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THE IMPROVEMENT IN THE EXTERNAL POSITION OF CENTRAL AND EASTERN EUROPEAN COUNTRIES

Summary

Although it may be early to draw very firm conclusions, especially about durability, the balance of payments of most Central and Eastern European countries (CEEC) have experienced a notable improvement since 1994.

In 1994, exports grew strongly and current account deficits shrank considerably in a majority of countries, reversing the severe deterioration that had occurred in 1993. Preliminary data for 1995 are not as favourable. Although the aggregate current account deficit of the region remains, in terms of GDP, significantly below its 1993 peak, it increased in 1995. It is too early to fully assess this recent deterioration, but projections for 1996–97 point towards a renewed decline in the deficit to around its 1994 level.

Capital inflows have increased sharply in many CEEC. The region has been receiving since 1993 an average net annual capital inflow which is larger in terms of GDP than that observed in most countries of Latin America and Asia during their capital inflow surge episodes of the late 1980s and early 1990s. Reflecting the strengthening of the current and capital accounts, official foreign exchange reserves have been rising rapidly and stand now at their highest level since the transition began and, in many countries, at relatively comfortable levels in terms of imports.

Ratings and access to the international capital markets are improving. Three countries (the Czech Republic, Slovakia and Poland) have obtained investment grade marks from at least one of the major international rating agencies. In the case of Poland, Bulgaria and Slovenia, the restoration of market access has been facilitated by the 1994 debt agreements with their commercial bank creditors.

After increasing rapidly in 1992 and 1993, net foreign direct investment (FDI) into CEEC fell moderately in 1994 and, with the exception of Estonia, Hungary and the Czech Republic, continued to represent a relatively small fraction of GDP. Supported by several important privatization operations, however, FDI is estimated to have recovered strongly in 1995.

The region's foreign debt/GDP ratio has fallen by one third between end–1990 and mid–1995. However, this is explained by the impressive decline in the Polish and Bulgarian ratios. The foreign debt/GDP ratio has increased in a majority of countries over recent years and remains relatively high for the region as a whole.

The main exception to these positive general trends in the balance of payments is Hungary. Although Hungary has been, together with the Czech Republic, the major beneficiary of the surge in capital inflows to the region and has recorded an important increase in its reserves, it suffered in 1993–94 a sharp deterioration in its current account and a rapid worsening of its debt ratios from already high levels. The current accounts of the Baltic states and, to a lesser extent, the Czech Republic also worsened quite sharply in 1993–94. But this deterioration has taken place from comfortable surpluses and has been offset (particularly in the case of the Czech Republic) by the increase in capital inflows.

The abrupt increase in capital inflows experienced by CEEC as a group since 1993 has been fully explained by the expansion of private inflows. As a result, the proportion of official inflows in total capital inflows has fallen considerably between the periods 1990–92 and 1993–95.

The sustainability of these positive external trends, however, will crucially depend on the economic policies implemented by CEEC. If the authorities pursue policies conducive to macroeconomic stability and systemic transformation, private capital should continue flowing into CEEC in substantial amounts in the coming years, and the trend towards an increasingly dominant role for this type of flows in total capital flows should not be reversed. The main risks to this favourable scenario stem from the slow progress being made by some CEEC in the main areas of structural reform and from the still vulnerable macroeconomic position of several countries.

This issue of Supplement A reviews external trends in the ten CEEC having signed (or initialed) association agreements with the EU (CEEC 10). Because of lack of data, however, the analysis is sometimes restricted to the Czech Republic, the Slovak Republic, Hungary, Poland, Bulgaria and Romania (CEEC 6), that is, to the first six associated countries.

I. Current account trends

Largely reflecting the recovery of economic activity in the West and in the Visegrad countries, *exports* in CEEC expanded rapidly in 1994. As table 1 shows, the growth of real exports of goods and services in CEEC 6 accelerated from only 0.9% in 1993 to 11.4% in 1994 and the Commission expects it to remain strong in the coming years, averaging about 8% per annum until 1997.

At the same time, *imports* grew in 1994 much less than had been expected. Despite the nascent economic recovery in Central and Eastern Europe, real merchandise import growth in CEEC 6 declined from 13.1% in 1993 to 8.3% in 1994. Tight macroeconomic policies restraining domestic demand, the lagged response of investment demand (which has a relatively high import content) to the strengthening of economic activity and, in some countries, the imposition of temporary import restrictions seem to be, in general, the main explanations for this lower than expected import growth. In the case of Bulgaria, another relevant factor has been the significant depreciation of the real exchange rate that took place between mid–1993 and April 1994.

The combination of a rebound in exports and a deceleration in import growth resulted in a sharp correction of the total *current account deficit* of CEEC 6 in 1994, thus reversing the severe deterioration that had occurred in 1993. The deficit declined from 4.1% of GDP in 1993 (by far the highest level since the transition began) to 2.1% of GDP in 1994. The aggregate deficit of the CEEC 10, for its part, declined from 3.6% to 1.8% of GDP over the same period. This favourable average performance, however, hides a divergent pattern between two groups of countries. While in six countries the current account improved (and in most cases very strongly), in the other four it deteriorated (and in three of them quite sharply).

Noteworthy improvements in the current account were achieved in 1994 by *Bulgaria, Romania, Slovakia, Slovenia and Poland* (see table 2). The figures for Poland shown in table 2 in fact seriously underestimate the amelioration of its current account since they do not take into account the growing amount of unrecorded Polish exports to neighbouring countries (which are currently classified under short–term capital inflows). According to the IMF, if estimates of unrecorded trade flows are included, Poland's current account recorded in 1994 a *surplus* of US$ 2.3 bn (2.3% of GDP), implying an improvement of about three percentage points of GDP relative to 1993. This is important because, given the weight of Poland, the use of these adjusted figures significantly affects the totals for the region. With the adjusted figures, the 1994 current account deficit of CEEC 10 amounts to only US$ 1.3 bn or 0.5% of the region's GDP.

TABLE 1 : **Trade flows in CEEC 6**
(% rate of change)

	1993	**1994**	**1995(1)**	**1996(1)**	**1997(1)**
Real exports of goods and non–factor services	0.9	11.4	7.1	9.2	8.0
Real imports of goods and non–factor services	10.0	7.4	14.0	9.2	8.8
Real merchandise exports	0.3	13.4	8.3	9.2	8.1
Real merchandise imports	13.1	8.3	16.8	10.0	9.1

(1) Autumn 1995 forecasts.
Source: European Commission.

TABLE 2 : **Current account balances**

		1989	1990	1991	1992	1993	1994	European Commission Autumn 1995 forecasts 1995	1996	1997
1. Former CSFR	bn $	0.9	–1.3	0.4	0.3	–	–	–	–	–
	% of GDP	1.9	–2.9	1.2	0.8	–	–	–	–	–
2. Czech Republic	bn $	–	–	–	–	0.7	0.0	–1.6	–1.5	–1.2
	% of GDP	–	–	–	–	2.2	0.0	–3.7	–2.8	–2.0
3. Slovakia	bn $	–	–	–	–	–0.6	0.7	0.3	0.4	0.3
	% of GDP	–	–	–	–	–5.4	5.7	2.2	2.1	1.5
4. Hungary	bn $	–1.4	0.1	0.3	0.3	–3.5	–3.9	–3.1	–2.8	–2.4
	% of GDP	–5.0	0.4	0.8	0.9	–9.6	–9.5	–7.6	–6.5	–5.1
5. Poland	bn $	–1.8	0.7	–2.2	–0.3	–2.3	–1.1	–1.7	–1.7	–3.1
	% of GDP	–2.7	1.1	–2.9	–0.3	–2.7	–1.1	–1.3	–1.1	–1.9
6. Bulgaria	bn $	–1.5	–1.0	–0.3	–0.8	–1.1	–0.0	0.1	0.3	0.4
	% of GDP	–6.8	–12.5	–4.1	–9.3	–9.8	–0.2	0.4	2.9	3.1
7. Romania	bn $	2.9	–1.8	–1.3	–1.7	–1.4	–0.4	–1.1	–1.0	–0.8
	% of GDP	13.0	–7.9	–4.7	–8.8	–5.4	–1.3	–3.5	–3.0	–2.4
8. Slovenia	bn $	–	–	0.1	0.9	0.2	0.5	0.5	0.7	0.9
	% of GDP	–	–	1.0	7.5	1.2	3.4	2.5	3.3	4.1
9. Estonia	bn $	–	–	–	0.1	0.0	–0.2	–0.2	–0.4	–0.3
	% of GDP	–	–	–	7.6	0.7	–6.4	–5.4	–8.0	–5.3
10. Latvia	bn $	–	–	–	0.0	0.2	–0.1	–0.1	–0.1	–0.1
	% of GDP	–	–	–	1.8	6.8	–2.5	–1.7	–1.2	–1.2
11. Lithuania	bn $	–	–	–	0.2	–0.2	–0.2	–0.2	–0.2	–0.2
	% of GDP	–	–	–	11.0	–5.7	–3.7	–4.0	–2.7	–2.1
Total (1–7)	bn $	–0.9	–3.3	–3.1	–2.2	–8.2	–4.7	–7.1	–6.2	–6.8
	% of GDP	–0.4	–1.7	–1.6	–1.2	–4.1	–2.1	–2.7	–2.0	–2.0
Total (1–11)	bn $	–	–	–	–1.0	–8.1	–4.7	–7.1	–6.2	–6.5
	% of GDP	–	–	–	–0.6	–3.6	–1.8	–2.4	–1.8	–1.7
Simple average (1–11)	% of GDP	–	–	–	1.2	–2.8	–1.6	–2.2	–1.7	–1.1

Sources: National authorities, European Commission, and IMF.

