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Indebtedness in Central and Eastern Europe

Eight years of new EU members

SUMMARY: The pre-crisis growth of Central and Eastern Europe was based on significant external fundraising. The gross external debt of the 11 new Member States last year reached 80 per cent of the GDP, doubling in the course of eight years. The reason for the indebtedness in Baltic and South-East Member States was the foreign trade balance deficit, while in Central European countries the deficit of the current account balance due to capital gains. This indebtedness was in great part the result of private sector borrowing, made up of one third bank loans, and two thirds cross-border loans of companies. Half of the external indebtedness of the corporate sector was related to the inflow of operating capital. A trend-like relation may be observed between the volume of cross-border loans and the volume of foreign capital influx. The indebtedness of the state was only strong in Hungary, though in the spirit of anti-cyclical fiscal policy, the level of public debt did increase in the majority of countries. Caution must be taken – due to the demand decreasing recession effect – during the deleveraging process.

KEYWORDS: international lending and debt, public debt, banks, economic growth
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The external debt of the 11 new Central and Eastern European EU Member States has close to doubled between 2004 and 2011. My paper is searching for answers to the following questions: From a macro-economic aspect, what was the reason for indebtedness? Which sectors became indebted? What was the relationship of working capital influx and borrowing? What was the relationship of growth and indebtedness? Were there typical forms of indebtedness? What conclusions can we draw, what lessons have we learnt?

For the past 12–15 years, global financial capital has frequently regarded the Central and Eastern European region as a single entity;[1] therefore, instead of the isolated analysis of a given country, an examination covering several countries of the given region would be more expedient.[2] I will attempt to analyse the 11 countries in spite of the fact that this will force me to present a more arborescent process in the study. Another reason why indebtedness is such a crucially important topic is because instead of the overly simplified three Maastricht criteria, the EU's fiscal policy employs a complex system of ratios, four of which are related to indebtedness (EC, 2012).

External indebtedness is one of the most sensitive indicators of the macro-economies of smaller countries. Indebtedness or the repayment of earlier debts are impacted not only by the income processes of the given country, but by the outside world as well. If the producers of a country are forced out by

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companies of other countries, foreign trade starts showing a deficit and indebtedness is inevitable in order to finance this deficit. The development of a category broader than debt, namely amounts owed must also be taken into account, since debt and capital financing are interchangeable to a significant extent. However, debt is also impacted by the accumulation ability of the economy as well as the population's propensity to save.

The indebtedness of the private sector is a category of micro-economics. Its examination, however, cannot be separated from the debt of the public sector – if limits can or must be set up with respect to external debts or amounts owed, they can only be formulated for the whole of the economy – regardless of whether this is manifested in the debts of the public or the private sector.

METHOD OF ANALYSIS

I wish to present the growth of the gross debt portfolio of countries and the structure of this debt. This allows for the better identification of what incoming external funds actually financed. In order to see the entire picture, we must note that the presentation of the gross external debt of the various sectors in itself does not provide a full picture of the key moments of processes. This is due to two reasons. On the one hand, because funds received from abroad earlier may be refinanced through domestic indebtedness. On the other, because even though banks have taken an initiating role by borrowing external funds, the final debtors are still the customers (population, companies).

> The so-called crowding-out effect of public indebtedness for instance is well-known from text-books or relevant literature – this is when the population and companies do not have access to sufficient loans because banks and investors lend to the state instead. With today's relatively open money markets and banking systems, this does not lead to a failure of borrowing, but rather becoming indebted to foreign countries.

The analysis breaks the debt increase down into factors by examining the change in the positions of the various sectors. The method applied is the analysis of financial portfolios in the 2004–2011 period. I will also elaborate on the relationship between portfolio ratios and the current account balance. In addition to the analysis of gross debt, I will only deal with the changes in net debt and net investment position very briefly.

> My analysis will concentrate on focal points in time and sectors of debt increase, and not the financing of the debt burden. This is why I will pay less attention to ratios such as coverage by foreign exchange reserves or the ratio of annual export and debt service or the interest conditions of the fundraising of various players. The analysis does not examine the currency of indebtedness in detail.[3]
> I have only reviewed countries acceding to the EU and only processes after 2003. I must, however, note that growth was accompanied by significant indebtedness in non-EU Member States of the region as well.

AS A PREFACE ABOUT DEBT RATIOS

There are a number of different debt ratios that can be calculated based on the detailed financial statistics of the BIS. The gross debt of countries is used most frequently.[4]

The net debt of a country is calculated by deducting the external claims of the given state from its external gross debt. Though the gross indicator is important in case of emergency (in

terms of liquidity or short-term financeability), the true economic power, or vulnerability for that matter, of a country is much better indicated by net debt. Not to mention that in countries with developed money markets, where with a relatively smaller value of net positions, gross portfolios are quite large (both on the claims and debt side).

External debt is a concept broader than described above. In addition to debt, external (total) amounts owed include non-debt type items as well, such as working capital volume, or portfolio-type stakes financing corporate capital. This also has a gross and net ratio. The former *(gross investment position)* shows the total amount owed by the country (also including, in addition to debt, the inflow of foreign capital). If, from this we deduct total claims of the given country towards others (loans provided, foreign securities, stakes, etc.), we arrive at – as a balance of the two – the value of the net (external) investment position.[5]

MACRO-ECONOMIC REASONS

Péter Koroknai (Koroknai, 2008, pp. 16–20) analysed the change of debt level per countries for the 2003–2007 period. Among the factors influencing the debt rate, he emphasised income balance and primary balance. While the former is determined by legacy from the past, the latter is fundamentally a function of whether the foreign trade of goods and services is characterised by deficit or surplus. In addition to the above, among the factors influencing the debt rate, he quantified growth as well as inflationary and revaluation effect (one of the most important factors of the latter is nominal exchange rate change.[6]

The processes of the finances of the Central-Eastern European region until 2007 have been discussed comprehensively by *Banerji – Kahkönnen* (Banerji, 2009). Not long before the financial crisis (2007), the regional situation was compared with the situation preceding the South-East Asian crisis. The high willingness of foreign capital to take risks and the appreciation of currencies were deemed to be similar, but on the one hand, the high current account deficit and the high ratio of working capital involvement in our region, and on the other, the high ratio of short-term loans in South East Asia were found to be different. When juxtaposing the arguments of the (then) lenient approach to the Eastern European indebtedness process and the approach looking to keep the situation in hand, it was emphasised that the integration linked to Western countries of the European Union, (in addition to several opportunities) also carries with it the danger of the crisis originating from these countries spilling over. Unfortunately, this fear became a reality – this forced even moderately indebted countries into a liquidity crisis at the beginning of 2009 (see the Czech Republic and Poland).

