Summary for non-specialists
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Determinants of Capital Flows To the New EU Member States Before and During the Financial Crisis

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This paper uses both descriptive and econometric techniques to analyse the characteristics and determinants of international capital flows to the EU New Member States from central and eastern Europe (NMS10). The descriptive investigation examines how the role played by various types of capital flows – direct investment, portfolio investment, financial derivatives and other investments – has varied over time and across countries. The analysis reveals that all NMS10 recorded large private capital inflows from the late 1990s until 2007 but that the global financial crisis presented a clear turning point. Since the end of 2007 the NMS10 have been experiencing an unwinding of capital flows, a process which was exacerbated when the financial crisis intensified in summer 2008. Foreign capital inflows to the NMS10 even turned negative in Q4-2008 and Q1-2009. Capital outflows were initially driven by portfolio investment and financial derivatives, with 'other investment' outflows (including interbank lending) materialising at a later stage. However, in the two countries receiving international financial assistance - Latvia and Romania – as well as in Lithuania and Slovenia, other investment flows represented the dominant channel of net foreign capital outflows throughout the whole crisis period. By contrast, direct investment remained a source of net foreign capital inflows into the region throughout the whole crisis period.

The econometric analysis separates the common component of capital flows – which, broadly speaking, reflects external conditions or "contagion" – from its country-specific component, which should be related to the country's economic fundamentals. It turns out that external factors have played a large role in explaining foreign capital inflows to the NMS10 although the responsiveness of capital flows to global factors varies across recipient countries. Lower interest rates and higher economic activity in the euro area seem to stimulate capital flows to the NMS10. Moreover, risk aversion seems to be a robust driver of capital flows. Investment flows to the NMS10 react significantly not only to risk sentiment in the euro area but also to country-specific risk. At the same time, the ability of the NMS10 to attract foreign capital has also been influenced by other domestic economic and financial conditions and policies, including short-term interest rates, GDP and house price growth.

Overall, the analysis in this paper suggests a need for caution by the NMS10 in borrowing too heavily during good economic times, especially if the capital flows are largely driven by external liquidity situation and economic conditions rather than by domestic 'pull' factors and are not directed at productivity-enhancing investment. Since a reversal in credit availability can be triggered by developments unrelated to the domestic policy framework, the accumulation of large external liabilities and/or high dependence on large foreign capital inflows are sources of high vulnerability to changes in the external and domestic environment and risk perception.