On the negative side, *Hungary*'s current account deficit widened again in dollar terms in 1994 and remained at a worryingly high 9.5% of GDP. The sharp deterioration of the Hungarian current account in 1993–94 resulted from a combination of factors. It reflected the country's high budget deficits, the cumulative appreciation of the real exchange rate between end–1990 and end–1993, and deep structural problems in the export sectors. But it also reflected factors of a more special and transitory nature, like the effect of the UN embargo on Serbia and Montenegro and the detrimental impact on agricultural production of a protracted drought.

The *Czech Republic, Estonia and Latvia* have also experienced a deterioration of the current account in 1994. The Czech current account has continued to worsen rapidly in 1995 and is expected to reach a deficit of about 3–4% in 1995–96. As it is well known, however, the negative trend in the Czech current account has been more than offset by (and partly reflects) a strengthening of the capital account, resulting in the sharpest increase in official foreign exchange reserves experienced by any country in the region (see sections II and VI). Similarly, in Estonia, where imports have increased sharply owing to the surge in FDI, and in Latvia the deterioration in the current accounts has been compensated and partly caused by the increase in capital inflows. The behaviour of the current account in these three countries, however, may be of some concern to the extent that it signals weak external competitiveness following several years of sustained real exchange rate appreciation.

Import growth is estimated to have accelerated considerably in 1995, responding at last to the recovery of economic activity in CEEC. According to the Commission's Autumn 1995 forecasts, this more rapid expansion of imports, coupled with a deceleration of export growth from its 1993 peak, will produce some deterioration in the region's current account deficit as a percentage of GDP in 1995. But the deterioration will only be significant in the case of Romania, Slovakia and, as noted, the Czech Republic, and the region's current account deficit will remain significantly below its 1993 peak. Furthermore, although a number of uncertainties remain, projections suggest that the region's deficit will decline again in 1996–1997, stabilizing at around the level that had been achieved in 1994 (see table 2).

II. Trends in official reserves

After declining to low levels at the beginning of the transition, official international reserves in CEEC 6 recovered gradually in 1991–92 and have been increasing sharply since 1993[1], with the pace of expansion accelerating dramatically in the first half of 1995 (see table 3). The official reserves of the CEEC 10 have tripled between end–1992 (US$ 13.6 bn) and mid–1995 (US$ 40.1 bn), and rose by a startling US$ 12 bn in the first six months of 1995.

On average, official reserves in CEEC 6 represented 5 months of imports in mid–1995, compared with only 1.9 months at end–1990. The average import cover ratio for the

1 Official reserves increased by US$ 6.5 bn in 1993 despite the record current account deficit reached that year, reflecting the improvement in the capital account (see section VI).

TABLE 3 : **Gross official reserves** (end of period)

		1989	1990	1991	1992	1993	1994	June 1995
1. Former CSFR(1)	bn $	2.3	0.5	1.4	1.3	–	–	–
	months of imports(2)	2.4	0.6	1.3	1.1	–	–	–
2. Czech Republic	bn $	–	–	–	0.9	3.9	6.2	11.8
	months of imports(2)	–	–	–	1.3	2.7	4.0	7.4
3. Slovakia	bn $	–	–	–	0.5	0.9	2.2	2.8(5)
	months of imports(2)	–	–	–	1.1	1.2	3.0	3.4(5)
4. Hungary	bn $	1.7	1.2	4.0	4.4	6.7	6.8	7.6
	months of imports(2)	3.5	2.3	5.3	5.2	7.1	7.2	7.8
5. Poland	bn $	2.5	4.7	3.8	4.6	4.6	6.5	11.0(6)
	months of imports(2)	3.3	5.5	3.3	3.5	3.0	3.6	5.8(6)
6. Bulgaria	bn $	1.2	0.2	0.4	1.2	1.0	1.4	1.7
	months of imports(2)	2.4	0.4	1.8	2.8	2.1	3.0	3.5
7. Romania(3)	bn $	2.5	0.4	0.6	0.8	1.0	2.0	1.8
	months of imports(2)	6.0	0.8	1.0	1.3	1.6	2.6	2.1
8. Slovenia(4)	bn $	–	–	0.1	0.7	0.8	1.5	1.8
	months of imports(2)	–	–	0.3	1.2	1.3	2.3	2.5
9. Estonia	bn $	–	–	–	0.2	0.4	0.5	0.5
	months of imports(2)	–	–	–	4.5	4.8	3.3	3.2
10. Latvia	bn $	–	–	–	0.2	0.5	0.6	0.5
	months of imports(2)	–	–	–	1.5	4.4	4.5	3.3
11. Lithuania	bn $	–	–	–	0.1	0.4	0.5	0.6
	months of imports(2)	–	–	–	1.2	2.3	2.8	3.0
Total (1–7)	bn $	10.2	7.0	10.3	12.3	18.0	25.0	36.7
Total (2–11)	bn $	–	–	–	13.6	20.1	28.1	40.1
Average import cover	**(simple average)**							
	(1–7)	3.5	1.9	2.5	2.8	3.0	3.9	5.0
	(1–11)	–	–	–	2.4	3.1	3.6	4.2

(1) Convertible reserves only.
(2) Imports of goods and services.
(3) Foreign exchange reserves of the banking system.
(4) Excluding claims on gold and other foreign assets held by the National Bank of Yugoslavia at the time of the break–up of the federation.
(5) August 1995.
(6) July 1995.
Sources: National data, IMF, EBRD, and UN Economic Commission for Europe.

CEEC 10, for its part, has increased from 2.4 months at end–1992 to 4.2 months at mid–1995.

Although practically all countries have benefited from this positive trend, the rise in reserves has been increasingly concentrated in a few countries since end–1994, with the Czech Republic, Poland and Hungary largely being responsible for the sharp improvement recorded in the region's average import cover ratio in the first half of 1995. Furthermore, the average import cover ratio for the region hides important differences among countries. The Czech Republic, Poland and Hungary all stood out with ratios of at least 6 months of imports in mid–1995. By contrast, Romania (where reserves fell significantly in the first half of 1995) and, to a lesser extent, the Baltic states continue to have a somewhat vulnerable foreign exchange position, with import cover ratios of 3 months or less[2].

III. Foreign debt

Except in 1994, the aggregate gross convertible debt of CEEC 6 has increased in nominal terms every year since the transition began. But the region's foreign debt/GDP ratio, which is a much more relevant indicator of the economic burden represented by the debt, has fallen by one third between end–1990 and mid–1995 (see table 4). The region's average debt service–over–exports ratio improved markedly in 1991–92 and has approximately stabilized since then (see graph 1).

The improvement in the region's average debt ratios, however, gives an over–optimistic picture of foreign debt trends for three reasons. Firstly, it is basically explained by the impressive decline in the ratios of Poland and Bulgaria. This is particularly true for the debt/GDP ratio. The Polish and Bulgarian debt/GDP ratios have halved since they reached their peaks in, respectively, 1990 and 1992. In all the other CEEC 10, the debt/GDP ratios have experienced some deterioration in recent years (although in many cases the deterioration has been moderate and from low initial levels).

Secondly, the decline in the region's foreign debt/GDP ratio is partly accounted for by the appreciation of the real exchange rates, which tends to increase the value of the US dollar–denominated GDPs. Following the sharp devaluations of the early transition years, the real exchange rates of many CEEC 10 have tended to show, beyond short–term fluctuations, an appreciating trend. Part of this real appreciation probably reflects an equilibrium phenomenon due to

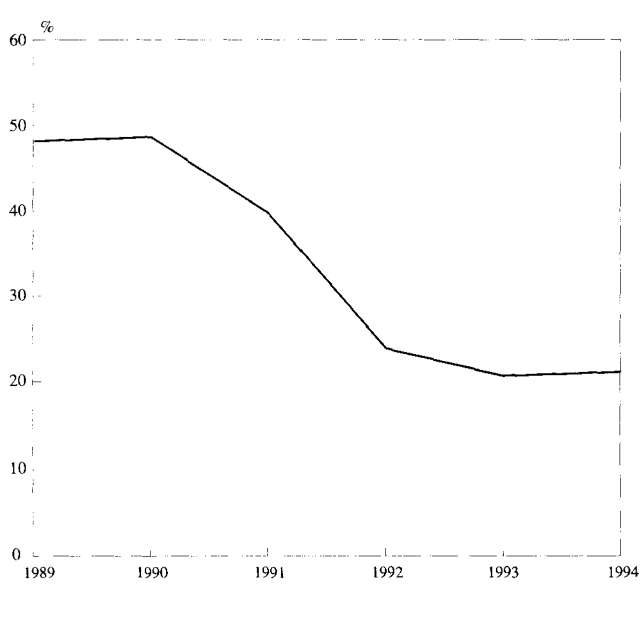
2 The import cover ratio shown for Slovenia in table 3 (2.5 at mid–1995) is also relatively low but the reserves data used in this table for Slovenia exclude unresolved claims on the gold and other foreign assets held by the National Bank of Yugoslavia at the time of the break–up of the federation.