The question is: can we say that beyond a critical level, serious disadvantages and dangers may arise? According to Koroknai's analysis, as a trend, the lower the per capita (calculated at exchange rate) GDP level, the higher the GDP-proportionate value of net foreign debt. In 1999, Hungary was just on the trendline with the 72 per cent net foreign assets/GDP value at the time. In 2007, in contrast, we 'stuck out' (a 50-60 per cent GDP-proportionate net foreign assets/GDP level would have corresponded to the level of development, but the Hungarian level exceeded 100 per cent).

For more points of reference, see *Reinhart – Rogoff* as quoted by *Belyácz* (Belyácz, 2012, p. 784).[7] Based on the analysis of close to 50 countries, they have determined that the external debt level exceeding 90 per cent was linked to a significantly lower rate of economic growth, and in fact, this negative

impact already took effect above the 60 per cent level in the case of emerging countries.

The deficit of the current account balance

The balance of payments deficit of the new EU Member States accumulated over the course of eight years is near equal to the growth of the debt volume. This seems almost trivial in itself as due to the correlations of the balance system, the deficit of one balance (current account balance) must be financed by the incoming capital flow as shown in the other balance (financial balance or capital balance). With respect to the structure of the current account balance, the region's countries can be divided into two groups. In the three South-Eastern countries and the Baltic states, the primary cause of the deficit over the eight years was the absence of foreign trade (goods and services) turnover. In the other five countries, in contrast, capital gains liability was the most important factor of the deficit. *Table 1* shows the two main factors responsible for the accumulation of the current account balance deficit.

Károly Lóránt deduced the two times 20 year process of the accumulation of Hungarian debt in an itemised manner based on the key items of the balance of payments (Lóránt, 2009, p. 219). *Giday* and *Szegő* encouraged achieving a significant current account balance surplus in Hungary – due to the high external debt (Giday – Szegő, 2012).

Financial integration

Banerji – Kahkönnen (Banerji, 2007, 177) were of the opinion that one of the factors responsible for the higher rate of indebtedness

Table 1

CURRENT ACCOUNT BALANCE, 2004–2011

(EUR million)

	Current account balance net	Capital gains net	Goods and services net
Bulgaria	–27,729	–8,451	–23,888
Czech Republic	–30,826	–30,132	14,595
Estonia	–6,918	–4,472	–5,280
Latvia	–12,500	–3,412	–14,787
Lithuania	–12,658	–4,585	–12,870
Hungary	–32,296	–33,413	–3,501
Poland	–114,682	–56,361	–39,816
Romania	–71,578	–19,922	–61,311
Slovenia	–6,383	–3,307	–2,164
Slovakia	–19,575	–13,834	–5,679
Croatia	–15,996	–7,325	–13,269
5 Central European countries	–197,379	–133,740	–34,401
South Eastern countries	–121,686	–39,005	–100,632
Baltic States	–32,076	–12,469	–32,937

Source: authors' own editing based on Eurostat data

of our region compared to other emerging regions was that new Member States were strongly integrated into the European financial system. This ensured greater opportunities for fundraising. In their view, other converging regions with similar levels of development would not have had the possibility to become indebted to such an extent.

In his study published just before the crisis, Koroknai (Koroknai, 2008, p. 15) considered the rise of external debt in Eastern European states a natural process resulting from the loosening of earlier liquidity barriers and financial integration.

Savings

The analysts of the debt of the Eastern European region mention that general experience shows that borrowing opportunities due financial integration lead to a decrease in household savings. According to *György Szepesi* (Szepesi, 2010, pp. 88–90), around 2000 a decade-long housing cycle began in Hungary, which is characterised by a transformed structure of household asset creation: financial savings are replaced for the most part by investments into real estate. This is the reason why no savings are (were) left to satisfy increasing corporate and state loan needs. Dependence on external funds generated indebtedness.

Exchange rate

The currencies of the region greatly appreciated (at real value) in the past decade.[8] This change of the exchange rate also played a role in that no significant foreign trade surplus was achieved in the new EU Member States. It was, at times, an openly admitted strategy of central banks following inflation targets to allow (real) appreciation to a certain extent as inflation could be more moderate as a result. The inflow of foreign currency funds resulted in foreign exchange abundance anyway, which had an appreciation impact on local currency.

If we compare consumer inflation differences and nominal exchange rate changes, on the basis of this comparison we find that the rate of real appreciation (between 2003–2011) was 19 per cent on average. This lowered the debt rate: inflation increased current price inflation; at the same time though, the value of external debt calculated in national currency increased at a lower rate. *Table 2* shows the debt rate generally used (initial debt/GDP, which is calculated at the nominal euro exchange rate), the rate of appreciation as well as how much the given country's adjusted external debt rate for 2011 would have been without the appreciation.[9]

Initial position (2004): similarities and differences

EU membership brought about an entirely new situation for the region with respect to indebtedness – due to financial liberalisation and strong financial integration. This magnified the fact that by this time, at the majority of banks owners were foreign parent banks – Slovenia being the only exception. In addition, (as a legacy of the former system) demand for home ownership was strong around the turn of the millennium.

The differences were as follows.

- The application of traditional monetary policy or an exchange rate linked to an anchor-currency in its place (openly in the four currency board-using countries and implicitly in a fifth).
- The difference of foreign capital portfolio levels at the start.
- The high and low levels of public debt at the start.

Table 2

GROSS EXTERNAL DEBT ADJUSTED WITH (REAL) APPRECIATION

(as a%)

	Appreciation to the euro 2004–2011	External debt/ GDP	External debt/ GDPadjusted
Bulgaria	1.35	92	124
Czech Republic	1.26	43	54
Estonia	1.21	97	118
Latvia	1.26	118	148
Lithuania	1.18	81	96
Hungary	1.05	131	138
Poland	1.14	67	76
Romania	1.41	72	102
Slovenia	1.07	116	124
Slovakia	1.10	99	108
Croatia	1.07	102	109
Average	**1.19**	**75**	**92**

Source: authors' own calculation based on Eurostat data

- Different sectoral focal points in working capital influx (the more significant ratio of the manufacturing industry, and the dominance of services).
- While eight countries were granted membership in 2004, Romania and Bulgaria acceded in 2006 while Croatia will join the EU in 2013.

