sum \mathbf{FPI}_{t-i}$, and net indebtedness $\sum \mathbf{OI}_{t-i}$.

$$\mathbf{B_t = \sum FDI_{t-i} * (1-d)^{i} + \sum FPI_{t-i} + \sum OI_{t-i}} \qquad (1)$$

The effects of foreign owned assets on the investment account balance are apparent: foreign ownership implies outflow of capital from the host country in the form of profits on FDI stock, earnings on portfolio investment, and interests on loans..

$$\mathbf{CAI_t = \alpha_0 + \alpha_1 * \sum FDI_{t-i} * (1-d)^{i} + \alpha_2 * \sum FPI_{t-i} + \alpha_3 * \sum OI_{t-i} + \alpha_4 * rGDP_t} \qquad (2)$$

$\boldsymbol{\alpha_1}$, $\boldsymbol{\alpha_2}$ and $\boldsymbol{\alpha_3}$ in equation (2) should be negative, and their absolute values should differ[7]. Furthermore, as one can assume that profits and their outflows

[6] In the observed period, the majority of foreign owned assets in the CEE were created by inward FDI; with the exception of Slovenia, outward FDI was negligible.

[7] Formally, with the identity **CA + KA = dR** (CA – current account, KA – capital account, and dR – changes in official reserves) and assuming that other capital flows and changes in official reserves are 0, there are three alternative effects that FDI has on the current account balance. Firstly, if FDI increases capital formation without crowding out domestically financed investment, it worsens the current account by the same amount. Secondly, if FDI crowds out domestically financed investment, the effects depend on the reduction of domestically financed investment; a part of FDI can be used to finance existing indebtedness of the country. Thirdly, if FDI implies the acquisition of existing assets in the host country, FDI provides a source of financing the existing current account deficit.

The structure of income account balances in the CEE countries in the 1996–2008 period indicates that financial flows related to FDI were much greater than flows of portfolio investment or

depend on the current economic situation which implies that α_4 should also be negative and α_0 insignificant.

While the direct effects of foreign-owned assets on the current account balance are straightforward, the indirect effects i.e. the effects on the trade balance are ambiguous[8]. Whether the effects of FDI on trade balance are positive or negative depends on the production structure of FDI (Aizenman, J. and Noy, I., 2005). One would expect positive effects if the key aim of FDI was to enjoy advantage of cheaper labour in the host compared to the home country, and negative effects if the key aim of FDI is to acquire new markets. In the first case β_2 should be positive, in the second case it should be negative. One could also expect a significant negative value of β_o. which reflect structural trade account deficit linked to transition. Trade balance is also influenced by economic growth and availability of foreign credits; β_3 and β_4 should be negative while β_1 should be positive.

$$CAG_t = \beta_o + \beta_1 * FDI_{t-1} + \beta_2 * \sum FDI_{t-i} * (1-d)^i + \beta_3 * OI_{t-I} + \\ + \beta_4 * rGDP_t \qquad (3)$$

Finally, one can assume that balances of services, transfers and remittances **CASTL** are not affected by FDI; they are therefore considered exogenous.

$$CA_t = CAI_t + CAG_t + \underline{CASTL_t} \qquad (4)$$

One can thus specify a simple model of current account balance linked to with inflows of capital through FDI, portfolio, and other investments.

borrowing abroad, and also that net compensation for labour services (remittances) in the period were relatively miniscule.

[8] There are two-way linkages between international trade and FDI; the present paper is concerned with only one of these links: the effects of FDI on trade balance.