TABLE 4 : **Gross convertible foreign debt**

		1989	1990	1991	1992	1993	1994	June 1995
1. Former CSFR	bn $	7.9	8.4	9.8	9.5	–	–	–
	in % of GDP	14.3	14.4	25.6	26.9	–	–	–
2. Czech Republic	bn $	–	–	–	6.9	8.5	10.7	15.0
	in % of GDP	–	–	–	25.4	27.4	29.6	33.4
3. Slovakia	bn $	–	–	–	2.8	3.4	4.0	5.0
	in % of GDP	–	–	–	26.0	30.6	31.7	34.4
4. Hungary	bn $	20.4	21.3	22.7	21.4	24.6	28.5	33.0
	in % of GDP	70.3	64.8	73.5	58.3	66.6	69.5	77.1
5. Poland	bn $	40.2	48.9	48.3	48.2	48.7	42.2	45.1(4)
	in % of GDP	60.2	78.5	71.5	53.7	52.7	43.3	39.1(4)
6. Bulgaria(1)	bn $	9.2	10.2	11.6	12.5	12.8	11.1	10.2
	in % of GDP	42.0	134.0	147.0	151.0	124.0	111.0	82.0
7. Romania	bn $	0.8	1.1	2.1	3.4	4.4	4.9	5.2
	in % of GDP	3.6	4.9	7.6	17.5	16.9	16.3	16.0
8. Slovenia (2)	bn $	–	–	1.9	1.7	1.9	2.3	2.6
	in % of GDP	–	–	14.7	14.4	15.5	16.5	14.7
9. Estonia	bn $	–	–	–	0.04	0.14	0.17	0.23
	in % of GDP	–	–	–	4.2	8.6	6.5	6.2
10. Latvia	bn $	–	–	–	0.04	0.23	0.36	0.37
	in % of GDP	–	–	–	3.0	10.0	10.0	9.0
11. Lithuania	bn $	–	–	–	0.1	0.28	0.44	0.58
	in % of GDP	–	–	–	5.1	9.8	7.5	7.2
Total (1–7)	bn $	78.5	89.9	94.5	95.0	102.4	101.4	113.5
	% of GDP	52.3	67.1	66.8	55.5	49.5	45.7	44.5
Simple average (1–7)	% of GDP	38.1	59.3	65.0	59.8	53.0	50.2	47.0
Total (2–11)	bn $	–	–	–	97.1	104.9	104.7	117.3
	% of GDP	–	–	–	46.2	46.5	43.0	41.7
Average debt/GDP ratio of:								
severely–indebted low–income countries(3)		124.0	129.7	128.1	122.1	117.2	–	–
severely–indebted middle–income countries(3)		51.3	48.3	49.9	47.9	42.2	–	–
developing and transition countries		34.5	34.0	36.4	37.7	39.7	–	–

(1) Including non–convertible debt.
(2) Excluding the part of the debt from the former Yugoslovia to be allocated to Slovenia and debt to the IMF.
(3) As classified in World Bank (1994).
(4) July.
Sources: National authorities, IMF, and World Bank (1994).

GRAPH 1 : **Average debt service–over–exports ratio in CEEC 6(1) (2)**



(1) Simple average.
(2) As a percentage of exports of goods and services. Debt service includes interest payments and amortizations.
Sources : National authorities, World Bank and IMF.

the strong initial undervaluations and/or to an increase in the medium–term equilibrium real exchange rate[3]. But, to the extent that not all the real appreciation is a movement towards the equilibrium level, the decline in the debt/GDP ratios is temporarily being exaggerated by an appreciation of the real exchange rate that will eventually be corrected.

Thirdly, the improvement in the region's average ratios hides a substantial deterioration since 1993 in Hungary's ratios from already very high levels. Contrary to what has happened for example in the Czech Republic and Slovakia, the increase in the Hungarian gross debt has only partly been offset by the rise in official reserves, leading to an increase in net debt. The jump in Hungarian net debt reflects the huge deficits recorded by the current account since 1993, which the non–debt creating capital inflows have only been able to finance in part. Hungary's debt service indicators have also worsened significantly. Since mid–1995, Hungary's current account has been responding to the stabilization measures adopted by the government in March 1995, but its deficit is projected to remain above the net inflow of FDI until 1996. Hungary's net debt will therefore continue to increase, underlining a still delicate balance of payments position.

3 See Halpern and Wyplosz (1995).

At an estimated 44.5% of GDP in mid–1995, the aggregate foreign debt/GDP ratio of CEEC 10 remains somewhat above the average ratio found in non–developed countries and in highly–indebted middle–income countries. On the other hand, with the exception of Hungary, there has been a positive "redistribution" of the foreign debt burden across countries, with the debt generally increasing where it was low and falling where it was high. CEEC 10 can now be classified in three distinct groups according to the importance of their foreign debts: i) Hungary and Bulgaria have both very high debt/GDP ratios (of about 80%); ii) Poland is at an intermediate level with a ratio slightly below 40%; iii) the rest of the CEEC 10 have an average debt/GDP of only 17 %, with the Baltic states enjoying ratios below 10%.

The positive evolution of the average debt and debt service ratios since 1991 has been facilitated by the substantial debt relief granted by the Paris Club to Poland in that year, and, more recently, by the signing in July 1994 and September 1994 by Bulgaria and Poland, respectively, of debt and debt service reduction (DDSR) agreements with their commercial bank creditors. Slovenia has also made substantial progress in normalizing relations with its creditors. It has agreed with the Paris Club on a set of principles for allocating its share of the official bilateral debt of the former Yugoslavia and, in June 1995, it reached an agreement in principle with commercial banks to assume 18% of the outstanding commercial debt of the former Yugoslavia, an agreement that still has to be approved by two–thirds of the creditors and ratified by the Slovenian Parliament. While the implementation of these allocation agreements will show up as an increase in Slovenia's recorded debt, the country's debt burden will remain relatively low.

IV. Ratings and market access

The improvement in the balance of payments and, more generally, in the macroeconomic situation has had a favourable effect on the perceived creditworthiness of several CEEC. Moody's and Standard & Poor's have both upgraded the Czech Republic several times since they first assigned to this country an investment grade mark in 1993, in the wake of the dissolution of the CSFR (see table 5). The latest of these positive reassessments took place in November 1995, when Standard & Poor's increased the Czech Republic's rating from BBB^+ to A. The Czech Republic, which had already been assigned an A^- rating by the London agency IBCA in August 1995, has thus become one of the few non–developed countries that can boast an "A" level mark from a major rating agency. In April 1995, Standard & Poor's upgraded Slovakia's rating from BB^- to BB^+, and in May 1995 Moody's awarded to Slovakia an investment grade rating (Baa3). Poland, for its part, obtained in June 1995 its first assessments by these two US rating agencies. Standard & Poor's assigned to Poland a BB rating and Moody's a Baa3, making of Poland the only country to have received an investment grade mark following a Brady–style debt reduction operation. There are, therefore, already three CEEC enjoying an investment grade mark from at least one of the two leading international rating agencies.

By contrast, the negative evolution shown by Hungary's current account and foreign debt since 1993 has not only prevented the country from reaching the investment grade category but also led Standard & Poor's to revise its rating outlook for Hungary from stable to negative in February 1995. Romania, for its part, decided in December 1995 to delay seeking a sovereign debt rating until spring 1996 due to the recent deterioration of its current account and reserve position. In mid–1995, the Romanian authorities had invited the major international rating agencies to assign to

TABLE 5 : **Credit ratings assigned by Moody's and Standard & Poor's to CEEC[1]**

	1989	1990	1991	1992	1993	1994	1995
Moody's :							
Former CSFR				Ba1 (Jan.)			
Czech Republic					Baa3 (March)	Baa2 (May)	Baa1 (Sept.)
Slovakia							Baa3 (May)
Hungary	Baa2 (July)	Ba1 (July)					
Poland							Baa3 (June)
Standard & Poor's :							
Czech Republic					BBB (July)	BBB+ (July)	A (Nov.) (stable outlook)
Slovakia						BB– (Febr.)	BB+ (Apr.) (stable outlook)
Hungary				BB+ (Apr.)			(Outlook revised in April from stable to negative)
Poland							BB (June) (positive outlook)

[1] Long–term foreign currency ratings. The ratings are ranked in descending order according to the degree of creditworthiness as follows:

	Moody's	Standard & Poor's
Investment grade	Aaa, Aa, A, Baa	AAA, AA, A, BBB
Non–investment grade	Ba, B	BB, B
Default grade	Caa, Ca, C	CCC, CC, C, D

In addition, borrowers within a given grade are often differentiated by attaching either numbers from 1 (highest creditworthiness) to 3 (Moody's), or + and– sings (Standard & Poor's).
Sources: Moody's Investors Service and Standard & Poor's rating agencies.