SECTORS OF INDEBTEDNESS

More than half of the increase in external indebtedness of the five new Central European Member States over the eight years manifested itself in the private sector. Public indebtedness, so frequently analysed in the international press, was only responsible for the debt rate increase to a smaller extent. In the other two country groups, the increase of the debt rate was exclusively (the Baltics, Romania, Bulgaria) or for the most part due to the private sector.

Within the region, five areas are competing for domestic and foreign loan sources. The state that, at times, has become prisoner to populist promises; the central bank striving to present a level of foreign currency reserves as high as possible; the banking sector looking to expand through lending to domestic partners; the real estate and car purchasing population; as well as Hungarian-owned enterprises striving to increase domestic loans and foreign-owned corporations proclaiming the unlimited accessibility of the global money market. It is difficult for economic policy to find the right balance among these. Even more so that according to experiences gained between 2003 and 2008, even the two players (one being the state with the political class behind it, the other being the central bank) that are, in theory, responsible for the balance of the entire system encouraged (in the interest of objectives deemed important by them) the involvement of as much funds as possible, led by short-term considerations.

BANKS

The swift upswing in retail lending was helped along in each country by the emergence of consumption needs (housing, technical appliances) suppressed in the previous system, which were magnified by exaggerated expectations of EU membership.

After 2004, the objective of the fundraising of banks operating within the country was to expand domestic lending. Household savings decreasing as a result of financial liberalisation could not finance the increasing loan demand of the corporate sector or the upswing in retail loans. Classic examples of this are are Romania and the Baltic states, but the very same effect took hold in dominant Slovakia and Slovenia as well. The loan expansion was primarily targeted at the population, but in certain countries the corporate sector also received significant portions of this. Also contributing to the dynamic lending policy was the fact that banks only took on relatively low risk due to high collateral values (see mortgage) and foreign currency-denominated lending. In the years before the crisis, the ratio of retail loans compared to the GDP for instance increased 20 percentage points in the five Central European countries, while that of corporate loans by 10 percentage points. Wherever household incomes increased, housing prices rose considerably. Other financial intermediaries also played roles in retail lending (car loans, leasing financing). According to Banerji – Kahkönnen (Banerji – Kahkönnen, 2009, p. 175), in Central-Eastern European emerging countries[10] the value of the (domestic) loans of the corporate sector relative to GDP increased from 15 to 30 per cent (between 1999–2007); however, the surplus showed up entirely in the service provision sector (primarily in the trade and real estate sector).

Following the crisis, banks in contrast became overly cautious in their lending, thus deepening recession even further. György Szepesi (Szepesi, 2010, p. 93) mentions that maintaining the volume of funds provided to subsidiaries is not a primary concern for parent banks – this led to a credit crunch in Hungary. While in other countries, the decrease in loan volume stopped in the past two years, in Hungary this shrinking is ongoing even now (in the second half of 2012). According to MNB data, only in 2010–2011 foreign banks withdrew EUR 12 billion of funds from their Hungarian subsidiaries (MNB, 2012). *Montoro* and *Rojas-Suarez* (Montoro, 2012, p. 28) examined why post-crisis bank lending is(was) different in emerging European countries and Latin America. They found that lending activity failed to decrease in countries where external indebtedness was not previously at a high level and where landing by banks was prudent. Greater loan volume decrease was carried out by foreign-owned banks as well as those that increased their lending to an above average extent prior to the crisis.

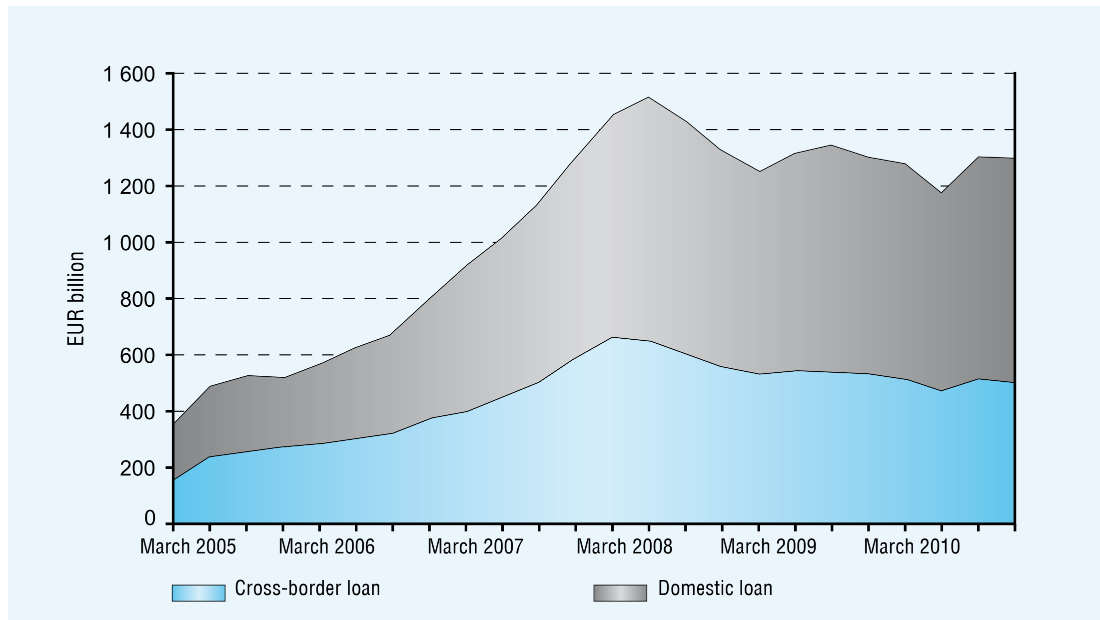
COMPANIES

The total loans of the corporate sector directly taken from abroad constituted two thirds of the increase of private debt. Following the EU accession, the main barriers to cross-border banking transactions were eliminated; thus a significant of foreign-owned companies requested part of the loan financing for subsidiaries from their 'usual' home financing institution. For the most part, the given firms do not even require the intermediation of local banks (or bank branches). There are some countries where companies take on more loans from abroad than from inside the country.