3. MODEL ESTIMATES

Panel least squares method was used to estimate equations (2) and (3) for the 1996–2008 period. Each equation can be estimated as:

$$\mathbf{Y_{it}} = \boldsymbol{\alpha} + \mathbf{X_{it}}\,\boldsymbol{\beta_{it}} + \boldsymbol{\delta_i} + \boldsymbol{\gamma_t} + \boldsymbol{\varepsilon_{it}} \quad (5)$$

where $\mathbf{Y_{it}}$ is the dependent variable, $\mathbf{X_{it}}$ is a k-vector of independent variables, and $\boldsymbol{\varepsilon_{it}}$ are error terms for cross-sectional units observed in pooled periods. The $\boldsymbol{\alpha}$ parameter represents the overall constant, while $\boldsymbol{\delta_i}$ represents cross-section-specific and $\boldsymbol{\gamma_t}$ period-specific effects. One may view the data as a set of cross-section-specific regressions, so that we have M cross-section equations, or one may view the data as a set of T period-specific regressions. Thus, $\boldsymbol{\beta}$ coefficients may be divided into sets of cross-section-specific, period-specific or common parameters. If $\boldsymbol{\beta}$ are common across cross sections and periods, equation (7) can be simplified to:

$$\mathbf{Y_{it}} = \boldsymbol{\alpha} + \mathbf{X_{it}}\,\boldsymbol{\beta} + \boldsymbol{\delta_i} + \boldsymbol{\gamma_t} + \boldsymbol{\varepsilon_{it}} \quad (6)$$

If $\boldsymbol{\beta}$ are country-specific we have:

$$\mathbf{Y_{it}} = \boldsymbol{\alpha} + \mathbf{X_{it}}\,\boldsymbol{\beta_i} + \boldsymbol{\delta_i} + \boldsymbol{\gamma_t} + \boldsymbol{\varepsilon_{it}} \quad (6a)$$

If $\boldsymbol{\beta}$ are period-specific we have:

$$\mathbf{Y_{it}} = \boldsymbol{\alpha} + \mathbf{X_{it}}\,\boldsymbol{\beta_t} + \boldsymbol{\delta_i} + \boldsymbol{\gamma_t} + \boldsymbol{\varepsilon_{it}} \quad (6b)$$

The presence of cross-section (country)-specific and period-specific effects, terms $\boldsymbol{\delta}$ and $\boldsymbol{\gamma}$ were handled using a fixed effects method. Country-specific effects improved the estimation results considerably, while period-specific effects did not. The results of cross fixed restrictions specification are presented in Table 2.

Estimated coefficients for investment balance are in accordance with expectations. Specifically (equation 2), each additional unit of FDI stock increases the investment account deficit in GDP by 0.1197 units, one unit of portfolio stock by 0.0514 units, and one unit of other investments stock (credits) by 0.0455 units. In other words, average rates of return on FDI (11.97 percent) in the NMS in the observed period were more than two times higher than the rates of return on portfolio investments (5.14 percent) and the rates of return on credits to the host country (4.55 percent). Finally, an increase in GDP growth of one percentage point increased outflow through the investment account by 0.145 units.

Table 2.