TABLE 6 : **Euromoney and institutional investor country risk ratings and rankings**

EUROMONEY

		1990	1991	1992	1993		1994		1995	
					March	Sept.	March	Sept.	March	Sept.
Czech Republic[1]	Credit rating[2]	61.7	54.1	53.4	54.9	64.5	66.2	68.2	73.9	69.3
	Position in ranking(3)	39	35	49	48	43	40	39	35	41
Slovakia[1]	Credit rating (2)	61.7	54.1	44	45.3	47.2	46.3	48	57.9	60.21
	Position in ranking[3]	39	35	58	56	63	64	66	53	51
Hungary	Credit rating (2)	60.8	52	54.5	54.9	61.6	60.7	59.8	60.2	63.8
	Position in ranking[3]	40	44	46	47	46	44	46	50	44
Poland	Credit rating[2]	43	50.4	36.5	35.8	44.6	41.8	45.1	47.9	48.4
	Position in ranking[3]	73	57	71	78	72	80	73	71	72
Romania	Credit rating (2)	43.3	30.7	35.8	36.9	43.2	43	43.3	48.7	50.4
	Position in ranking[3]	71	89	72	66	75	74	77	68	64
Bulgaria	Credit rating[2]	34.7	22.6	29.9	24.8	28.5	38.1	37.7	40.7	40.8
	Position in ranking (3)	90	114	91	122	125	88	98	90	90
Slovenia	Credit rating[2]	–	–	34.2	42.2	47.6	43.1	53.1	61.3	60.5
	Position in ranking[3]	–	–	74	63	61	73	53	47	50
Estonia	Credit rating[2]	–	–	24.2	23.4	28.9	33.5	35	49.4	46.1
	Position in ranking[3]	–	–	117	126	122	105	102	66	76
Latvia	Credit rating[2]	–	–	23	21.7	26	33.5	30	35.6	31.1
	Position in ranking[3]	–	–	123	133	132	104	125	106	116
Lithuania	Credit rating[2]	–	–	24.1	21.4	26.6	32.7	31.3	35.4	31
	Position in ranking[3]	–	–	118	134	130	110	121	108	118
Average rating	**CEEC 6**	50.9	44.0	42.4	42.1	48.3	49.3	50.3	54.9	55.5
	CEEC 10	–	–	36.0	36.1	41.9	43.9	45.2	51.1	50.2
Average position of CEEC 10 in ranking		–	–	81.9	87.3	86.9	78.2	80	69.4	72.2
(number of countries rated)		132	130	169	169	170	167	167	187	181

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		1991		1992		1993		1994		1995	
		March	Sept.	March	Sept.	March	Sept.	March	Sept.	March	Sept.
Czech Republic[1]	Credit rating[2]	50.2	48.3	47.1	46.1	44.6	46.6	49.7	52.8	55.8	58.4
	Position in ranking[3]	32	34	37	39	42	40	40	39	33	30
Slovakia[1]	Credit rating[2]	50.2	48.3	47.1	46.1	31	30.6	31.6	33.1	33.2	35.7
	Position in ranking[3]	32	34	37	39	57	57	59	59	61	59
Hungary	Credit rating[2]	41.1	40.9	41.7	42.3	44.3	44.8	46.1	46.2	46.4	45
	Position in ranking[3]	41	42	42	43	43	43	43	44	45	48
Poland	Credit rating[2]	21.7	24.5	25.6	24.7	26.9	28.6	30.5	33.1	35.7	37.6
	Position in ranking[3]	73	69	70	69	69	62	62	58	57	56
Romania	Credit rating[2]	27.9	26.7	25.6	24.8	24.2	24.4	25.4	26.2	28.1	29.7
	Position in ranking[3]	60	64	69	68	73	75	76	74	73	71
Bulgaria	Credit rating[2]	27.8	22.2	21.1	19.8	18.9	19.5	19.8	20.8	21.9	22.2
	Position in ranking[3]	62	74	81	86	91	89	91	95	93	94
Slovenia	Credit rating[2]	–	–	–	20.4	22.5	28.6	33.4	36.7	39.5	42.4
	Position in ranking[3]	–	–	–	83	75	61	57	56	52	50
Estonia	Credit rating[2]	–	–	25.7	22.1	21.4	20.9	20.7	23.6	25.4	26.3
	Position in ranking[3]	–	–	68	74	81	84	88	86	79	79
Latvia	Credit rating[2]	–	–	23.9	21.4	19.5	20	19.6	21.3	22.6	23.4
	Position in ranking[3]	–	–	72	77	89	87	94	92	91	89
Lithuania	Credit rating[2]	–	–	23.7	20.7	18.9	19	18.4	20	21.7	22.9
	Position in ranking[3]	–	–	73	80	91	93	97	96	95	90
Average rating	**CEEC 6**	36.5	35.2	34.7	34.0	31.7	32.4	33.9	35.4	36.9	38.1
	CEEC 10	–	–	–	28.8	27.2	28.3	29.5	31.4	33.0	34.4
Average position of CEEC 10 in ranking		–	–	–	65.8	71.1	69.1	70.7	69.9	67.9	66.6
(number of countries rated)		111	113	119	126	127	133	135	135	135	135

(1) Until 1991 in the case of "Euromoney" and until 1992 in the case of "Institutional Investor", rating or position in the ranking assigned to the former CSFR.
(2) Countries are rated on a scale of zero to 100, with 100 representing the least chance of default.
(3) The higher the ranking number, the lower the degree of creditworthiness of the country.
Sources: "Euromoney" and "Institutional Investor" magazines.

TABLE 7 : **Access of CEEC to the international capital markets**
(in millions of U.S. dollars)

	1989	1990	1991	1992	1993	1994	First half 1995
International bond issues	879	1263	1511	1614	5735	2404	2028
Former CSFR	–	375	276	129	–	–	–
Czech Republic	–	–	–	–	694	400	–
Slovakia		–	–	–	240	275	–
Hungary	879	888	1235	1485	4801	1729	1778
Poland	–	–	–	–	–	–	250
International equity issues	–	68	81	21	9	218	159
Czech Republic	–	–	–	–	–	10	32
Slovakia	–	–	–	–	–	–	113
Hungary	–	68	81	21	8	200	–
Poland	–	–	–	–	1	–	14
Romania	–	–	–	–	–	1	–
Estonia	–	–	–	–	–	7	–
Medium– and long– term syndicated bank loan commitments(1)	n.a.	n.a.	502	483	781	2223	960
Former CSFR	n.a.	n.a.	16	58	–	–	–
Czech Republic	–	–	–	–	170	566	240
Slovakia	–	–	–	–	–	10	–
Hungary	n.a.	n.a.	172	269	252	938	287
Poland	n.a.	n.a.	236	105	236	381	267
Romania	n.a.	n.a.	37	51	–	60	150
Bulgaria	n.a.	n.a.	41	–	–	150	–
Slovenia	–	–	–	–	115	114	16
Estonia	–	–	–	–	8	4	–

(1) Excluding cofinancing facilities.
Sources: IMF (1995) and European Commission (1994).

the country a rating ahead of its first Eurobond issue, originally planned for late 1995 or early 1996.

The widely monitored country risk rankings and ratings regularly produced by the *Euromoney* and the *Institutional Investor* magazines[4] also suggest a significant improvement since 1993 in the perception by foreigners of the country risk involved when investing in CEEC. After declining in the first years of the transition and reaching their trough at the beginning of 1993, the average rating of CEEC 10 has been consistently increasing and already exceeds the pre–transition level (see table 6). As one would expect, the improvement in the rating has been particularly marked for the Czech Republic and Slovenia. The average position of CEEC 10 in the rankings has also improved, although the improvement is partially masked by the increase in the number of countries rated by the magazines.

The amelioration in the ratings has been translated into an easier access to the international capital markets, although issuance activity in the international bond and equity markets continues to be concentrated in a handful of countries (see table 7).

International bonds: Following the debt deal with commercial banks and the assignment of favourable ratings by Moody's and Standard & Poor's, Poland made a successful comeback to the international capital markets in June 1995 through the issuance by the government of a 5–year, US$ 250 mn Eurobond. Slovakia has also taken advantage of its stronger macroeconomic position to tap the international bond market. Thus, the National Bank of Slovakia placed in the Samurai market two bonds of about US$ 250 mn each in September 1993 and July 1994, respectively. In addition, Calex, a Slovak state–owned manufacturing company, issued in January 1994 a US$ 21 mn Eurobond carrying a guarantee from the Slovak government. Latvia, for its part, entered the market in August 1995 with a JPY 4 bn bond privately placed among Japanese and European institutional investors. Also, the normalization of Slovenia's relations with its creditors is expected to open the way for the issuance of international bonds by this country.

While bond issues by the Czech Republic declined in 1994–1995 reflecting the cessation of sovereign issues[5], some Czech companies have managed to issue Eurobonds at relatively low spreads. Despite investors' concern about worsening foreign debt indicators, Hungary remained the largest sovereign borrower among CEEC in 1994 and in the first half of 1995. It placed bonds to the amount of US$ 1.7 bn in 1994 (sharply down from US$ 4.8 bn in 1993) and of US$ 1.8 bn in the first half of 1995.

International equity: Total international equity issues by CEEC increased quite sharply in 1994, but this increase took place from insignificant levels and is largely accounted for by Hungary, which is practically the only country that had previously been active in this market. It should be noted, however, that companies from the Czech Republic, Estonia and Romania entered the market for the first time in 1994. Also, in 1995, Slovakia launched its first international equity issue.

4 These ratings are partially (*Euromoney*) or totally (*Institutional Investor*) based on polls of country risk analysts at major international banks and other institutions.

5 The interruption of sovereign bond issues has been one of the policy responses to the surge in capital inflows experienced by the Czech Republic.