C. Till[11] published *Chart 1* (C. Till, 2012, p. 89) on corporate loans to East European emerging countries[12] placed by banks that report to the BIS (Bank for International Settlements).

Chart 1

THE CORPORATE LOANS TO EAST EUROPEAN EMERGING COUNTRIES PLACED BY BANKS THAT REPORT TO THE BIS



Source: Bank for International Settlements (BIS)

It shows that cross-border lending has become dominant within all lending practices. Loans taken from domestic banks now only represent a smaller portion of total volume.

In the case of Central-Eastern European countries, borrowing related to working capital made up a significant portion (almost half) of the cross-border borrowing of the foreign-owned corporate sector.[13] It is probable that foreign-owned financial institutions are also behind the vast bulk of the other portion. The foreign lending market is relatively easily accessible to them, while nationally-owned companies are more dependent on domestic banks.

PUBLIC FINANCES

Public deficit manifested itself in the region in two forms. In the case of the increase of social expenditures or larger investment programmes, there was state overspending with normal conditions, in other words which could be described with the term 'ordinary', (with Hungary practically being the only example of this). The other form is the financing of Keynesian crisis management. This requires temporary expenditure surplus, while keeping in mind that the expenditure level until that point is also adjusted to reduced revenues with a delay – in order to avoid a deepening of the crisis. This was typical of practically every country – with the exception of those where previously introduced austerity measures did not (or only partially) allow this (Hungary, Latvia, Estonia).

We must note that the spending of surplus revenues of the state generated through consumption and investments boosted by private sector loans may also be considered overspending in the broader sense.

There is also a third form, namely involuntary indebtedness. In a state of financing crisis, only the state was able to mobilise external funds (e.g. asking the IMF for assistance), even if indebtedness was caused by the private sector.

FOREIGN CURRENCY RESERVES

The fact that the already high level of foreign currency reserves was further increased in many countries also contributed to the increase of external debt. The EUR 220 billion foreign currency reserves of the eight non-euro area EU Member States[14] amounted to 24 per cent of their GDP in 2011. The value of foreign currency reserves was equal to five months import (in 2003, this was only four months – *see Table 3*). Foreign currency reserves were 130 per cent of short-term loans – this ratio improved continuously over the past three years. In the majority of countries, the ratio value exceeds 120 per cent, above average in Hungary and Bulgaria. One thing, though, is for certain: the reserve level in Hungary in the autumn of 2008 was insufficient to fend off speculative attacks.

RAISING CAPITAL OR BORROWING?

The energy sector privatisation, which was conducted with unfavourable conditions, contributed to Hungarian indebtedness. Tariffs increased due to the guaranteed high level of profits, and the triple return on investment of capital burdened the current account balance (Giday, 2011, p. 468).

According to *Beáta Farkas* "new cohesion countries had based their economic convergence on foreign direct investment, which made them particularly vulnerable during the global economic crisis" (Farkas, 2012, p. 56). After the autumn of 2008, there was a withdrawal of net capital in certain countries, but working capital influx was substantially below previous levels in the other countries as well (same place, p. 54).

András Komáromi (Komáromi, 2008, pp. 18–21) reviewed all the arguments found in the literature for and against the involvement

Table 3

HOW MANY MONTHS OF IMPORT DO FOREIGN CURRENCY RESERVES FINANCE?

Country/period	2003	2004	2005	2006	2007	2008	2009	2010	2011
Bulgaria	5.3	5.6	4.9	4.7	5.1	4.9	7.0	6.5	5.6
Czech Republic	4.4	3.5	4.1	3.3	2.7	2.7	3.7	3.3	2.9
Estonia	1.8	1.8	1.8	1.8	1.7	2.2	3.2	1.8	0.1
Latvia	2.4	2.3	2.5	3.1	3.0	2.9	6.7	6.3	4.3
Lithuania	3.3	2.7	2.6	2.9	2.9	2.1	3.5	2.9	2.8
Hungary	2.2	2.2	2.6	2.4	2.1	2.9	4.7	4.5	4.6
Poland	4.3	3.4	4.0	3.3	3.3	2.9	4.5	4.7	4.6
Romania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovenia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovakia	6.3	5.8	5.7	3.2	3.2	2.5	0.3	0.3	0.3

Source: authors' own calculation based on data from central bank websites

of working capital and debt-generating resources. He showed that, based on international experience, the role of debt-type financing usually increases once a higher level of development is attained. In his view, the question of whether working capital or debt-generating resources are dominant in external debt is of secondary importance in Hungary. Most important is the level of indebtedness, with respect to which, Hungary falls into the vulnerable category._In contrast, according to the authors Belyácz – *Kuti*, involving working capital is more beneficial and brings greater stability. In their view, the lowest loan capital/ equity capital ratio possible of the national economy would be desirable[15] (Belyácz, 2012, pp. 786–787).

Banerji – Kahkönnen showed (Banerji – Kahkönnen, 2009, p. 173) that within inflowing working capital (until 2006) the service provision-financial sector was dominant. The ratio of the industrial (competitive) sector reached 42 per cent in Central European countries and 31 per cent in South Eastern countries, but only 20 per cent in the Baltics (2006). According to the authors, the role of debt in fundraising will most likely increase in the region. The reason for this on the one hand, is the end of privatisation, and on the other, the fact that finding new investment opportunities with an already high working capital portfolio is more difficult.

The inflow of working capital in the given year allows for the financing of the current account balance deficit. In Hungary, according to *Balatoni* for example (Balatoni, 2012, p. 22), working capital brought significant GDP surplus (compared to if growth were financed through loans), even if the current account balance is considerably burdened by the capital gains yield.[16]

Sooner or later, the high equity of foreign companies increases the volume of loans taken out by the given country. *Table 4* shows that every EUR 1 billion of foreign capital flowing into the region results in the taking out of an external loan of EUR 620 million by the other sector – via cross-border transaction. In the seven countries representing three quarters of the region's GDP, this ratio does not deviate much from the 62 per cent average value.

The high level of external loans of companies raise the given country's debt level, thus the central bank is forced to keep more foreign currency reserves.[18] As a result, a great portion of benefits gained on one side is lost later on. In other words, the application of the "if you don't have sufficient funds, leave development to the influx of foreign capital" cure also has certain – not insignificant – side effects.