The Results

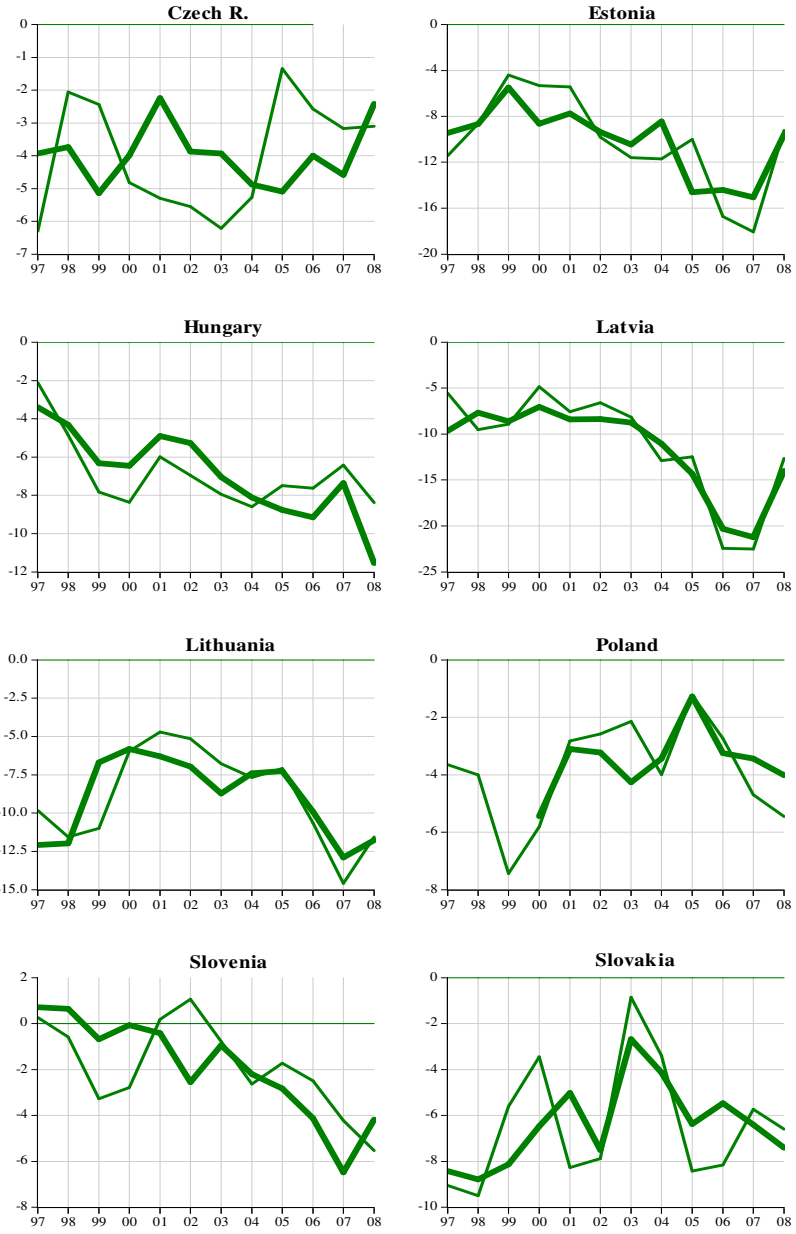
equation	investment balance						
	α_0	α_1	α_2	α_3	α_4	R^2 DW	Restrictions
2	0.9772 (3.09)	-0.1197 (-9.71)	-0.0514 (-2.58)	-0.0455 (-4.59	-0.1405 (-3.97)	0.84 0.88	Cross Fixed
	trade balance						
	β_o	β_1	β_2	β_3	β_4	R^2 DW	Restrictions
3	-9.061 (-13.1)	-0.1180 (-1.56)	0.2514 (9.24)	-0.1591 (-7.47)	-0.2477 (-3.29)	0.92 1.47	Cross Fixed

The equation for trade balance (3) indicates that FDI first increases and then as a stock begins to diminish the trade account deficit, which would imply that the predominant aim of multinationals to invest in the CEE countries is labour cost reduction. Loans increase trade account deficit by enabling imports to exceed exports. Highly significant negative constant shows the role of a structural trade account deficit created by transition.

The estimated (thick line) and actual data (thin line) for current account balances (equation 4) are in Graph 2.

Graph 2

Estimated and Actual Current Account Balance in CEE



4. "ADDICTION" WITH FDI AND WORLD FINANCIAL CRISIS

Foreign ownership of productive assets in the CEE countries has deteriorated their current account balances through the investment account and improved it through the trade account. The long-term dynamics of the current account balance has been shaped by the investment account, while fluctuations and country-specific levels have been formed by the trade account. Positive effects of the latter might or might not outweigh negative effects of the former, they also might or might not prevail over "structural" trade account deficit created in transition. If positive effects of the trade account are smaller than the sum of negative effects on the income account and "structural" trade account deficit, a country faces persistent large current account deficit. Three groups of countries can be distinguished. In Czech Republic, Hungary, and Poland, the trade account deficit was gradually decreasing or turned to a surplus which however did not suffice to outweigh growing investment account deficit. Baltic countries continued to have large trade account and growing investment account deficits. Slovakia and Slovenia differ in the levels. In Slovakia, current account deficit was shaped by the trade account deficit until 2003, and was after 2004 enhanced by the investment account deficit. Slovenia retained current account in balance until 2005. This was followed by rapid deterioration in 2007 and 2008 which was a result of changes in economic policies and abolition of previously prevailing gradualism.

