The 12 new member states of the EU (NMS) have been running quite sizable current account deficits which have averaged 5.6% of GDP over the last decade. These deficits have increased slightly since these countries officially joined the European Union. The average deficit during 1999-2003 was 4.9% of GDP while it increased to 6.3% of GDP during 2004-2008. Using non-weighted averages the increase has been slightly larger, growing from 5.1 to 8.9% of GDP due to the fact that the current account deficits have been particularly large in the smaller Baltic economies. Large current account deficits, although somewhat typical of all the emerging economies in Europe, are presently atypical of most emerging markets which have increasingly been running current account surpluses. For 2008, five of the NMS had current account deficits greater than 10% of GDP and all of them were above 3.0%. With the global tightening of credit conditions, these deficits now represent a serious macroeconomic vulnerability; the required economic adjustments in terms of exchange rates, credit growth, asset prices, and fiscal spending will be significant and could potentially precipitate domestic financial crises in these economies. Already Hungary and Latvia have experienced some difficulty and over the next year a number of others are likely to require IMF borrowing or some other form of assistance in order to replace their more limited access to private international capital markets.

Rapidly growing and fundamentally sound economies like those of the new EU member states should be able to borrow externally and thereby run large current account deficits for a considerable period of time. They have been doing this for almost a decade and as a result their businesses have been able to invest more and their residents consume more than would have been possible otherwise. That development model is now being tested severely by the current financial crisis. The degree to which they will be able to maintain capital inflows and growth over the next year will have important implications not only for them, but for what is generally considered to be a desirable development model. The world’s overall assessment of the acceptability of, and the need for, a fundamental reform of the current international monetary architecture will also depend critically on what happens in these economies.

Savings and Investment in the NMS

Given these sizable, persistent and somewhat atypical current account deficits, questions arise as to what have been the underlying factors causing them. Since a current account deficit is an accounting identity equal to the difference between national savings and investment, one way to address this question is to ask whether they are due to insufficient savings or excessively large investment; in other words, in the identity below, is the negative current account (CA) due to S (savings) being too small or is I (investment) too big?

\[ CA = S - I \]

There are however, several ways that this question can be answered. For instance, the actual values of savings and investment can be compared to international norms in order to see to what degree the NMS values are “abnormal”. Alternatively, current values of saving and investment can be compared to historical values for these economies when they did not have large current account deficits in order to see what changed in order to bring them about. Unfortunately for a clear interpretation of the underlying cause of the NMS deficits, these two approaches provide somewhat different answers. In Figure 2, savings and investment in the NMS are provided for the last decade and are compared to that of its closest reference.

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1 Bulgaria and Romania did not join the EU until 2007 while the other ten joined at the beginning of 2004. Although this article focuses on the 12 NMS, the situation of the south-east European countries, some in various stages of EU accession, are roughly similar.
group, the upper-middle income countries. For the NMS, investment exceeds savings as expected from the current account identity presented above, and the increase in the difference in the last several years is due solely to an increase in investment as savings actually increased very slightly. Unfortunately there is no historical period for which there is consistent and reliable data where savings and investment were equivalent which would allow a more complete answer to this question. Thus, from a historical point of view all that can be said is that the more recent increases in the size of the deficits in the NMS are due to increasing investment.

However, a comparison of the NMS with the upper-middle income countries suggests that deficient savings is also important. The NMS have on average an investment rate which is higher by four percentage points of GDP due possibly to the many opportunities of EU membership although this differential has not increased since well before EU accession. In terms of other geographical comparison groups, investment rates in the NMS are above those in Latin America but below those in east Asia. In terms of savings, the NMS have savings rates in the range of two to three percentage points of GDP lower than the upper-middle income countries. Thus, comparatively speaking, the NMS appear to under-save and over-invest, with the latter slightly more important.

This pattern of deficits for the NMS is really not that different from the longer-term pattern of the southern European economies (Greece, Portugal, and Spain) which have also financed much of their investment over the last two decades from foreign borrowing. In fact, even now, these three economies, in aggregate, have even larger deficits (as a percentage of GDP) than the NMS. Empirical research has shown that being in the EU increases the magnitude of the absolute value of the current account as a percentage of GDP while being in the eurozone increases it further; the poorer economies generally have deficits. The so-called Feldstein-Horioka estimate of the correlation between savings and investment was only 0.14 in the eurozone during 1991-2001. This suggests that in the eurozone investment is now largely independent of savings with the difference readily financed by international capital flows.

What lies behind these savings and investment patterns? A factor often alleged to contribute to a current account deficit by lowering savings is a government budget deficit, the so-called twin deficits proposition. Since a government budget deficit represents dis-savings, it is clear from the identity above that lower public savings could reduce total national savings and thus create a current account deficit. However, except for Hungary, the NMS do not have large public deficits and therefore this would not appear to be a significant factor causing savings to be so low in these economies. In fact as shown in Figure 3 there is a rather strong negative relationship between the budget balance and the current account balance for these economies.

Thus the reason for low domestic savings in the NMS must be low private savings, but exactly why pri-

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2 The use of the appropriate reference group has important implications for this comparison as savings and investment rates for the NMS are lower than for many developing countries but somewhat higher than the advanced economies.


4 It is sometimes alleged that public dis-saving leads the private sector to compensate by saving more as they anticipate higher future taxes will be necessary to pay off the debt accumulated. This proposition, known as Ricardian equivalence, has mixed empirical support.