NET DEBT, NET INVESTMENT POSITION

Table 5 shows that the net external debt in 2011 in the 11 countries amounted to 35 per cent of the GDP (this was 16 per cent in 2003). The net ratio deteriorated at a lower rate than the gross ratio. This deviation is explained in part by the fact that the raising of foreign currency reserves was also financed from external borrowing.

The GDP-proportionate value of the net (external) investment position was on average 31 per cent higher in 2011 than net external debt. The difference, however, was a high 40–50 percentage points in five countries – two of these countries were Central European (Hungary and Slovakia), two South Eastern (Bulgaria and Croatia) and one Baltic (Estonia).[19] In case of the other half of countries (the ones with the largest population such as the Czech Republic, Poland and Romania), the value of net amounts owed exceeded that of net debt by 20–30 per cent. Slovenia's ratio was outstandingly good.[20]

Table 4

THE EXTERNAL DEBT OF OTHER SECTORS[17] COMPARED TO THE VOLUME OF FOREIGN CAPITAL,* 2010

	per cent
Bulgaria	80
Czech Republic	35
Estonia	60
Latvia	105
Lithuania	60
Hungary	60
Poland	60
Romania	75
Slovenia	95
Slovakia	65
Croatia	110
Average	**62**

**Note*: ratio of gross values, rounded data

Source: authors' own calculation based on Eurostat data and central bank websites

Table 5

GROSS AND NET DEBT RATIOS

(expressed as a percentage of GDP)

	Gross external debt		Net external debt		Net investment position	
	2003	2011	2003	2011	2003	2011
Czech Republic	33	47	1 (2004)	20	–20	–50
Hungary	56	131	29	52	–78	–106
Poland	44	67	22	37	–42	–64
Slovakia	49	99	2	22	–24	–64
Slovenia	68	116	–3 (2004)	38	0	–42
Bulgaria	58	92	9	33	–26	–85
Croatia	66	102	18	46	–35	–90
Romania	34	72	14	37	–27	–62
Estonia	64	97	13	7	–66	–58
Latvia	60	118	24	45	–44	–73
Lithuania	40	81	13	36	–33	–52
Average	**57**	**99**	**16**	**41**	**–40**	**–80**

Source: authors' own calculation based on Eurostat data, central bank websites and the IMF Fin. Stat. Yearbook for 2011

We must note that in theory, the EU regulation finds a maximum 35 per cent net investment position desirable in the future for members of the euro area.

GROWTH BUBBLE?

Paul Marer (Marer, 2010, p. 10) emphasised that external funds played a crucial role in the financing of Eastern European growth. As these decrease as a result of the global financial crisis, he is of the opinion that we should be much more dependent on internal resources. According to the IMF, in the 2003–2008 period, the financing provided by Western banks added 1.5 percentage points to Eastern Europe's GDP growth, bringing it to 6.5 per cent (IMF, p. 86).

The 11 new continental EU Member States showed high growth dynamics before the crisis, but used external funds for this. The driver of growth for the most part was internal consumption and the increase of investments. Though the primary reason for the crisis of the region, which has been ongoing for four years, was the drop in external demand, the drying up of external funds also contributed to the halting of growth. The process described can be illustrated well with the category of net amounts owed *(net external position)*.[21] The GDP proportionate value of the net external position of the region grew by 32 percentage points between 2001 and 2008 (almost doubling in value). In the meantime, GDP growth was 37 per cent (2002–2008).

A stable link can be observed between the growth rate and the increase in the volume of amounts owed in the case of certain countries (*Table 6*). In the region (on average), every 1 per cent increase of the GDP was accompanied by a 0.5–0.9 per cent increase of the val-

Table 6

THE RELATIONSHIP OF NET EXTERNAL DEBT[22] AND GDP GROWTH (2001–2008)

	Growth December 2001–December 2008 % net debt/GDP	Growth 2002–2008 %	
		GDP	ratio
Bulgaria	71	51	1.4
Czech Republic	30	38	0.8
Estonia	28	51	0.6
Latvia	41	63	0.7
Lithuania	17	66	0.3
Hungary	40	24	1.6
Poland	27	29	0.9
Romania	28	54	0.5
Slovakia	34	36	0.9
Slovenia	39	56	0.7
Croatia	58	35	1.7
Total	**32**	**37**	**0.9**

Source: authors' own calculation based on Eurostat and Croatian Bureau of Statistics data

ue of the net debt/GDP ratio. If we disregard Hungary (due its unique method of indebtedness), only the three smaller countries (Croatia, Bulgaria and Lithuania) representing only a tenth of the region's GDP were outside of the value range.

If someone were to analyse a smaller (past) fundraising alternative by asking "what if...?", they should primarily examine the swift growth and subsequent shrinking of the real estate and housing sectors (also responsible for the 'bubbles') as well as trade. Also, what proportion of producers was forced off the domestic or export market due to appreciating national currencies.

It would be very instructive using an impact study to show what growth the region would be capable of without the surplus of funds. Since accession to the EU, there has not been a single period of at least three years in any country when observable growth was observed without the increasing of debts.

> Even the case of Poland, which is showing unbroken growth, supports this statement, as the GDP growth of the past three to four years was achieved with external indebtedness.

TYPES OF INDEBTEDNESS

With respect to fundraising and subsequent crisis management, we can observe the following country strategies in the region:

"The (near) uncontrolled indebtedness of the private sector" was characteristic of the Baltics and South Eastern Europe. The motto of this particular approach was probably "we shall not interfere with the activities of foreign-owned banks and companies". One of its sub-types was dominated by borrowing by commercial banks. In the other sub-type, the loans related to working capital were most emphatic (Bulgaria). Naturally, the state was forced to interfere in the end to manage the crisis generated.

We could call the practice employed by the Czech Republic and Poland "replacing fundraising". Before the crisis, external loan sources were only allowed in to a moderate extent – partly through the banking sector, and partly via corporate loans. During the crisis, these were no longer available, but they generated significant public indebtedness.

"Indebtedness on all sides" was typical of Hungary. The state, commercial banks, households and local governments are all severely indebted (Belyácz, 2012. p. 791).[23] I feel we can venture to say that due to the simultaneous appearance of several types of indebtedness, risks do not simply add up, but might even multiply.

