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Current Account Balances and External Debt in Transition Economies: Lessons for Central Asia

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In thinking about the transition economies, observers in the West often forget that the process of transition began less than ten years ago. In the late 1980's some of the central European countries in the Soviet bloc began to liberalize some aspects of their economies. Notably, the Poles became more supportive of independent entrepreneurs and the Hungarians introduced some non-state banking institutions. Nevertheless, the transition process did not get started until the political transformation of the entire Soviet bloc occurred in the early 1990's. There are now twenty six transition economies in Europe and Asia in an area where only nine political entities existed a decade ago (14 of the 26 were part of the USSR). These countries face many common challenges as they create independent enterprise sectors and the institutions to support them. However, the differences among these countries are astounding. On one hand, the real GDP per capita in the Czech republic and in Slovenia is close to the EU level. On the other hand, some of the central Asian and Southern European countries are in dire economic straits and have made only a little progress towards effective privatization and less progress towards building the economic infrastructure for a free economy.

The progress so far in the more advanced transition economies can provide valuable guidance to those countries that are at an earlier stage in the transition process. This is the perspective that I will take in discussing the balance of payments and foreign debt positions of the transition economies. A crucial issue for any country with chronic current account deficits is whether or not the imbalances are sustainable. The experiences of the more advanced transition economies can help us identify the characteristics of imbalances that may not be sustainable and, most importantly, identify the types of institutional developments that can help a transition economy avoid sustainability problems.[1]

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[1] This paper draws on my earlier work with Nouriel Roubini, *Current Account Sustainability in Transition Economies,* National Bureau of Economic Research Working Paper 6468, March 1998. That paper discusses current account sustainability in the more advanced transition economies of Central and Eastern Europe. It was prepared for the Third Dubrovnik Conference on Transition Economies held by the National Bank of Croatia, Dubrovnik, June 1997.

Current Account Trends and Developments in the Transition Economies[2]

The current account balances of all transition countries taken together (see Table 1) were in surplus in 1988 but this turned into deficits of $6bn. in 1989 and $22bn. in 1990 when the political transformation began. In the early 1990s, the aggregate current account balances varied from year to year. However, the overall deficit rose sharply to $19bn. in 1996 and $26bn. in 1997. IMF forecasts of the overall current account deficits for the transition economies in 1998 and 1999 exceed $30 bn.

While the aggregate data for the transition economies as a whole suggest that the current account imbalances have been modest in the 1991-1995 period, a disaggregation by sub-regions of transition economies presents a somewhat different picture. If we distinguish among three separate regions (Central and Eastern Europe, Russia, and Transcaucasus and Central Asia), we find that the small overall imbalances in the early 1990's were largely the result of the very large current account surpluses (in the range of $3-10bn.) in Russia. The other two subgroups had large current account imbalances that worsened in the mid-1990's. For example, the Central and Eastern Europe countries had imbalances averaging $5bn. per year in the 1991-1995 period; in 1996 this imbalance grew to $18 bn. and is expected to be exceed $20 bn. in 1998. The Transcaucasus and Central Asia group has a surplus in 1991 but deficits emerged in subsequent years and grew steadily to $5 bn. per year in the last three years.

Even this subgroup data are excessively aggregated as in each subgroup we observe large current account imbalances in some countries and surpluses in others. For example, EBRD data shown in Table 2, indicate that in the Central and Eastern Europe group, almost all countries had current account deficits above 4 percent of GDP in 1995 or 1996. In the Transcaucasus and Central Asia group, all but one of the countries for which we have data had current account deficits of at least 4 percent of GDP in 1995.

Distinguishing among different types of current account imbalances and determining whether the capital inflows are sustainable or are likely to derail the stabilization process will be critical issue in the late 1990's. The data suggests that the current account deficits can be classified into three episodes:

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[2] Trends in the current accounts of the transition economies are difficult to analyze for many countries because of the paucity of data. In many instances, only rough estimates of the overall current account balance are available and little or no information on the composition of current account and capital flows. For this reason it is useful to lump all of the transition economies together, a procedure followed in many IMF publications. Although, this approach aggregates many disparate situations, it provides us with an overall picture that can be used to discuss trends and issues.

- *Countries experiencing a collapse of output.* The collapse of production in the early stages of transition is often quite large. In 1991 and 1992, real GDP growth in all of the transition countries was -7.7% and -10.9% respectively. Positive real growth did not return to most of Central and Eastern Europe until 1993 and to the Former Soviet Union until 1997. As output collapses, national saving may fall a lot (more than national investment) since private saving falls sharply and the government deficit is large. In such instances, the current account deficit is a source of resources for both private and public consumption and is unsustainable if protracted for a prolonged period of time.

- *Countries experiencing capital outflow.* In some (but not all) countries, there is a period of extensive capital flight as the transition begins. In these instances a capital account surplus occurs and resources are diverted abroad from domestic investment.