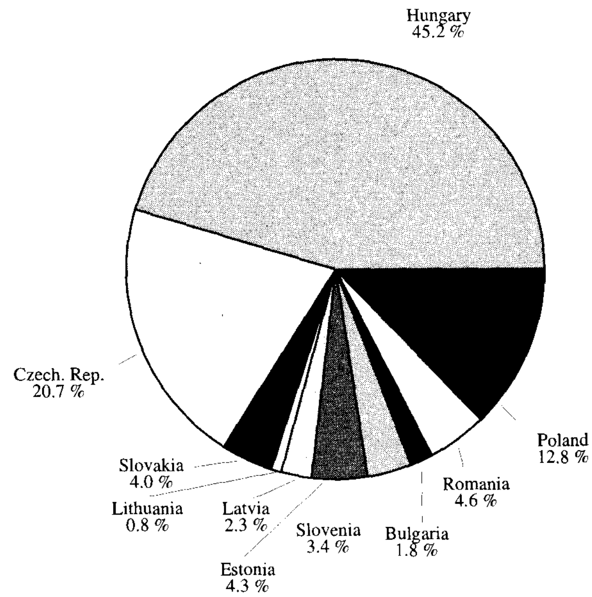
Commercial bank loans: International bank lending to CEEC 10 recovered strongly in 1994 and the first half of 1995. New medium– and long–term syndicated loan commitments increased from US$ 781 mn in 1993 to US$ 2223 mn in 1994 and US$ 960 mn in the first half of 1995. The expansion of new bank loans has been concentrated in the Czech Republic, Hungary and Poland but other countries have also benefited from it. In 1994, Slovakia received its first syndicated loan commitment and Bulgaria returned to the market after a two–year absence. Also, the Romanian central bank easily obtained a 12–month syndicated loan in the second quarter of 1995. The loan, which had initially been arranged for US$ 75 mn, was oversubscribed and had its amount finally raised to US$ 150 mn. In addition, balance of payments data indicate that non–syndicated loans directly granted by foreign banks to local enterprises have been rising considerably in several countries, and in particular in the Czech Republic and Hungary, since 1994.

V. Foreign direct investment

After increasing rapidly in 1992 and 1993, net FDI into CEEC 10, measured on a cash basis and in dollar terms, fell by about 10% in 1994 (see table 8)[6]. This decline, however, is more than explained by the sharp reduction in the net FDI inflow received by Hungary. In fact, net FDI into the CEEC 10 excluding Hungary expanded by 40% in 1994. The rate of growth was particularly high in Romania and Latvia, although in both cases the increase took place from low 1993 levels. In Estonia and Slovenia, there was a continuation of the positive trend seen in recent years, and the Czech Republic experienced a substantial recovery following the sharp decline recorded in 1993.

FDI into the region remains highly concentrated in a few countries, with Hungary, the Czech Republic and Poland alone accounting for 66% of total net FDI into CEEC 10 in 1994. But the degree of concentration continued to decline in 1994. In 1993, these same three countries had accounted for 84% of net FDI, and Hungary and the former CSFR alone had received about 90% of the region's net FDI in 1990–91. The tendency towards a lower geographical concentration is also evident in the data on per capita FDI, which show an increasingly strong performance in several small countries. Despite this increasing geographical diversification, however, the aggregate figures for the region continue to be very much affected by developments in Hungary and the Czech Republic, and in particular by the pace of privatization in these two countries. For example, if the sale by the Hungarian government to foreign investors

GRAPH 2 : **Net FDI inflows received by CEEC 10 between 1992 and 1994 : country shares**

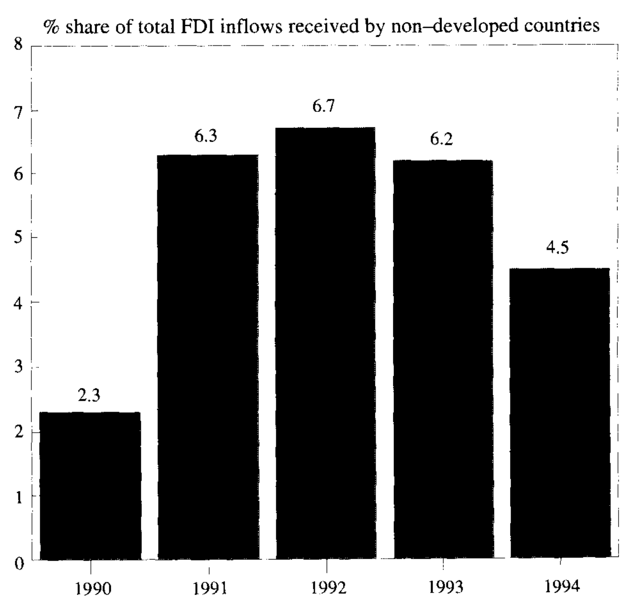


Source: National balance of payments statistics, IMF, and European Bank for Reconstruction and Development (1995).

of a 30% stake in the Hungarian telecommunications company (Mataf), amounting to US$ 875 mn, had taken place in early 1994 instead of late 1993, net FDI into the region would have shown practically no growth in 1993 and a very sharp increase in 1994, that is, a profile almost opposite to that displayed in table 8.

Despite the important expansion of FDI flows into the region since 1990, FDI continues to represent for most countries a relatively small fraction of their respective GDPs. For the CEEC 10 as a whole, net FDI was equivalent to only 1.5% of the region's GDP in 1994, which compares

GRAPH 3 : **Net FDI inflows into CEEC 10**



Source: World Bank (1994) and data on table 8.

[6] Cash flow data on FDI flows are taken from balance of payments statistics and normally measure only investments made in cash through the banking system. They tend to understate actual FDI (particularly the accumulated stocks) because they do not incorporate either "in kind" contributions or reinvested earnings. However, they are the only type of statistics on FDI which exist for all CEEC and are available on a timely basis. Data on FDI commitments based on the foreign component of statutory capital compiled by the UN Economic Commission for Europe also suggest a significant slowdown in total FDI inflows into CEEC 10 in 1994. See UN Economic Commission for Europe (1995 b).

TABLE 8 : **Net foreign direct investment** (on a cash basis, in million of US dollars unless otherwise indicated)

						Forecasts(1)		Annual per capita net inflow			Net FDI as a % of GDP in 1994
	1990	1991	1992	1993	1994	1995	1996	1992	1993	1994	
Former CSFR	199	594	1083	–	–	–	–	69	–	–	–
Czech Republic	–	–	983	542	749	2200	1500	95	53	73	2.2
Slovakia	–	–	100	156	187	200	225	19	29	35	1.5
Hungary	337	1474	1471	2329	1147	2500	1700	143	226	111	2.8
Poland	88	117	284	580	542	900	1250	7	15	14	0.5
Romania	–18	37	73	95	341	400	450	3	4	15	1.1
Bulgaria	4	56	42	55	105	115	130	5	7	12	1.1
Slovenia	–2	41	113	116	140	160	175	58	70	80	1
Estonia	–	–	58	160	253	200	200	36	100	158	9.5
Latvia	–	–	43	51	155	165	175	16	19	57	3.9
Lithuania	–	–	10	23	60	70	90	3	6	16	1.7
Total CEEC 10	608	2319	3177	4107	3679	6910	5895	30	39	35	1.5

(1) Tentative forecasts.
Sources: National balance of payments statistics, European Commission, IMF, and European Bank for Reconstruction and Development (1995).

unfavourably with, for example, an average FDI/GDP ratio of about 3% of GDP in the dynamic economies of South East Asia in the period 1989–92. Also, after increasing significantly between 1990 and 1992, the share of CEEC 10 in total FDI flows into non–developed economies declined in 1993 and 1994 (see graph 3).

Projections for 1995–96 point towards a strong recovery of FDI into the region. But, again, these forecasts crucially rely on assumptions regarding the privatization process in the major countries. In particular, the projections assume that, following the impasse in 1994 and the first half of 1995, privatization in Hungary will accelerate, with the government achieving before end–1996 much of its current plan to sell majority stakes in large companies of the energy, telecommunications and banking sectors. They also incorporate the following decisions taken by the Czech government in the summer of 1995: 1) to sell a 27% stake (worth US$ 1.23 bn) in SPT Telecom to a foreign investor, the largest privatization operation conducted in the Czech Republic to date; 2) to sell a 49% stake in Czech Refineries to a consortium of foreign oil companies; and 3) to prepare plans to privatize additional stakes in 53 big companies (including the largest commercial bank, the largest saving bank, the power generating conglomerate CEZ, the steel company Vitkovice and a major petrochemical group). This is reflected in the sharp increase in FDI inflows expected for the Czech Republic in 1995–96. Finally, the projections assume that the significant pick–up of FDI into Poland that occurred in the first nine months of 1995[7] will continue. If Hungary, the Czech Republic and Poland are excluded, the rise in FDI inflows into the region projected for 1995–96 is relatively moderate.

VI. The capital account in historical perspective

The magnitude of the net capital inflows (outflows) received by a country can be approximated by the difference between the recorded current account balance and the recorded change in official reserves[8]. Table 9 has made this evaluation for each of the CEEC 10 as well as for the CEEC 6 as a whole for the period 1989–June 1995.