The "few years of temporary financial discipline" was enforced in the countries admitted to the euro area. The political and economic elite of these countries asked for (and were granted) a few years of temporary financial discipline from their respective societies in order to be able to introduce the euro, which represented the promise of lower interests and lower financial risk for them. In the end, the euro did bring increased leeway. This meant that debt financing was accompanied by bearable burdens, without acute liquidity problems, and at the time of the subsequent relapse, nothing stood in the way of temporary Keynesian crisis management – in the case of Slovenia and Slovakia.

In addition to the basic type, we can identify certain elements of some other types as well in the practice of several countries. The best example of this is Estonia. Similarly to the other Baltic states, the borrowing of banks in Estonia also financed an outstanding foreign trade deficit; however, at the beginning of the crisis (from 2008), the country switched to a tightening dictated by financial discipline. It did so not only due to the gravity of the

situation, but also because by meeting the Maastricht criteria, they were able to join the euro area in 2011.

BALANCE SHEET RECESSION[24]

In the literature of more developed countries, other renowned authors (such as Krugman, 2010) also deal with balance sheet recession. In other words, with the situation when all players of a closed economy strive to reduce indebtedness. According to their findings, in this case total internal demand drops significantly, resulting in (potentially permanent) recession. This why it is important for there to be at least one party that is willing to take on the increase of its debt during the temporary period. The idea occurs almost reflexively that this player should be the state itself. In this case, demand can be increased and deep, long-term recession may be avoided.

If this does not happen, balance is achieved by an increase in inflation, by forced provisioning or a depreciation of assets, which may lead to even decade-long depression or shrinking (Szepesi, 2010, p. 91). In his view, in the case of open economies, the buffer role is assigned to international financial relationships.

According to the author trio of *Berlinger-Horváth-Vidovszky* (Berlinger, 2012, p. 21), "balance sheet recession could be even more severe in an emerging economy that is greatly dependent on external financing, because if foreign capital is withdrawn as a result of risk appetite, this increases deleveraging in the private sector, and also narrows the opportunities for state borrowing."

> The question is, of course, what conclusion we can draw from this regarding the reduction of external debt. First of all, caution is important. Secondly, I think the negative impact of the restriction of internal economy could be alleviated by turning to the external market. This is why the question arises: would the region stand greater chance with tools – for example (external or internal) depreciation – facilitating the increase of net export. This, however, is not something industry, much less politics, is brave enough to openly state.

THE BEGINNINGS OF DEBT REDUCTION?

The highest value of the debt rate for the region was reached in 2010, and has dropped slightly in the past year. The rise of this ratio has come to a halt in all countries. The ratio dropped by 27 and 16 percentage points in Estonia and Bulgaria respectively, while among the countries that have "substantially reduced debt" we find Hungary, the two largest Baltic states and Slovenia. At the same time, in the three largest countries that have 'allowed' themselves several years of Keynesian crisis management, 2011 indebtedness is just slightly below that of 2010.[25] In their case, the reduction of debt levels has just commenced.

In theory, 'growing out' of debt may be one of the ways to reduce indebtedness. At the same time, we can only observe faint signs of this as the new drivers of growth must be identified beforehand.

ANSWERS TO THE QUESTIONS POSED

The questions posed in the introduction chapter may be answered at the end of the study.

- The reason for the indebtedness in Baltic and South Eastern Member States was the significant foreign trade balance deficit, while in Central European countries the deficit of the current account balance due to capital gains.

- For the most part, indebtedness was caused by the private sector; the indebtedness of the state was only characteristic of Hungary in the entire period and in the Central European countries employing several years of anti-cyclical fiscal policy in the years after the crisis.
- Within the indebtedness of the private sector, the weight of the external indebtedness of domestic banks amounted to one third, while cross-border corporate borrowing to approximately two thirds.
- Half of the cross-border borrowings of companies was related to the inflow of operating capital.
- It is safe to say that a situation approximating a growth bubble was established, since the driver of growth was the increase of consumption and investment financed for the most part by external loans.

CONCLUSIONS

The high value of debt volume did not come out of the blue. As a result of the current account deficit liabilities that have been around for several years, the significant rise in debt was expected.

Such grave indebtedness could only have been avoided if economic policy rules were laid down in advance, rules that would not have allowed the level of the country's external debt to exceed a certain limit. This would of course also entail laying down a clear order of priority in the interest of providing funds to the objectives and sectors competing for them. Subject to debate: are the experts capable of comprehending these issues in the right positions, are they sufficiently informed and do they have the courage to raise their voices upon seeing the negative trends?

Traces of a policy wiser than that of others can only be found in the case of three to four countries. One of these countries is Poland, which limited the state's indebtedness. This way the indebtedness of banks and corporations did come to pass; however, public indebtedness was avoided. Upon the outbreak of the crisis, the private and corporate sectors switched places in terms of indebtedness, maintaining growth. The other country is Slovenia, which did allow extensive bank and corporate borrowing, but by introducing the euro, it purposefully raised the level of loans available to the whole of the country to a still reasonable level. The third is Bulgaria, which used the tax revenues generated by the growth due to the indebtedness of the private sector partly to reduce public debt.

The paradox of the situation is that even if a given country is able to exhibit a low level of debt, this represents no immunity against external financial threats. In such countries, financial capital is looking to flow in in certain periods to an excessive extent. Preventing this or fighting against it (with foreign currency reserves for example) could take significant energy and resources. The best example of this is the Czech Republic.

Based on the 'end result' of indebtedness, we can state that in general there were no institutions that called attention to the expected risks of a given country's total debt in time or with sufficient vigour. Risk was most hidden in the case of the currency board system. Not to mention the fact that due to the emphatic role played by foreign parent banks, examining certain countries or even the indebtedness and financing risks of the entire region is insufficient.[26] According to authors Belyácz–Kuti, in Hungary "the indebtedness of the past decade… is the consequence of a lack of coordination" (Belyácz, 2012, p. 790).

RESULTS

The analysis showed that the volume of cross-border loans taken by (foreign-owned)

companies increases in proportion to the volume of foreign capital. These loans are usually considered part of external debt, which means higher foreign currency reserves must be maintained or perhaps higher premiums must be paid to creditors.