- *Countries experiencing capital inflows.* Once a macroeconomic stabilization has been completed and positive GDP growth resumes, large capital inflows are fairly common. Such inflows come from foreign borrowing, portfolio investments, deposit inflows and foreign direct investments and finance both investment and consumption.

The sustainability of current account deficits has already been a critical issue in more advanced transition economies and several of them have had exchange rate crises or near crises. Most recently, the Czech Republic's devaluation of the Krone in mid-1997, indicated that unsustainable current account imbalances can develop rapidly in growing economies. Rapid economic growth and real exchange rate appreciation that results from a fixed nominal rate can easily lead to rapid increases in the size of current account deficits. IMF forecasts for real GDP growth in the transition economies are optimistic -- 2.9% in 1997 and 3.4% in 1998[3] (*World Economic Outlook,* May 1998) -- and suggests that sustainability problems might become common.

Lawrence Summers, the U.S. Deputy Treasury secretary, wrote in *The Economist* on the first anniversary of the Mexican financial crisis (Dec. 23, 1995 – Jan. 5, 1996, pp.46-48) "that close attention should be paid to any current account deficit in excess of 5% of GDP, particularly if it is financed in a way that could lead to rapid reversals." Although, large deficits can persist, an

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[3] The forecasts for Central and Eastern Europe excluding Belarus and the Ukraine are 4.4% and 4.6% respectively and for the Transcaucasus and Central Asia forecasts for 1998 and 1999 are 4.5% and 5.1% respectively. The forecasts for the transition economies as a whole are smaller because of slow growth forecast in Russia (1.0% and 1.9%), Belarus and the Ukraine.

imbalance is less likely to be unsustainable if (i) it is large, (ii) national saving is low and (iii) financing is not permanent and continuing.

Current account deficits up to now in the Central Asian republics have largely been due to the collapse of output in the early transition process. However, output growth has returned to much of the region. As the central Asian republics enter more advanced transition stages, the sustainability of even rather small current account deficits cannot be taken for granted. Rapid growth and low national savings can lead to difficulties unless sustained capital inflows can be counted on to finance deficits.

The return to economic growth is usually associated with a likely worsening of current account imbalances. The reason for this is that the return to growth will lead to a recovery of national investment rates that would worsen the current account. The return to growth will over time also increase national savings rates but not as much as investment rates. The increase in national savings rates will be due to an increase in public savings; as budget deficits are reduced as part of the stabilization efforts. However, private savings rates might not grow a lot and might actually fall: in fact, the experience of many developing countries suggests that high expected income growth often leads to increases in consumption rates that tend to depress private savings rates. Such a boom in private consumption driven by anticipated increases in future permanent incomes is likely to be even larger when the financial sector is liberalized and household have access to credit markets for consumption purposes.

Transition economies discover that current account deficits are difficult to avoid but that capital inflows that might in one year appear to be readily available can quickly disappear.

Capital Flows and the Composition of the Current Account

A useful way to begin to examine the potential problems is to decompose the current account balance in three different ways (see Table 3):

- The current account is the difference between national savings and investment.
- It is also the sum of three components:
    - the resource balance (or net exports of goods and services)
    - current (unilateral) transfers
    - and the factor income balance.
- Finally, the current account is the negative of the capital account balance or, more precisely:
    - Capital inflows

- Minus the change in foreign exchange reserves.

The decomposition of the imbalance between savings and investment shows why the overall imbalances were small (as a share of GDP) in the early transition years. There was a significant drop in the national savings rates of the transition economies as the result of persistently negative growth of rates of output that have depressed private savings and caused large public sector deficits. While the collapse in output at the outset of the transition process significantly depressed national savings, it has also drastically reduced investment rates. The fall in the savings rate was larger than that of the investment rate between 1990 and 1993 so that large current account imbalance emerged in that period. Between 1993 and 1995, investment rates fell faster than savings rate so that the current account imbalance tended to shrink. However, the more recent data and forecasts for the rest of the decade indicate that the current account imbalance will widen as the investment rate begins to increase (with the recovery of sustained growth) while the savings rate remains stagnant.

Further insights into the current account balances can be seen from the decomposition into a resource balance, factor income and current transfers. First, the resource balance (net exports of goods and non-factor services) is in structural deficit. Although such imbalances (as a share of GDP) fell from 1992 to 1995, trade deficits increased a lot in 1996 and are expected to continue to grow significantly.

Second, the factor income balance is structurally in deficit and is a major factor behind the overall current account imbalance. The transition countries are all net foreign debtor countries and the interest burden on the foreign debt is the most important cause of the large factor income imbalance. The interest burden on such foreign debt has declined as a percentage of GDP as a number of transition countries have rescheduled their foreign debt; however, it is expected to constitute about one-half of the overall current account deficit for the foreseeable future.