The results shown in table 9 are interesting in several respects. First, they indicate that in spite of capital flight and the interruption of new international bank lending that characterized the beginning of the transition, the aggregate capital account of CEEC 6 was in balance in 1990. The relatively sharp decline in official reserves that took place that year (US$ 3.2 bn) reflected almost exactly the large current account deficit run by CEEC 6. Capital flight, the interruption of new commercial bank loans and the debt repayment obligations actually honoured seem to have been offset by the provision of official assistance[9], the accumulation of arrears and the rescheduling of debts by Bulgaria[10] and Poland, and, to a lesser extent, the expansion of FDI inflows into Hungary and the former CSFR (see section VII). However, it must also be noted that a significant part of the capital flight probably took the form of export under–reporting and import over–reporting. To the extent that this was the case, the current account deficit shown in table 9 exaggerates the actual deficit and part of the 1990 decline in reserves does reflect the existence of a negative capital account.

In 1991, a sharp improvement in the capital account of CEEC 6 took place. In that year, the aggregate current account, which had been negatively affected by the dismantling of the CMEA trading system, including the shift to world price levels and to convertible currency settlement, remained at relatively high levels. However, official

[7] FDI into Poland (in cash) reached in the first nine months of 1995 US$ 577 mn, compared to US$ 390 mn in the same period of 1994.

[8] Strictly speaking, the difference between the current account balance and the change in official reserves is equal to the capital account plus the item "net errors and omissions".

[9] In 1990, Hungary became the first transition country to receive macro–financial assistance from the international community. The size of the assistance package was important, involving IMF and World Bank lending, and substantial additional assistance from the EU and other bilateral donors.

[10] In March 1990, Bulgaria declared a moratorium on its external debt.

reserves recovered strongly (by US$ 3.3 bn) reflecting an aggregate net capital inflow of US$ 6.4 bn (3.3% of the combined GDP of CEEC 6). This improvement in the capital account was largely explained by an important increase in official assistance: the balance of payments support operations of the IMF/World Bank and the EU/G–24 to CEEC gathered momentum, and the Paris Club granted Poland debt and debt service reduction on exceptional terms. Also, there was a further (US$ 1.7 bn) expansion of FDI inflows into the region (again concentrated in Hungary and the former CSFR).

In 1992, both the capital account surplus and, to a lesser extent, the current account deficit declined in CEEC 6 but, since the former continued to exceed the latter, reserves rose again. Then, in 1993, the capital account improved dramatically, reaching a net inflow of US$ 13.9 bn (or 6.9% of GDP) and allowing these countries to finance both the record current account deficit of that year and a US$ 5.7 bn increase in official reserves. This very positive trend in the capital account of CEEC 6 has continued until at least mid–1995, with the surge in capital inflows accelerating again abruptly in the first half of 1995. In the first half of 1995, CEEC 6 are estimated to have received a net capital inflow equivalent (on an annual basis) to 9.7% of projected GDP. Given that the current account deficit declined significantly after 1993, the bulk of the net capital inflow received by these countries since 1994 has translated into an increase in reserves.

When expressed as a percentage of GDP, the magnitude of the net capital inflow to CEEC is considerably larger than that observed in most countries of Latin America and Asia during their capital inflow surge episodes of the late 1980s and early 1990s. In the period 1990–92, the eight most dynamic economies of South Asia obtained on average a net capital inflow of about 4% of GDP, with only three countries (Indonesia, Malaysia and Thailand) receiving net inflows of 5% of GDP or more[11]. This compares with an average annual surplus of 7.3% of GDP for the CEEC 6 between 1993 and mid–1995, and with the fact that five CEEC 10 obtained average net inflows of 6% of GDP or more during that period (see table 9).

The surge in capital inflows has been particularly marked in the Czech Republic and Hungary, both as a percentage of GDP and in absolute values. Estonia has also experienced a very high net inflow relative to the size of its economy, an inflow fundamentally explained by the boom in FDI inflows, which reached 9.5% of GDP in 1994. In the Czech Republic, the strength of the capital inflow has raised concerns about possible negative macroeconomic effects (difficulties in sterilizing its monetary effect, overheating, appreciation of the real exchange rate, deterioration of the current account, etc.). In the first half of 1995, the net capital inflows received by the Czech Republic amounted (at an

[11] See Calvo, Leiderman and Reinhart (1993), page 25, table 3.

TABLE 9 : **Capital account of CEEC : 1990 – June 1995**(1)

		1990	**1991**	**1992**	**1993**	**1994**	**First half 1995**	**Total accumulated since 1993**
1. Former CSFR	in bn US $	–0.5	0.5	–0.4	–	–	–	–
	in % of GDP	–1.1	1.5	–1.1	–	–	–	–
2. Czech Republic	in bn US $	–	–	–	2.3	2.3	6.3	10.9
	in % of GDP	–	–	–	7.2	6.8	15.1(2)	9.7(3)
3. Slovakia	in bn US $	–	–	–	1.0	0.6	0.3	1.9
	in % of GDP	–	–	–	9.0	4.9	4.5(2)	6.1(3)
4. Hungary	in bn US $	–0.6	2.5	0.1	5.8	4.0	2.8	12.6
	in % of GDP	–2.4	6.7	0.3	15.9	9.7	13.5(2)	13.0(3)
5. Poland	in bn US $	1.6	1.3	1.1	2.3	3.0	5.3	10.6
	in % of GDP	2.5	1.7	1.1	2.7	3.0	9.2(2)	5.0(3)
6. Bulgaria	in bn US $	0.0	0.5	1.6	0.9	0.4	0.3	1.6
	in % of GDP	0.0	6.8	18.6	8.0	3.8	4.8(2)	5.5(3)
7. Romania	in bn US $	–0.3	1.5	1.9	1.6	1.4	0.6	3.6
	in % of GDP	–1.3	5.4	9.8	6.2	4.6	3.8(2)	4.9(3)
8. Slovenia	in bn US $	–	–	–0.3	–0.1	0.2	0.2	0.4
	in % of GDP	–	–	–2.4	–0.8	1.4	2.4(2)	1.0(3)
9. Estonia	in bn US $	–	–	–	0.2	0.3	0.1	0.6
	in % of GDP	–	–	–	14.0	11.3	5.4(2)	10.2(3)
10. Latvia	in bn US $	–	–	–	0.1	0.2	–0.03	0.3
	in % of GDP	–	–	–	4.5	5.8	–0.4(2)	3.3(3)
11. Lithuania	in bn US $	–	–	–	0.5	0.3	0.2	0.8
	in % of GDP	–	–	–	14.3	5.1	7.5(2)	9.0(3)
Total (1–7)	in bn US $	0.1	6.4	4.2	13.9	11.7	15.6	41.2
	in % of GDP	0.2	3.3	2.5	6.9	5.2	9.7(2)	7.3(3)

(1) Net capital inflows received by the country plus "net errors and omissions". Obtained as the difference between the recorded current account balance and the recorded change in official international reserves.
(2) As a percentage of half of 1995's projected GDP.
(3) Average annual net capital inflow/GDP received since 1993.
Source: Information in tables 2 and 3.

annual rate) to an impressive 15.1% of the country's 1995 projected GDP. In Hungary and Estonia, the increase in capital inflows has been accompanied, as noted, by a sharp worsening of the current accounts and, as a result, the domestic monetary repercussions of the inflows have been less important. In Slovenia, by contrast, the combination of a weaker capital inflow and a sizeable current account surplus has obliged the authorities to engage in massive sterilization operations to keep their monetary programme on course.

To summarize, three main conclusions can be drawn from the analysis above. First, except perhaps in 1990, the capital account of CEEC 6 has never been in deficit during the transition period. Second, the transition period can be divided into two distinct periods as far as the capital account is concerned: 1) between 1990 and 1992, the annual capital account showed on average a moderate surplus (equivalent to 2% of GDP) which allowed CEEC 6 to finance their current account deficits and finish 1992 with a level of official reserves similar (in terms of imports) to that which prevailed at end–1989; 2) between 1993 and 1995, the capital account improved sharply, reaching an average annual surplus of 7.3% of GDP in CEEC 6 and leading to a rapid rise in official reserves. Third, inflows have increasingly been used to finance the build–up of reserves rather than current account deficits. The proportion of the total net capital inflow received by CEEC 6 that was used to finance the current account deficit declined from about 60% in 1993 to only an estimated 26 % in the first half of 1995.

Using statistical information from the IMF World Economic Outlook data base for the period 1987–93, Calvo, Sahay and Végh (1995) also conclude that the CEEC 6 as a whole began receiving in 1993 a net capital inflow which, as a percentage of GDP, was very high for international standards. The orders of magnitude of the total net capital inflow (including net errors and omissions) estimated by these authors for 1992 and 1993 (US$ 1.6 bn and US$ 12.2 bn, respectively) are similar to those obtained in this report. In contrast to the figures displayed in table 9, however, their study suggests that the capital account of CEEC 6 recorded a substantial deficit in both 1990 (US$ –4.7 bn) and 1991 (US$ –8 bn).