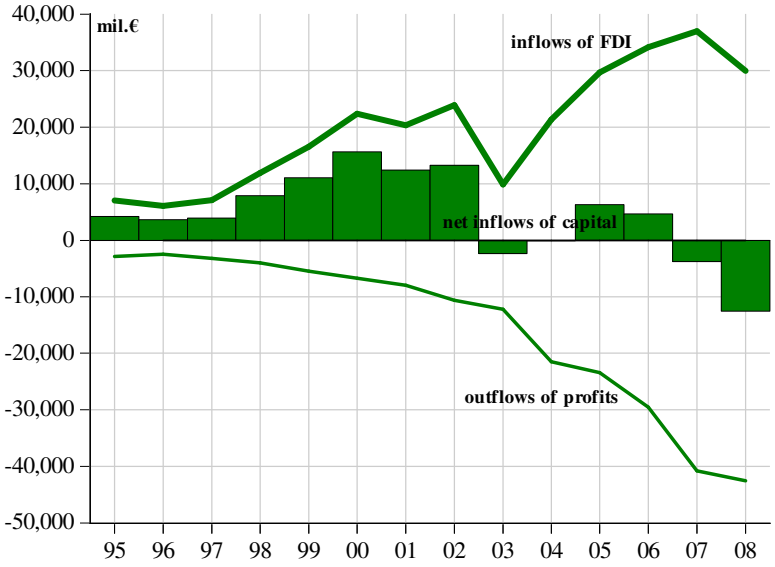
Current account deficit in the CEE will remain an important issue threatening their economic stability and weakening economic policies. While exchange rate policy in the countries which retained its own currency can, at least in theory, shape the trade account balance, it can hardly shape the investment account balance. The outflows through the investment account are namely to a great extent determined by inflows of capital in the past. Furthermore, the resulting negative net external position must again be financed by inflows of foreign savings which are creating new outflows through the investment account and enhancing current account deficit. It was therefore even before the crisis certain that CEE countries would by "addiction" to FDI inevitably face a kind of vicious circle and that sudden termination of FDI would create a situation similar to the situation in South East Asia (Fry, M. J. 1996), where sudden interruption of FDI in 1998 was followed by a 10 percent drop in GDP and devaluations of approximately 40 percent.

Where are the limits of current accounts deficit? Most CEE countries have covered the deficits by selling productive assets and they have been left with only a few locally owned companies which could become targets of acquisition by multinationals. At the same time, the countries have faced rapidly growing competition for green-field investments by countries where even cheaper labour was available. As a result, FDI in the CEE shifted to real estate

and services. In 2007, inflows of FDI began to lag behind the outflows of capital which was created by FDI inflows in the past. Such development strengthened in 2008 when FDI to CEE amounted to € 30 billions or 3.79 percent of GDP, while outflows of capital through the investment account amounted to € 43 billions or 5.38 percent of GDP. The gap had to be replaced by borrowing.

Graph 3

Flows of capital to CEE



Financial crisis affected international flows of goods, services, labour and capital much more than it affected domestic activities, international flows decreased faster and more than GDP. In the first quarter of 2009 compared to the first quarter of 2008 imports of goods in CEE countries decreased by 28 percent and exports by 24 percent. The crash of imports greater than the crash of exports cut their trade account deficits and their service account surpluses. Profits of foreign owned companies - a major a source of outflows through the income account - diminished as well or turned to losses[9]; the outflow through the income account dropped by 22 percent. At the same time, FDI decreased even more; FDI inflows in the first quarter of 2009 was only a quarter of inflows in the first

[9] The assets of the European banks most engaged in CEE and enjoying the rates of returns on capital three times the rates of returns on capital in their home countries (Havrylchyck, O., Jurzyk, E.2006; Önaran, 2006, Altzinger, 2005) became “toxic” and could not be retrieved quickly.

quarter of 2008. A kind of spontaneous de-globalization emerged by cutback of the flows of goods, services, labour and capital while making the core problem - enormous net negative financial assets position of the CEE countries harsher.

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