Third, swings over the 1990's in the size of unilateral transfers have a particularly important role. Unilateral current transfers were very large in the 1992-1994 period as the transition countries received a significant amount in official grants during the difficult early years of the transition process. These transfers were as large as the overall current account in those years. However, such current transfers have fallen significantly and are likely to remain fairly small.

The last two columns of Table 3 shows the change in foreign exchange reserves and uses the fact that current account and the capital account sum to zero to imply total capital inflows. In

the early 1990's the former Soviet economies used their foreign reserves to sustain the old economic system. In 1990 and 1991, the capital inflows were actually less than the current account deficits: therefore, the economies embarking on transition experienced declines in their international reserves. However, in 1992 a number of transition economies started to implement macro stabilization and structural reforms that led to a dramatic turnaround in the international capital positions. For the transition economies as a group, capital inflows exceed the current account deficits in almost every year since 1992. Foreign reserves increased substantially as the current account deficits were still modest and the capital inflows were significantly larger. Foreign reserves did not increase in 1996 as the capital inflows slowed down and IMF forecasts indicate that the inflows will moderate (as a fraction of GDP) in the remainder of the 1990's but will continue to exceed the current account. Although the capital inflows are expected to grow, the accumulation of foreign exchange reserves will be much smaller as current account imbalances are growing more rapidly.

Additional evidence on the composition of capital flows is shown in Table 4 which shows the components of total capital inflow or net external borrowing to the transition economies in billions of dollars. Specifically:

- Foreign direct investment
- Portfolio investment
- Other private inflows
- Official flows

The total capital inflow is shown inclusive of errors and omissions under the assumption that the bulk of the residual between the measured capital flows and the current account balances is due to unrecorded private external asset transactions. However, many transition countries have large amounts of hidden exports that would suggest that the errors and omissions be included in the current account.

At the start of the transition period, the current account deficits for all the transition countries were larger than the capital account balances, which showed an inflow equal to andofficial reserves of the transition countries fell in 1990-91. There were dramatic changes in capital flows to the transition countries starting in 1992 when the net capital inflows were $7 bn. while the current account deficit was $1 bn. Official reserves began to as the net capital inflows have been significantly larger than the current account deficits. In four years (1992-95) official reserves increased by a total of $62 bn.

There are several distinct stages to the capital flows to the transition countries. Prior to the transition, in 1988-1989, the capital inflow consisted mostly of bank and private sector capital market borrowing. However, these sources disappeared early in the transition period and there were net outflows (either reduced borrowing or portfolio outflows shown as other asset transactions) in the early 1990's. This situation was dramatically reversed in the mid-1990's when there were significant net inflows from foreign direct investment and loans from the IMF and other official creditors.

Foreign direct investment that was close to zero before 1990, started to pick-up in 1991 ($2.3bn) and has steadily grown since then to reach $13bn. in 1995 (about one-third of total capital inflows in that year); however, such FDI flows have been concentrated only in a few countries that are at an advanced stage of transition (Hungary, Czech Republic and Poland). FDI is expected to reach $20 bn. 1999.

The composition of the capital account is important because short-term capital inflows are more easily reversed than long-term flows and equity inflows are more stable than debt-creating inflows. A current account deficit that is financed by extensive foreign direct investments (FDI) is more sustainable than a deficit financed by short-term portfolio investments ("hot money") that may be easily liquidated if market conditions or sentiment change. Foreign direct investment provides the least threat of reversibility Moreover, FDI tends to finance long-term investment projects that increase the capital stock of the country and tend to generate revenues required to repay the foreign debt in the future. Nevertheless, for FDI to be a sustained source of financing, the economy must provide an investment climate with an ample supply of attractive new projects.

While FDI capital inflows represent long terms investment, debt-creating inflows may be short- or long-term investments. It is hard to measure precisely the short-term component of capital inflows. Portfolio investment and errors and omissions that often represent unrecorded capital inflows are likely to be short-term. Table 4 indicates that for the transition economies as a whole, FDI growth has leveled off while portfolio investment continues to grow.

There is an important caveat to be mentioned before we express additional concern about short-term portfolio flows. Countries with developed capital market structures that are able to allocate capital efficiently are going to attract more capital. Capital markets increase allocative efficiency and provide liquidity. For both reasons they are an essential element in creating an environment that is favorable to foreign capital. However, capital market instruments are likely

to facilitate short-term portfolio flows that can be destabilizing. Thus, capital market development is a two-edged sword. On one hand it increases capital inflows and on the other hand it facilitates potential outflows. The countries with the highest amount of portfolio investment - Hungary and the Czech Republic - also tend to have the largest total capital inflows.