This divergence between the results reached by these authors and those presented in this paper seems to be mostly due to the data on foreign exchange reserves used for the early years of the transition. Unlike the figures shown in table 3, the data in Calvo, Sahay and Végh (1995) indicate that reserves continued to fall in 1991 and, although at a much slower pace, in 1992. This weaker behaviour of reserves might, in turn, be explained by the inclusion in the reserves statistics used by these authors for 1989–91 of the entire reserves held by the mono–bank systems before they were broken up. Between 1989 and 1992, most CEEC introduced two–tier banking systems separating central bank and commercial bank functions. The decline in reserves shown by Calvo, Sahay and Végh might therefore reflect in part the allocation by the authorities of a portion of the international reserves of the previous mono–banks to the newly–created commercial banks. This is not the case for the reserves data used in this report, which show only the part of the reserves of the mono–banks attributable to the central bank.

VII. Private versus official capital inflows

An important feature of the sharp increase in capital inflows experienced by CEEC 10 as a group since 1993 is that it is fully explained by the expansion of private inflows. This implies that the proportion of official inflows in total capital inflows has fallen considerably between the periods 1990–92 and 1993–95, although the data currently available still do not allow this decline to be quantified with precision.

Table 10 shows, for the CEEC 10 as a whole and for the period 1990–94, gross disbursements of macro–financial assistance and project loans, as well as commitments of technical cooperation grants, by the major multilateral and bilateral donors. It indicates that, after rising very strongly and reaching a peak in 1991, the sum of these official inflows practically halved during the period 1992–93 and recovered only moderately in 1994. A similar profile is obtained if the change in arrears[12] on official debt and the reschedulings and debt forgiveness approved by the Paris Club are added to the official loan disbursements and grant commitments. The support obtained through the accumulation of arrears on official debt and in the form of Paris Club debt relief is referred to in table 10 as "official exceptional financing" and has been very substantial during the transition period in the cases of Bulgaria and Poland.

The sum of the gross official assistance inflows shown in table 10 (including official exceptional financing) declined in the CEEC 6 from a peak of US$ 14.8 bn in 1991 to an average of US$ 5.3 bn in 1993–94. During the same period, and as shown in table 9, total net capital inflows into these six countries increased from US$ 6.4 bn to an average of US$ 13 bn. Although the information on official assistance presented in table 10 is not exhaustive, it is therefore difficult to escape the conclusion that the post–1992 surge in capital inflows to CEEC 10 is largely of a private nature (see graph 4).

Table 10 also seems to confirm the idea, advanced in the previous section, that official disbursements and the provision of both official and private exceptional financing were the main factors accounting for the fact that, despite initial capital flight, the interruption of international bank lending and the need to make substantial foreign debt repayments, the capital account of CEEC 6 was in balance in 1990 and recorded a significant surplus in 1991–92. In particular, without disbursements and exceptional financing from official sources, the aggregate capital account of CEEC 6 would have recorded an average annual deficit of US$ 6.3 bn in 1990–92, instead of the US$ 3.6 bn average surplus it actually showed. By contrast, even when official inflows

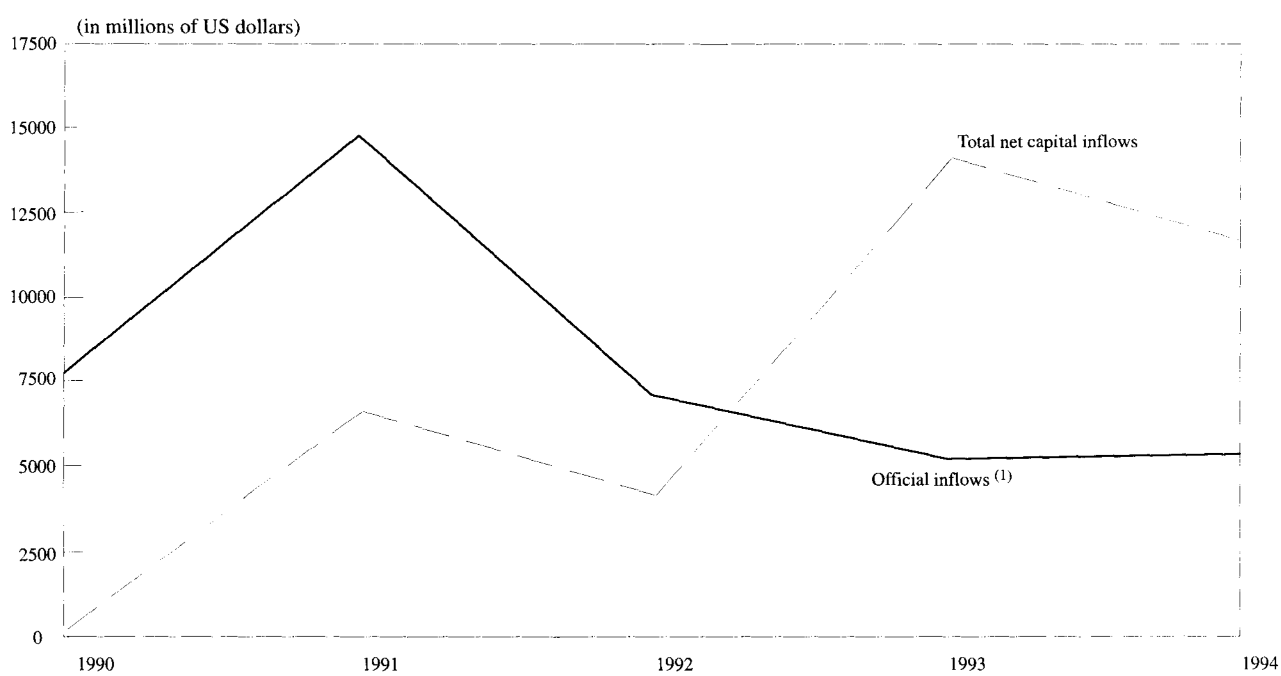
[12] Arrears on both interest and principal payments.

TABLE 10 : **Relative weight of official flows in total capital flows into CEEC 10**
(in million of US dollars)

	1990	1991	1992	1993	1994
Gross IMF disbursements	658	3716	1332	530	1851
Grosss World Bank disbursements (IBRD + IDA)	328	1014	1097	1066	1540
Gross disbursements by EBRD	0	0	160	357	666
Gross disbursements by EIB	0	35	154	180	210
EU/G–24 balance of payments support (gross disb.) (1)	957	1866	1182	444	148
of which:					
EU(2)	446	861	915	357	88
Other G–14	511	1005	267	87	60
Technical cooperation grants from the EU/G–24 (3)	416	1230	2028	1691	1064
(I) Total above	2359	7861	5952	4268	5479
(II) Official exceptional financing (4)	5592	6976	1491	1734	335
(III) Total (I) + (II)	7951	14837	7443	6002	5814
(IV) of which: received by CEEC 6	7772	14800	7125	5234	5404
(V) Total net capital inflows into CEEC 6	100	6400	4200	13900	11700
of which:					
Net FDI inflows	610	2278	2953	3757	3071
International capital markets (gross) (5)	1331	2094	2118	6402	4720
Total net inflows into CEEC 6 – disbursements and special finance from official sources to CEEC 6 (V) – (IV)	–7672	–8400	–2925	8666	6296
<u>*Memorandum items:*</u>					
Net disbursements from the IMF	328	3640	809	230	–36
Total (official and private) exceptional financing (4)	8738	10900	3042	2710	1489

(1) Excluding exceptional financing.
(2) Excluding bilateral contributions by EU member states.
(3) On a commitment basis.
(4) Excluding Slovenia. Includes debt deferrals or reschedulings, debt forgiveness and changes in arrears.
(5) Includes gross issues of international bonds and equity, and new medium– and long–term syndicated bank loan commitments.
Sources: European Commission, IMF, World Bank, EBRD, EIB, and tables 7, 8 and 9.

GRAPH 4 : **The declining role of official inflows to CEEC 6**



(1) Gross disbursements from the IMF, the World Bank, the EBRD and the EIB; gross disbursements of macro–financial assistance and commitments of technical cooperation grants from the EU/G–24; and official exceptional financing.
Source: European Commission, IMF, World Bank, EBRD, EIB and table 9.

are excluded, the aggregate capital account of CEEC 6 still shows a very substantial surplus in the period 1993–94 (amounting to an average of US$ 7.5 bn per annum).

A more complete picture of the evolution of official flows and of their relative role in total net capital inflows should show official inflows on a net basis (that is, after deducting amortizations). It should also include net official export credits, net credits granted by private creditors but guaranteed by foreign official donors (in particular, bank credits covered by a guarantee of an official export credit agency), and bilateral grants not classified under technical cooperation. All these official flows have been left out of table 10 for lack of reliable or sufficiently long time series. However, the incorporation of these additional elements into the analysis is unlikely to modify the bottom line.

Given that most of the loans granted by the international financial institutions and the EU/G–24 Network to CEEC 10 were disbursed from 1990 onwards and have relatively long maturities, the difference between the profile of gross and net official disbursements for such loans is still small. This difference is, if anything, likely to have increased since 1993, as the first repayment obligations associated with the 1990–92 loans fall due. Consequently, looking at net instead of gross inflows may in fact reinforce the argument of a declining share of official finance in total net capital inflows since 1993. Since purchases under IMF stand–by arrangements normally have to be repaid about three years after they are made, IMF assistance fits particularly well into this story. As shown in table 10, the trajectories described by net and gross IMF disbursements to CEEC 10 are very much alike until 1993: a sharp increase and a peak in 1991, followed by a marked decline in 1992 and 1993. Then, in 1994, gross IMF disbursements recovered substantially but net disbursements became negative reflecting a marked increase in repurchases (including the repayment ahead of schedule by the Czech Republic of its entire outstanding debts to the IMF, amounting to US$ 1.1 bn)[13].