Due to the phenomenon of the balance sheet recession, caution must be taken during the reduction of debt. The repayment of external debt and the reduction of internal and public debt all decrease internal demand and may lead to recession. In case of recession, the confidence of external partners in our repayment ability may be shaken, which is to say that in spite of the painful measures, the situation improves only very slightly.

WHAT TO DO?

In the interest of reducing vulnerability, I feel some of the external debt must be decreased – even in the case of the less indebted. In the countries showing the highest debt, the order of priority of economic policy must be reorganised. In such cases, the following order is recommended: current account balance, GDP growth, development of asset prices, real effective exchange rate level, and internal consumption.

> If possible, surplus should be achieved in the current account balance, which provides coverage to decrease debt. One of its primary tools could be the reduction of the budget deficit. Ranking growth in second place illustrates the necessary change in direction: when given a choice, the sector or investment alternative more beneficial for the balance of payments must be opted for. Even if it results in lower growth. The management of the development of so-called asset prices is a question of economic policy. Not just in case of their increase (these are the so-called bubbles), but also in case of strong decrease. If the extent of this is too great, the result could be the mass elimination of capacities and closure of banks, which leads to growth loss and reduces competitiveness. A permanently significant balance of payment in my view cannot be achieved with an appreciating trend of the given national currency. All this also requires the rethinking of central bank base rate policy.

Growth must be achieved in a structure different than before. In addition to strengthening export orientation, the better exploitation of opportunities provided by the region's markets is also crucial.

> For the others, three countries (country groups may provide – various – examples. The Baltics (management of real income decrease), Poland (skilful survival of external crisis through increase of internal demand) and Hungary (achievement of current account balance surplus). For certain countries, common regional issues also arise. In order to avoid a domino-effect, it would be expedient to jointly prevent certain countries from becoming outliers with respect to indebtedness. Furthermore, by increasing the ratio of foreign trade turnover with countries of the region, they could mutually increase the surplus of their current account balances *(See Annex, Table 7)*.

Annex

THREE COUNTRY GROUPS

Central Europe

Table 7

INDEBTEDNESS OF THE CZECH REPUBLIC, HUNGARY AND POLAND

Indicator	Czech Republic		Hungary		Poland	
	2003	2011	2003	2011	2003	2011
External debt, EUR billion	23	64	46	132	85	249
External debt/GDP, %	33	47	56	131	44	67
External private debt/GDP, %	30	35	33	77	25	42
Of this: • bank debt, %	*10*	*12*	*13*	*29*	*5*	*14*
• other debt, %	*20*	*24*	*20*	*48*	*21*	*28*
of this inter company loans, etc., %	*6*	*6*	*11*	*29*	*8*	*15*
External public debt/GDP, %	3	12	24	54	25	42
Of this: • government, %	*3*	*12*	*20*	*48*	*19*	*24*
• central bank, %	*0*	*0*	*4*	*6*	*0*	*1*

Source: *authors' own calculation based on data from central bank websites*

In Central Europe (the Visegrád countries and Slovenia), the bank credit boom played a lesser role; at the same time, however, public debt increase was more emphatic due to the expenditures of either overspending or Keynesian crisis management. The gross external debt in 2011 amounted to 83 per cent of the GDP (this was 50 per cent in 2003). The eight year accumulated value of current account balance deficits was EUR 250 billion. We arrive at a near equal amount if we deduct the increase in foreign currency reserves from the increment of external debt. In each of the countries, capital gains liability was near equal to the deficit. Within this, the negative balance of capital gains was the main factor *(see Table 8)*.

In 2011, one third of external debt was state debt and two thirds private sector debt. Banks shared in the latter with 15 percentage points, while other sectors (basically the corporate sector) with 32 percentage points. The GDP proportionate value of the state's external debt was 29 per cent, with the bulk provided by public finances (25 per cent), and a smaller portion (5 per cent) by central banks.

> In the two countries acceding to the euro area, central banks were able to draw down significant funds from the euro area. In the end, households and companies were able to finance real estate purchases and operations respectively with low euro interest rates, which operations enabled them to stand their ground in international competition.

Table 8

THE INDEBTEDNESS OF SLOVAKIA AND SLOVENIA

	Slovakia		Slovenia	
	2003	2011	2003	2011
External debt, EUR billion	14	69	18	41
External debt/GDP, %	49	99	68	116
External private debt/GDP, %	35	47	59	81
Of this: • bank debt, %	*8*	*10*	*20*	*38*
• other debt, %	*26*	*37*	*39*	*43*
of this inter company loans, etc., %	*7*	*22*	*18*	*15*
External public debt/GDP, %	14	51	9	35
Of this: • government, %	*11*	*22*	*9*	*27*
• central bank, %	*3*	*31*	*0*	*8*

Source: authors' own calculation based on data from central bank websites

Baltic states

The external debt rate of Baltic states was almost double in 2011 compared to eight years before (96 per cent). The EUR 39 billion increase of debt was almost exactly equal to the balance of payments deficit accumulated over eight years *(see Table 9)*.

Three quarters of the debt was private debt – the cross-border borrowing of banks and companies shared this volume 50–50 per cent. After 2003, in the course of five years banks increased their GDP-proportionate debt by 30 percentage points. Public external debt was a practically unknown term until 2008. As a result of the revenue loss due to the crisis and crisis management measures, however, public deficit increased sharply and it was necessary to resort to external funds. In Latvia, this came in the form of IMF assistance through government borrowing. After the outbreak of the crisis, giving up the fixed exchange rate was a serious alternative. This option was then discarded, and financial equilibrium in the two countries was established through the drastic restriction of internal demand. In Estonia, this was undertaken in the interest of introducing the euro, while in Latvia, this was the only way to acquire IMF funds. As a result of adjustment measures, GDP in these two countries dropped by 15-20 per cent. In the Baltics, the record-high liability of the payment deficit dropped to around breakeven value, and the debt rate noticeably decreased.

South-East European EU countries

In the three new South Eastern countries of the EU, external debt in 2011 was 82 per cent in proportion to the GDP (close to double the value of eight years before). During this period, the balance of payments deficit was EUR 101 billion, almost the same as the increase of debt. At the end of the period, the EUR 65 billion foreign currency reserves amounted to 25 per cent of the GDP on average. In some respects, their financial situation and crisis management is similar to that of Central European countries, while in others it resembles

that of Baltic states. Romania and Bulgaria started off with low external debt, and their high foreign trade deficit led to the radical increase in debt. The external financing for this was established through foreign funding by banks (see Romania) and companies (see Bulgaria). Croatia, in contrast, was forced to become indebted partly in order to finance the current account balance deficit resulting from investor yields. Indebtedness in the three countries was caused by the private sector, and the state only increased its debt ratio slightly at the time of the crisis *(see Table 10)*.