Other capital inflows will increase the liquidity of the domestic banking system; sometimes in terms of foreign exchange denominated liabilities and sometimes in the form of the domestic currency if the central bank buys the foreign exchange in order to avoid an appreciation of the exchange rate. In either case, the domestic banks can have severe liquidity problems in the event of a capital outflow, particularly if their assets are in domestic currency and illiquid. Thus, the capital inflows can increase the riskiness of the banks. A capital outflow then can have severe macroeconomic consequences if it creates a domestic banking liquidity crisis that the central bank is unable to manage.

Finally, there is financing from official sources. Of course, financing from the IMF may be less unstable than financing from hot money. However, official financing does not makes a current account deficit more sustainable; rather, large IMF loans are a usually a signal that current account imbalances are already unsustainable. Early in the transition, official intervention often averted crises in countries that were virtually insolvent. In later stages of intervention, IMF intervention is often the response to a currency crisis and surely cannot be viewed as permanent alternative to private sector financing.

Official flows (grants and bilateral, multilateral and IMF loans) were particularly important in the early transitions years. For example, in 1991 only 29% of the net medium to long-term financial flows to central and Eastern European countries (including the Baltics) were private; this share went up to 92% in 1995 (see IMF *World Economic Outlook,* October 1996). The greater reliance on private creditors and lower flows from official creditors signals the increasing creditworthiness of the transition economies of Central and Eastern Europe that are now able to rely on private international financial channels for their financing needs. Similarly, the improved macroeconomic environments in some of the transition economies has led to the rapid development of capital markets (including equity markets with significant foreign participation) and international bank loans. But, increased reliance on private rather than official financing and portfolio investment also means that such flows may dry up and/or reverse if poor domestic and external economic performance leads to increased country riskiness.

The large capital inflows of the 1993-95 period also led to serious problems for monetary policy and exchange rate management. In fact, capital inflows in excess of the current account deficit would have led to nominal appreciations of the domestic currency that would worsen the country's competitiveness. Central banks often attempt to avoid such appreciation by buying foreign currency in large amounts which leads to increases in foreign official reserves. While the increases in foreign reserves made the current account imbalances of the period more sustainable, such large capital inflows also exacerbated the real appreciation of the currency observed in many countries. Large capital inflows and rising foreign reserves may at times give the wrong signal about the long-run sustainability of a persistent current account imbalance. While in the short-run they enhance sustainability, they might also prevent the necessary exchange rate adjustment required to reduce in the medium term the loss of competitiveness caused by a real appreciation. Once investors realize that such imbalance are not sustainable, a sudden reversal of capital flows may lead to a sharp reduction of exchange rate reserves and eventually cause an exchange rate crisis.

A new stage of the capital flows trend to transition economies has emerged since 1996 that can be described as one of *capital inflow fatigue*. In many transition countries, increases in the current account deficits have occurred as there have been significantly reduced capital inflows. The inflows are often below current account financing needs and therefore the stock of foreign reserves has stagnated or even fallen. Further indications of these developments are found in Table 5 which shows the total external debt of the transition economies. The external debts of the Central and Eastern European transition economies are increasing rapidly. It grew by about 4% per year from 1991 to 1996 and at about twice that rate since then. Total external debt in the Transcaucasus and Central Asia grew even more rapidly in the early transition period because most of these countries started with very low debt levels by agreement with Russia when they gained independence from the CIS. But the growth of external debt has continued at a rapid pace; it is estimated to be about 20% per year for the period 1996-98.

Since current account imbalances are likely to remain large, this *capital inflow fatigue* - if continued - may become a matter of concern as it would lead to further losses of foreign reserves. The problem for the transition economies would be exacerbated if interest rates in the developed countries increase. Higher world interest rates would hurt the transition economies in two ways. First, countries with large amounts of foreign debt would experience an increase in their debt servicing payment that would directly further worsen their current account balances. Second,

higher world interest rates may further reduce the capital inflows to the transition group and, for given unchanged current account balances, lead to further losses of foreign exchange reserves.

Capital markets and the Banking System

The health of the domestic financial sector is key to avoiding *capital flow fatigue* and enabling the transition economies to sustain current account deficits. First, a weak banking system will quickly reduce the willingness of foreign investors to hold portfolio or fixed assets in the country or their willingness to extend credit to a country. Furthermore, a weak banking system will lead to capital flight by domestic savers, which increases the difficulty of financing a current account deficit. Second, banks facilitate international payments and foreign exchange transactions. A weak banking system that cannot provide such services will inhibit trade. Third, and most importantly, the overall quality of the financial system and the efficiency of financial intermediation are the foundations for political and economic stability, the ability to withstand adverse shocks and the ability to develop a market economy.[4]

Most of the advanced transition economies have already experienced banking sector crises.[5] Many of the republics of the former Soviet Union have avoided banking crises because they have not yet acknowledged the problems in their financial systems. Banking crises have their origins in the establishment of the commercial banking system at the start of the transition process. The Soviet era mono-banks were transformed into central banks and state-owned commercial banks. The newly established state owned commercial banks were often poorly capitalized and often lacked the managerial incentives to avoid accumulating large portfolios of non-performing loans. The banks, either under instructions from the government or by force of habit, provided credit to state owned enterprises without applying the standards that should be applied to commercial lending.