As for net official export credits, private credits with foreign public guarantees and grants not classified under technical cooperation, they may have risen since 1993. But they would need to have increased unrealistically sharply to alter in any significant way the conclusion that the post–1992 surge in capital inflows experienced by CEEC has been driven by the expansion of private inflows.

VIII. Prospects for the capital account

Future trends in the capital accounts of CEEC will largely depend on the economic policies implemented by the authorities. Provided government policies aim at ensuring continued progress in the areas of macroeconomic stability and structural transformation, the trend towards an increasingly dominant role for private flows in total capital flows should not be reversed in the coming years.

Disbursements of investment–project loans from official development banks (particularly those from the EBRD and the EIB) are likely to pick up significantly, reflecting commitments already made, strengthened lending facilities in some cases[14], and a gradually improving absorption capacity by the recipient countries. However, this will probably be more than offset by the expected increase in repayments on past balance of payments and project loans, the decline in new disbursements of macro–financial assistance (in line with the improved external position and market access of most CEEC 10), and a reduction in official exceptional financing following the implementation of the 1994 DDSR agreements in Bulgaria and Poland. At the same time, private capital should continue flowing into CEEC 10 in substantial amounts in the coming years, although the record levels currently seen in some countries are unlikely to be sustained for very long. Private capital should be attracted by favourable growth prospects, a more stable macroeconomic and political outlook, progress with systemic reform, the removal of restrictions on capital flows and the development of the domestic securities markets.

The major risks to this scenario stem from the slow progress being made by some CEEC in the main fields of structural transformation (privatization and enterprise restructuring; financial sector reform; tax, civil service and social security reforms), from the still vulnerable macroeconomic position of several countries, and, somewhat paradoxically, from the excessive strength of the capital inflows being received by several countries.

Structural deficiencies can not only prevent some countries from sustaining high rates of growth without causing inflation and current account problems but can also directly hinder the expansion of private capital inflows. A hesitant implementation of privatization and other structural policies, for example, can act as a deterrent for FDI. Underdeveloped domestic financial markets, for their part, tend to restrict portfolio inflows.

Regarding the still fragile macroeconomic situation of some countries, the favourable scenario assumes that the Hungarian authorities continue to adopt adjustment measures conducive to a reduction in the country's current account deficit. A serious risk to this scenario, therefore, is that a failure of the authorities to pursue such stabilization policies results in renewed balance of payment difficulties in Hungary. Also, the experience of Romania in 1995, where an unwarranted easing of financial policies has resulted in a weakening of the balance of payments after the substantial progress made in 1994, warns about how ephe–

[13] The Czech Republic is not the only CEEC 10 to have decided in recent times to repay IMF loans ahead of schedule in reponse to strong capital inflows and rapidly rising official reserves. In 1995, Poland repaid ahead of schedule all its outstanding debts to the IMF (about US$ 1.2 bn) and Hungary made early repayments on about US$ 600 mn of IMF debt maturing before end–1998.

[14] The EIB's capacity to lend to CEEC has been substantially reinforced by the decision taken by the EU Council in December 1993 to grant to the Bank guarantees to lend to these countries up to ECU 3 bn over the years 1994–96. The countries covered by the decision are Albania, Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and the Baltic states.

meral the improvement in market access can be when it is not supported by a continued implementation of sound macroeconomic policies.

Finally, another risk is that those countries that are currently benefiting most from the surge in private capital inflows (and in particular the Czech Republic) fail to take the necessary accompanying measures to limit their negative macroeconomic repercussions and the danger of a sudden, Mexican–style reversal of the inflows in the future[15].

15 Schadler, Carkovic, Bennett and Kahn (1993) discuss possible policy options for dealing with capital inflow surges.

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This contribution has been prepared by Heliodoro Temprano, from the Directorate for International Economic and Financial Affairs.

20 December 1995

Principal economic policy measures – December 1995

Community (EUR–15)

15/16.12 The Madrid December European Council approves the joint report submitted by the Council (Ecofin and Labour and Social Affairs) and the Commission on the implementation of the European Union's approach in the employment field.

15/16.12 The Madrid December European Council adopts the scenario for the changeover to the single currency and confirms that 1 January 1999 will be the starting date for Stage 3 of Economic and Monetary Union.

Belgium (B)

14.12 The central bank reduces its discount rate from 3.50% to 3%. At the same time, it brings its central rate down from 3.95% to 3.75%, its rate on advances within the ceiling from 6% to 5% and its rate on advances outside the ceiling from 8% to 7%.

14.12 A consortium made up of Ameritech, Tele Denmark and Telecom Singapore offers to pay BFR 73.3 billion for a 49.9% stake in Belgacom.

Denmark (DK)

14.12 The discount rate is lowered by 50 basis points to 4.25%. The repo rate is lowered by 25 basis points to 4.75%.

28.12 The Danish National bank lowers its repo rate by 15 basis points to 4.60%.

Germany (D)

14.12 The Bundesbank cuts its discount and Lombard rates by 50 basis points to 3.0% and 5.0% respectively. In addition, the next three repurchase agreements will be offered at a rate of 3.75%. The central bank also announces that its M3 money–supply growth target for 1996 will be in the range of 4%–7% (as against 4%–6% for 1995).

16.12 The Bundesrat approves the Federal budget for 1996.

Greece (GR)

30.11 The Government announces its incomes policy for 1996, which provides for nominal wage increases in the public sector equal to 2.5% on 1 January 1996 and 2.5% on 1 July 1996.

18.12 The Bank of Greece announces a cut in its discount and Lombard rates by half a percentage point to 18% and 21.5% respectively.

Spain (E)

15.12 The Bank of Spain cuts its daily intervention rate by 25 basis points from 9.30% to 9.05%.

28.12 The Government approves a package of fiscal measures to supplement the rolling–over of the 1995 budget into 1996.

30.12 Registration tax on small cars is reduced from 12% to 7%.

France (F)

7.12 The Bank of France cuts its intervention rate, which sets the floor on market rates, from 4.80% to 4.70%. The five–to–ten–day lending rate, which sets the money market ceiling, remains unchanged at 6.10%.

15.12 The Bank of France announces that it is cutting its intervention rate to 4.45% from 4.70% with effect from 18 December.

19.12 The National Assembly formally adopts the Finance Law for 1996, which cuts the central–government deficit to FF 287.8 billion (3.6% of GDP) in 1996 from FF 321.8 billion (4.2% of GDP) in 1995.

21.12 The Bank of France cuts its five–to–ten–day lending rate from 6.10% to 5.85%.

27.12 Following the "social summit" on 21 December 1995, the Government adopts measures intended to sustain consumption. These include a relaxation of conditions on the use of savings for home ownership and the possibility for employees to take money out of company saving schemes early.

Ireland (IRL)

14.12 The central bank reduces its key lending rate ("short–term facility") from 7% to 6.5%.

Italy (I)

22.12 The Italian Parliament approves the Budget Law for 1996. The Budget Law – and other related financial legislation – aims to reduce general–government net borrowing from an estimated 7.4% of GDP in 1995 to 5.9% of GDP in 1996. To achieve this, a LIT 32.5 trillion budgetary package is introduced, almost equally distributed between revenue– and expenditure–side measures. A small part of the package (LIT 5.3 trillion) is specified at a later date (29 December). Revenue–side measures are centred on four items: (i) the fight against tax evasion, (ii) the extension to 1996 of capital tax on enterprises, (iii) the extension to 1996 of the settlement of tax disputes, and (iv) a rise in excise duties. On the expenditure side, around half of the projected savings should come from the reduction of transfers to the local administration and to private enterprises and institutions, a quarter from the effects of the pension reform and the remainder from the rationalisation of public–administration and health–care expenditure.

Luxembourg (L)

None.

Austria (A)

1.12 The Austrian National Bank reduces the GOMEX rate (for open–market transactions) from 4.05% to 3.95%. The discount and the Lombard rates remain unchanged at 3.5% and 5.25% respectively.

14.12 In line with the German Bundesbank, the Austrian National Bank reduces the discount rate from 3.5% to 3.0%. The Lombard rate and the GOMEX rate stay at their previous levels of 5.25% and 3.95% respectively.

18.12 The Austrian National Bank reduces the GOMEX rate from 3.95% to 3.75%.

Netherlands (NL)

12.12 The Senate, following the Lower Chamber, approves a draft law concerning an energy tax. Intended to encourage small consumers (households and small firms) to save energy, this law will enter into force on 1 January 1996. Revenues from this tax will be redistributed to taxpayers via various tax allowances.

14.12 The Nederlandsche Bank reduces its rate on special advances from 3.60% to 3.40% and cuts its central rate from 3.25% to 2.75%.

Portugal (P)

19.12 The Banco de Portugal cuts its main money market intervention rates by 50 basis points. The rate for draining liquidity is lowered to 7.75% and the rate for injecting liquidity (overnight standing facility) to 10.5%.

Finland (FIN)

10.12 The Bank of Finland cuts its tender rate from 4.75% to 4.25%.

Sweden (S)

None.

United Kingdom (UK)

13.12 The Chancellor of the Exchequer cuts the base rate by ¼% to 6½%.

5.12 The House of Commons approves the budget.

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