Summary for non-specialists
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Capital flows to converging European economies – from boom to drought and beyond

Selected proceedings to the DG ECFIN's workshop held in Brussels on 1 October 2010

The aim of the workshop organized by the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission on 1 October 2010 in Brussels was to improve the understanding of the determinants, characteristics and prospects for foreign capital flows into converging European economies, in particular the new EU Member States. The workshop brought together participants from the Commission, academia, central banks, ministries of finance and permanent Member States' representations to the Union.

Given the crucial role of the banking sector in channelling foreign capital inflows into the CEE region, the workshop was split into two main sessions. The morning session was dedicated to foreign capital flows in general and to the evolution and determinants of their components. The afternoon session then focused specifically on the important role of banks and thus on the evolution and determinants of cross-border bank flows in the region.

The paper **"Determinants of capital flows to the new EU Member States before and during the financial crisis"** by Anton Jevčák, Ralph Setzer and Massimo Suardi confirms that external determinants have been important in explaining capital flows to the NMS10. In particular, it finds a strong role for euro area interest rates, business cycle, and risk sentiment. At the same time, the ability of the NMS10 to attract foreign capital has been also influenced by domestic economic and financial conditions and policies. Risk sentiment appears to be a robust driver for both the common component of aggregate capital flows to NMS10 and flows to individual countries. Overall, these results suggest a need for caution on the part of NMS in borrowing too heavily during periods of favourable external financial conditions. As the financial crisis has shown, this increases their vulnerability to a sudden reversal in the availability of financing, which can be largely driven by factors beyond their control.

Randolph Luca Bruno and Nauro Ferreira Campos show in their paper **"Capital flows to converging European economies: crises, reforms and FDI"** that within the EU15 capital tends to flow uphill, that is, richer countries within the EU15 attract relatively more FDI and portfolio inflows. As far as the NMS are concerned, market size is identified as a strong determinant of FDI inflows while institutional quality also has a positive, albeit smaller, impact. On the other hand, banking and currency crises are found to have a strong negative impact on FDI inflows into the NMS. Finally, although the NMS have received more FDI inflows than the EU15 since 1990, the volatility of FDI inflows to the NMS is also larger.

In their paper **"The dynamics of portfolio holdings in emerging Europe"** Vahagn Galstyan and Philip Lane find some evidence that shifts in the geographical composition of portfolio debt liabilities in the 2001-2007 pre-crisis period reflect shifts in bilateral trade patterns. In addition, the new Member States seem to have disproportionately attracted portfolio equity investment from other members of the European Union after 2004. During the crisis year 2008, the bilateral composition of the shift in portfolio positions period can be linked to three main factors. First, there is a systemic relation between the scale of pre-crisis holdings and the level of pull-back during 2008. Second, investors from geographically proximate countries were less likely to reduce exposures to emerging Europe than were investors from more distant countries. Third, investors from the euro area were more likely to maintain portfolio equity positions in emerging Europe than were investors from other regions.

The paper **"The determinants of cross-border bank flows to emerging markets: new empirical evidence on the spread of financial crises"** by Sabine Herrmann and Dubravko Mihaljek suggests that global as well as country-specific factors are significant determinants of cross-border bank flows. Greater global risk aversion and expected financial market volatility were the most important factors behind the decrease in cross-border bank flows during the crisis of 2007–08. The decrease in cross-border loans to Central and Eastern Europe was more limited compared to Asia and Latin America, in large measure because of the higher degree of financial and monetary integration in Europe, and relatively sound banking systems in the region.

In their paper **"Cross-border flows and foreign banks in the global financial crisis – has Eastern Europe been different?"** Ursula Vogel and Adalbert Winkler find that foreign banks in general did not stabilize cross-border bank flows during the recent global financial crisis. However, Eastern Europe has been different. Eastern European countries with a higher foreign bank asset share recorded significantly more stable cross-border flows during the crisis than their emerging market peers. This is in particular due to cross-border bank-to-bank lending. These results suggest that the special conditions of the European integration process have blurred the boundaries between home and host countries and thus led to additional efforts by parent banks to stabilize cross-border flows in the global financial crisis.

Mathias Lahnsteiner shows in his paper **"The refinancing structure of banks in selected CESEE countries"** that in the second half of 2008, most banking sectors received additional funds from abroad, while in the course of 2009, net capital flows to banks turned at least temporarily negative in all countries under review except Poland. However, the size of net outflows on the liability side of banks' balance sheets differed substantially across countries. Looking at the whole period from mid-2008 until end-2009, his findings suggest that the outflows affected above all banking sectors that had very high net foreign liabilities at the onset of the crisis (i.e. in the Baltic countries, particularly Latvia and Estonia) and banking sectors with comparatively low levels of foreign ownership (Slovenia, Ukraine and Russia).

A consensus seems to have emerged during the workshop on a set of conclusions which were shared by a number of papers. First, geographic proximity seems to have a positive impact on cross-border capital flows, both for international portfolio investment and interbank flows. Second, due to a higher degree of political, economic and financial integration, cross-border investments (again both portfolio and interbank loans) within the EU appear to be more stable compared to foreign investment in Asia and Latin America or investments from other regions in emerging Europe. Third, it appears that a stronger presence of foreign banks within the region was associated with a smaller decline in cross-border interbank flows in the post-Lehman period. Fourth, common external factors clear play a very important role in shaping capital flows to the CEE region. In particular, risk aversion (and expected financial market volatility) seems to be a very robust driver of capital flows. More specific to the CEE context, euro area macroeconomic and financial conditions have a significant impact on capital flows, especially in the case of cross-border lending. At the same time, domestic economic and financial conditions and policies, including structural reforms, also affect the ability of CEE countries to attract foreign capital. Fifth, there seems to be a broad consensus that outflows in the crisis period tend to be larger if they were preceded by rapid/large foreign capital inflows in the pre-crisis period.

Looking forward, these findings suggest that a stabilisation of global risk sentiment should result in a return to relatively favourable access of converging European economies to external funding. There are however three important restraining factors compared to the pre-crisis period. First, a key, and still open, question is to what extent there will be a lasting increase in risk premia on foreign investments after the crisis. Second, tighter financial regulation and supervision at the EU level (new supervisory architecture, higher capital requirements, etc) could reduce the willingness and capacity of EU15 banks to take risks in the CEE region. Third, a more cautious attitude of receiving countries is both likely and desirable. Domestic policies should in the future be employed more strongly to manage the risks associated with capital inflows and to ensure that these inflows are used more prudently in order to avoid a costly misallocation of resources.