As a result, many if not most of the state owned banks quickly became insolvent in the early part of the transition process. Various methods of recapitalization or restructuring the banks

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[4] The connection between banking and financial sector crises and current account crises in developing economies is discussed in Carl-Johan Lindgren, Gillian Garcia and Matthew Saal, *Bank Soundness and Macroeconomic Policy,* IMF, 1996 and G.M. Milesi-Ferretti and A. Razin, *Current Account Sustainability,* Princeton Studies in International Finance, No. 81, October 1996.

[5] For further discussion of banking crises in the Visegrad countries in particular see John Bonin and Paul Wachtel, "Towards Market-Oriented Banking in the Economies in Transition," in *Financial Sector Transformation: Lessons for the Economies in Transition,* edited by M. Blejer and M. Skreb, Cambridge University Press, forthcoming and J. Bonin, K. Mizsei, I. Szekely and P. Wachtel *Banking In Transitions Economies: Developing Market Oriented Banking Sectors in Eastern Europe,* Edward Elgar Publishing, 1998.

have been undertaken, and frequently more than once. Typically, restructuring involved the provision of government debt to the banks, direct government support, the transfer of bad loans to a separate institution, a so-called hospital bank, a loan workout program or a combination of approaches.

In addition, entry into the banking business was liberalized in the early transition period leading to a large number of private banks with small capitalization, limited banking skills and, most importantly, little regulatory oversight. Thus, irregular banking practices and banking sector crises were a common feature of all the transition economies.

Only in the mid-1990's did major changes in the banking sectors of transition economies become widespread starting in the Visegrad countries. Privatization efforts started with the Czech voucher scheme in 1992 and picked up steam in Poland from 1993 on and in Hungary from 1994 on. By 1997, large parts of the banking system in Hungary and to a somewhat lesser extent in Poland were privately owned.   Several approaches to privatization have been employed including voucher privatization, initial public offerings and participation of a (usually foreign) strategic investor or a combination of several techniques. Significant restructuring of the banking industry has taken place where strategic foreign investors have participated in the privatizations and where new private banks have attained significant market shares.

The existence of a large current account deficit can have implications for the stability of the domestic financial system in two ways. First, monetary policy enacted to enable a country to finance a current account deficit can be destabilizing for the macroeconomy and can lead to a banking sector crisis. Sharp increases in domestic interest rates which were introduced in order to attract and retain capital when capital inflows slow in the face of stubborn and large current account imbalances can lead to financial sector insolvency. Firms are unable to pay high rates and will default on existing bank debt or be given additional credits by the banks. Over time, efforts to finance the current account result in a banking sector with large portfolios of non-performing loans. Thus, efforts to use tight monetary policy to finance the current account deficit can be extremely disruptive to the financial system.

Second, the efforts of the banks to finance their activities can precipitate a foreign exchange crisis. With a current account deficit, the domestic banks can borrow abroad to provide financing. Easy access to foreign sources of funds can lead to poor lending and to severe difficulties when the domestic currency depreciates. Furthermore, a foreign exchange crisis can be the result of poor lending practices by banks that use foreign funding sources.

There are additional relationships between the current account and the banking sector. For example, countries with relatively sound banking systems and somewhat developed financial and securities markets may well attract portfolio investments. But financial sector development can be a mixed blessing; if it encourages short-run portfolio investments ("hot money"), they can be easily reversed and lead to sustainability problems. The converse to this problem is that a weak banking sector leads to capital flight. A strong banking system is needed to improve the transparency of financial flows and the efficiency of intermediation which are essential to sustaining capital inflows.

Current Account Balances in the Central Asian Republics

Table 6 presents a summary of the balance of payments in the Central Asian Republics. Most of the region is in the early stages of transition where the collapse of domestic savings leads to extremely large current account deficits except where there are substantial natural resource exports. However, in most instances the dollar amounts are not large by international standards and modest amounts of foreign direct investment and official sources of financing are adequate.

The situation in the Kyrgyz Republic is in many ways typical. The current account deficit is an extremely large fraction of a depressed level of GDP. This is typical for a country in the early stages of transition. The more alarming aspect of the situation is that capital inflows which were large at the start of the transition have leveled off, foreign exchange reserves did not increase in 1996 (the last available data) and foreign direct investment remains small. Similar conclusions can be drawn from the data for Azerbaijan, Tajikstan and Uzbekistan. Kazakstan and Turkmenistan are exceptions because of the energy exports.