Table 9

THE INDEBTEDNESS OF BALTIC STATES

	Estonia		Latvia		Lithuania	
	2003	2011	2003	2011	2003	2011
External debt, EUR billion	7	16	8	24	8	25
External debt/GDP, %	64	97	60	118	40	81
External private debt/GDP, %	61	94	54	84	28	50
Of this: • ˙bank debt, %	*27*	*43*	*32*	*37*	*12*	*29*
• ˙other debt,%	*34*	*50*	*22*	*47*	*15*	*21*
of this inter company loans, etc., %	*15*	*17*	*7*	*15*	*4*	*14*
External public debt/GDP, %	3	3	6	34	12	31
Of this: • ˙government, %	*3*	*3*	*6*	*34*	*12*	*30*
• ˙central bank, %	*0*	*0*	*0*	*0*	*0*	*1*

Source: authors' own calculation based on data from central bank websites

Table 10

THE INDEBTEDNESS OF SOUTH-EAST EUROPEAN EU COUNTRIES

	Bulgaria		Romania		Croatia	
	2003	2011	2003	2011	2003	2011
External debt, EUR billion	13	35	16	98	33	45
External debt/GDP, %	58	92	34	72	66	102
External private debt/GDP, %	22	85	18	48	45	86
Of this: • bank debt, %	*4*	*15*	*3*	*17*	*20*	*26*
• other debt,%	*17*	*70*	*15*	*32*	*24*	*60*
of this inter company loans, etc., %	*7*	*38*	*5*	*14*	*6*	*15*
External public debt/GDP, %	22	7	16	24	21	16
Of this: • government, %	*36*	*7*	*15*	*16*	*20*	*16*
• central bank, %	*0*	*0*	*1*	*8*	*1*	*0*

Source: authors' own calculation based on data from central bank websites

Notes

[1] This is the reason why Szilvia Szegő recommended establishing a Visegrád currency snake, HVG, January 2010

[2] Financial literature terms the regional spreading of crises as 'contagion'.

[3] This has been analysed in depth in relevant literature of the past three years.

[4] One of the basic debt ratios of external gross debt includes the loans related to direct operating capital, while the other shows debt without these loans.

[5] The significance of this particular indicator will most certainly increase in the future and will surely become one also used by the EU as it comprehensively indicates the financial vulnerability of a given country (see EU, 2012).

[6] The inflationary and revaluation effects move in opposite directions; their result fundamentally shows the change of the real exchange rate – which I will be analysing separately. Koroknai's analysis is more detailed than mine own in that it also shows the effect of revaluation – among these effects, for instance, is that the change in the value of shares held by foreigners impacted the debt level (this was usually growth due to the increase of value).

[7] Reinhart- Rogoff A Decade of Debt, 2010, NBER Working Papers No 16827

[8] While globally, in general, the financial crises were followed by the significant depreciation of the currencies of indebted countries, in Central-Eastern Europe this was temporary at best.

[9] It is worth noting that while Hungary's debt rate amounts to close to double that of the region, the comparison of adjusted rates shows Hungary's value to be only one and a half times that of the average value. The reason for this difference is the weak forint at the end of 2011.

[10] This group has four more Baltic states than the 11 countries I have analysed.

[11] Comment on an article by Martin Brown-Ralph De Haas entitled Foreign Banks in Emerging Europe, In: Economic Policy, January 2012, p. 89

[12] In other words, a region greater than the 11 countries I examined.

[13] György Kovács mentions that in the case of Hungarian subsidiaries of foreign companies, at times there were reclassifications among ownership claims and other claims of foreign companies towards domestic companies "for instance in 2008", (see Kovács, p. 56)

[14] The analysis of foreign currency reserves is only expedient in the case of countries that are not using the euro. Upon the introduction of the euro, the bulk of the assets of the given central bank have to be reclassified; euro-denominated claims will qualify as central bank investments from that point, but will not be considered part of foreign currency reserves.

[15] The value of this indicator increased from 1.18 in 2004 to 1.82 by 2010 (Belyácz, 2012). The numerator of the ratio contains the categories of gross external debt and working capital, while the denominator includes the sum of foreign working capital (excluding inter-company loans) and portfolio investments. In their view, the deterioration of the ratio owes much to the loans of foreign-owned large corporations which were used to finance foreign capital allocation.

[16] According to Balatoni, even when this is deducted, the balance would still be positive (9 per cent in the GDP and only 6 per cent in the GNI).

[17] Basically the corporate sector

[18] If we assume that parent companies would be less tight-fisted in launching their capital into the region (or would allow subsidiaries to better fill up their circulating funds from the profits generated), and therefore loan needs could be satisfied by loans taken from domestically registered banks, the gross external debt rate of the region would be approximately 5–10 percentage points lower, but the net debt rate would most likely also be considerably below the current level. If we assume that as a result, the level of foreign currency reserves could also be lower by 3-5 per cent of the GDP, this would currently result in interest expenditure savings of EUR 1-2 billion for the region per year.

[19] Typically the countries that excelled in attracting foreign capital.

[20] In other words, in retrospect we can determine that in the end Slovenia established a better position (in spite of all the criticism) through an only moderate level of privatisation for foreigners.

[21] In terms of content, this is the joint balance of net external debt and net capital raised.

[22] Net external investment position

[23] "In the history of finances, it is rare for the state, commercial banks, households, large corporations and local governments to all become severely indebted at the same time. This is exactly what happened in Hungary". To those listed by Belyácz, we must add the MNB as well as it was also forced to involve funds due to high foreign currency reserves resulting from vulnerability.

[24] Many authors discuss balance sheet recession under the name 'liquidity trap'.

[25] The actual result is somewhat better than what I have described, as half of nominal debt increase financed the increasing of foreign currency reserves, in other words, was not spent.

[26] For example, the London circles that in the spring of 2009 deemed the liquidity risks of the Eastern European region critical, also deemed the financial situation of the entire region critical due to the fundraising difficulties of Swedish and Austrian parent banks.

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