Although the published data are rudimentary and often not up to date, they do show reason for concern. In the absence of official inflows, these countries would likely already experience balance of payments crises. The problems are exacerbated by the fact that the banking sectors in the Central Asian republics are still in need of reform. As GDP in the Central Asian republics begin to grow, the current account deficits will be larger in dollar terms as they become a smaller fraction of GDP. Official inflows are unlikely to grow as rapidly. If *capital inflow fatigue* emerges and official flows become less readily available, these countries could quickly find themselves in crisis.

Thus, it is important to ask what are the other likely sources of financing of growing (dollar) current account deficits. Will FDI increase rapidly? Will capital flow fatigue spread

from Eastern Europe to Central Asia? Will domestic financial institutions attract portfolio investments and bank loans without excessive reliance on sovereign borrowing?

Answers to these questions are difficult, if not impossible, and the best we can do is look at some of the indicators of current account sustainability that suggest answers. Table 7 shows some standard indicators of current account sustainability.

- A traditional measure of the adequacy of foreign exchange reserves is the stock of reserves in months of imports (of goods and services). The data show wide variation from almost zero to 9 months in Turkmenistan. By comparison, the average for the four Visegrad countries for 1995 was 6.5 months

- The ratio of money assets to foreign reserves is an additional indicator of reserves adequacy because, in the event of an exchange rate crisis or panic, liquid money assets can be converted into foreign exchange. Table 7 shows the ratio of the monetary base (M0) to foreign reserves and the rate of M2 to foreign reserves.[6] In general reserves do not look small if compared to monetary base but may not be as adequate relative to total liquid assets in those countries where M2 is several times larger than foreign reserves.

- An economy more open to trade may be less fragile to external imbalances than a more closed economy because a country's ability to service its external debt in the future depends on its ability to generate foreign currency receipts. Openness is measured by the ratio of the average of exports and imports to GDP. The Central Asian Republics are all quite open although much of their trade is with the former Soviet Union or because of the energy industry. In most instances there is not enough diversification of exports to be confident that the ratio will not fall as GDP recovers.

- Additional indicators of sustainability are the foreign debt to GDP ratio and the debt or debt service to exports ratios (which are not shown here). According to the World Bank classification, a country is heavily indebted when the debt to export ratio is above 220% and moderately indebted when the ratio is above 132%. By this standard, the Central Asian Republics are remarkably without debt. However, this is misleading because these countries all came into existence without any debt when they left the CIS. The ratios have probably been increasing in recent years.

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[6] These ratios may be hard to interpret because the ratio of M2 to GDP varies a great deal across countries depending on the development of the banking system and the amount of financial intermediation that occurs. Thus, the M2 to reserves ratio may high because banking intermediaries are relatively more developed.

- The level of foreign direct investment is an additional indicator of sustainability since it is the most stable form of capital inflow and the least likely to be reversed. FDI inflows (see Table 6) to the Central Asian Republics have been restricted to energy and some other natural resource developments and are otherwise very small.

- Finally, political instability and the country risk that comes with it are important indicators of sustainability. Many of the countries in Central Asia are experiencing difficult political environments and varying degrees of political instability caused by a combination of domestic and external political problems.

Conclusion

The current account imbalances in the transition economies are not an easy subject to investigate for several reasons. To begin, many of the countries are just beginning to collect data consistent with international standards and build national income accounts that can show savings and investment balances reliably. In addition, data on capital flows, which are notoriously inaccurate, are also less reliable in transition economies without systems of financial recording. Also, judgments about the current account often require an understanding of real exchange rates, which are particularly hard to define in transition economies. Finally, the available data are hard to interpret because the macroeconomic situations in these countries are evolving very rapidly.

Although difficult, assessing the current account imbalances in the Central Asian republics is of great importance. These countries tend to have large imbalances (as a fraction of GDP) because of the large early-transition declines in output. In dollar terms the imbalances are not large because of the collapse of output. Although, the imbalances will be a smaller fraction of GDP in the future, they will grow in dollar terms as investment increases more rapidly than savings.[7] The external situation in Central Asia is misleading for another reason as well. The external debt burden may seem small because there is no debt burden inherited from the Soviet era.

The puzzle for the future is whether additional official and new private sector capital inflows will enable these countries to sustain current account deficits and growing GDP levels or

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[7] Throughout this paper, I have argued that GDP growth in transition economies will increase current account deficits as investment grows more rapidly than savings. In his discussion of this paper in Bishkek, Mr. John Odling-Smee of the IMF suggested that this conclusion may be too hasty. National saving consists of saving by households, enterprises and the government. Although household consumption is likely to grow rapidly, improved tax collections could reduce government deficits and enterprise saving (retained earnings) might grow as growing firms are eager to finance investments.

whether *capital flow fatigue* and a slowdown in official financing will throw the countries into crisis.

My intent in this paper has been to see whether answers to the puzzle in Central Asia can be learned from the experiences of the more advanced transition economies of Central and Eastern Europe for the Central Asian Republics. What are those lessons?

To begin, policymakers ought not be dulled into inaction by the current situation. It can change very quickly as an increase in GDP will quickly generate much more rapid increases in consumption and investment. Thus, unsustainable current account deficits can emerge very rapidly. This is especially the case if monetary authorities maintain relatively fixed exchange rates that allow for excessive real exchange rate appreciation.

Relatively large current account deficits may be easy to finance for a time as capital flows from official sources will be replaced by capital flows from private sources. Relatively low debt and interest burdens will encourage such flows. However, the *capital inflow fatigue* phenomenon can set in quickly. Initial bursts of investor interest – FDI and portfolio investment – will disappear if ample investment opportunities and institutions for intermediation do not develop. Thus, inflow fatigue can create problems even when the overall debt burden seems to be modest.

Thus, the importance of developing an economic and financial infrastructure cannot be underestimated. Both direct and financial investments require an environment that is friendly to capital inflows. These include the development of legal and accounting frameworks that provide investors with some certainty of control.

Most importantly, an environment that favors inward investment must be developed. That is, it must be supportive of entrepreneurial activities, it must provide the financial and legal services for venture capital, bank lending and other forms of finance. A stock market is just the last point on a long continuum of forms of financing that starts with personal and enterprise savings, venture capital activities, new forms of financing such as leasing and mortgages and so on. All of these must be encouraged and feasible to avoid capital inflow fatigue and support domestic savings. These are formidable challenges that are yet to be met in Central Asia.

Table 1
Current Account in Transition Economies
(billions of U.S. $)

	TOTAL for Transition Economies	Central and Eastern Europe	Russia	Transcaucasus and Central Asia
1988	2			
1989	-6			
1990	- 22			
1991	3	-6	4	5
1992	-1	2	-1	-1
1993	-7	-9	3	-1
1994	4	-5	10	-1
1995	-4	-6	4	-2
1996	-19	-18	2	-4
1997	-26	-20	-1	-5
1998 (f)	-33	-22	-6	-5
1999 (f)	-35	-23	-7	-5

Source: IMF *World Economic Outlook,* May 1997, December 1997, May 1998.

(f): forecast

Table 2
Current Account Balance as Percent of GDP

	1995	1996
Central and Eastern Europe		
Albania	-7.6	-4.7
Belarus	-2.4	-6.7
Bulgaria	-0.5	1.3
Croatia	-9.4	-7.6
Czech Republicd	-2.8	-8.1
Estonia	-4.7	-10.3
Hungary	-5.7	-3.8
Latvia	-3.7	-7.2
Lithuania	-4.4	-4.4
Macedonia	-6.1	-7.8
Moldova	-8.6	-13.1
Poland	4.7	-1.0
Romania	-4.9	-5.9
Slovak Republic	-2.2	-10.2
Slovenia	-0.2	0.3
Ukraine	-4.2	-2.7
Russia	1.3	2.3
Transcaucasus and Central Asia		
Armenia	-37.6	-26.6
Azerbaijan	-11.5	-23.6
Georgia	-8.3	-4.9
Kazakstan	-4.0	-3.4
Kyrgyz Republic	-19.3	-23.7
Tajikistan	0.2	-10.9
Turkmenistan	-0.3	1.7
Uzbekistan	-0.5	-7.9

Source: EBRD *Transition Report 1997.*

Table 3

Savings, Investment, Current Account and Its Financing As a Perecnt of GDP

	Savings	Invest-ment	Current Acct.	Net Exports	Factor Income	Current Transf.	Capital inflows	Chg. in Reserve
1990	27.7	29.0	-1.3	-1.2	-0.6	0.5	1.1	-0.2
1991	29.7	31.1	-1.4	0.9	-3.1	0.8	0.8	-0.6
1992	26.6	31.2	-4.6	-2.1	-4.7	2.2	6.3	1.7
1993	22.3	27.3	-5.0	-3.3	-3.2	1.5	7.9	2.9
1994	24.8	25.9	-1.0	-0.2	-1.8	1.0	2.5	1.5
1995	23.7	23.5	0.2	-0.4	0.0	0.7	3.8	4.0
1996	22.0	22.4	-0.4	-2.3	1.2	0.7	0.3	-0.1
1997	19.0	22.3	-3.3	-2.7	-1.4	0.8	4.2	0.9
1998 (f)	19.2	23.0	-3.8	-2.7	-1.7	0.6	4.4	0.6
1999 (f)	20.0	23.7	-3.7	-2.6	-1.7	0.5	4.3	0.4

Source: IMF, *World Economic Outlook,* May 1997, May 1998. (f): forecast.

NOTE:

Savings – Investment = Current Account =
Net Exports (resource balance) + Factor Income + Current Transfers =
-   [Capital inflows – Change in Foreign exchange reserves]

Table 4

Capital Inflows In Transition Economies
(billions of U.S. $)

	Current Account	Increase in Reserves	Capital Inflow	*OF WHICH:* FDI	Portfolio Investment	Other Pvt. Investment	Official Inflows
1992	- 1	6	7	4	- 1	4	0
1993	- 7	12	19	6	4	2	3
1994	4	9	5	5	4	9	-11
1995	-4	36	40	13	3	14	8
1996	-19	0	19	13	2	6	-6
1997	-26	6	32	18	7	9	1
1998 (f)	-33	5	38	19	9	8	4
1999 (f)	-35	4	31	20	10	10	-4

Source: IMF *World Economic Outlook,* December 1997, May 1998. (f): forecast

Table 5
External Debt of Transition Economies

	TOTAL for Transition Economies	Central and Eastern Europe	Russia	Transcaucasus and Central Asia
1990	201			
1991	211	114	95	1
1992	212	105	105	2
1993	232	116	110	5
1994	247	120	120	7
1995	266	136	120	10
1996	277	141	124	12
1997	285	151	119	15
1998 (f)	301	163	119	19
1999 (f)	313	178	114	21

Source: IMF, *World Economic Outlook,* May 1998.

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Table 6

Balance of Payments in the Central Asian Republics

(millions of $ unless indicated)

	1992	1993	1994	1995	1996	1997
Kyrgyz Republic						
Current Account		-267	-201	-391		
As % of GDP		*-27%*	*-20%*	*-24%*		
Current Account (EBRD data)	-61	-162	-124	-288	-414	
Capital Account		73	108	230		
Overall Balance		-134	-56	-29		
Change in For. Reserves		35	32	0		
For. Dir. Invest.		10	45	61		
External Debt		290	414	543	746	
Azerbaijan						
(to Q3 96 only)						
Current Account			-121	-379	-476	
As % of GDP			*-8%*	*-13%*	*-20%*	
Current Account (EBRD data)	488	2	-121	-318	-811	-725
Capital Account			54	456	413	
Overall Balance			-79	145	-10	
Change in For. Res.			2	161	2	
For. Dir. Invest.			22	277	409	
External Debt						
Kazakstan						
Current Account	-1900	-400	-905	-709	-768	-1400
As % of GDP				*-4%*	-3%	
Capital Account			1194	1367	1797	
Overall Balance			298	-79	74	
Change in For. Res.			326	287	227	
For. Dir. Invest.			635	859	1220	
External Debt		1848	2717	3428	3890	
Tajikistan						
Current Account		-208	-170	1	-110	
As % of GDP		*-31%*	*-23%*	*0%*		
Capital Account		-29	-52	-133		
Overall Balance		-238	-223	-132		
Change in For. Res.		2	-1	3		
For. Dir. Invest.		9	12	13		
External Debt	0	509	760	817		

Turkmenistan						
Current Account		776	84	23	43	
As % of GDP		*20%*	*2%*	*1%*	*2%*	
Capital Account		-551	-208	-51	55	
Overall Balance		446	135	113	73	
Change in For. Res.		79	103	233	129	
For. Dir. Invest.		446	135	113	73	
External Debt		168	418	550	668	
Uzbekistan						
Current Account	-238	-429	118	-49	-1075	-500
As % of GDP	*-12%*	*-8%*	*2%*	*-1%*	*-8%*	
Capital Account	224	858	-64	255	545	
Overall Balance	530	487	298	431	-50	
Change in For. Res.	530	492	309	578	33	
For. Dir. Invest.	9	48	73	-24	50	
External Debt	62	1039	1107	1781	2330	

Source: International Monetary Fund, *Staff Country Reports*; European Bank for Reconstruction and Development, *Transition Report 1997.*

Note:

> *Current Account – Capital Account + Errors and Omissions and other payments*
> *= Overall Balance*
> *= Change in Foreign Exchange Reserves + Exceptional financing*

Table 7

Current Account Sustainability Indicators in Central Asia

	Gross Reserves in months of imports	*M0/FX*	*M2/FX*	*Openness (X+M)/ GDP*	*External Debt as % of GNP*	*External Debt as % of Exports*	*Debt Service as % of Exports*
Kyrgyz	2.0			.57	16.2	129.8	18
Azerbaijan	1.5		2.56	.55	3.1	17.7	10
Kazakstan	3.4	.64	1.06	.56	14.9	88.1	6
Tajikstan	0.1		6.51	1.99	28.7		53
Turkmenstan	9.0	.03	.07	1.54		17.2	16
Uzbekistan	4.8	.13	.20	.62	5.4	33.0	8

Sources: International Monetary Fund, *Staff Country Reports;* European Bank for Reconstruction and Development, *Transition Report 1997;* World Bank, *World Development Report, 1996.*