3 Structure of the international investment position of new European Union member states in 2007–2016

Introduction

After 2004, 13 states acceded the European Union, most of them from the Central and Eastern Europe. The majority of the so-called new members were less developed than the old EU members. Integration with the common European market provided them with an easier access to the financial resources of other states with which they finance investments carried out in the country on account of their insufficient savings.

The import of foreign capital finds its reflection in a current account deficit as well as in growing foreign liabilities. It may cause a loss of external balance of an economy, thereby increasing a risk of a sudden departure of capital destabilizing country's finances (International Monetary Fund, 2013). It is confirmed by the experiences of the most recent crisis which affected many European Union states, particularly the ones most indebted (Gross, 2015). It showed that better monitoring and analysis of risks related to long-term external imbalance are required in order to prevent the loss of a country's financial stability. International investment position is an important tool for the evaluation of an economy's external balance. It provides information about both the volume and the structure of invested foreign capital at home and abroad. From the point of view of evaluating the risk of a sudden capital departure, not only does the country's net IIP play a significant part but so does the analysis of its structure. A growing share of debt instruments in the creditors' structure results in an increased risk related to a sudden mass departure of non-residents from the national financial market.

The purpose of the paper is to present and evaluate the changes in the structure of the international investment position of the countries that

acceded the European Union in 2004 and later in terms of the security of financing their economies with foreign capital. The study was conducted for the years of 2007–2016. In the first part the author presented the role of foreign liabilities and assets structure for the stability of external financing of the economy, while in the second part the structure of net international investment position (net IIP) of these countries was discussed along with its change after the crisis. The research method enabling the achievement of the objective included the analysis of statistical data, which was complemented by the study of literature on the subject regarding the impact of foreign assets and liabilities structure on the status of a country's external balance. The results were prepared on the grounds of Eurostat data.

1. The structure of international investment position and the stability of external financing of the economy

In 2008 a global crisis broke out that triggered a deep recession in the real sphere and led to disturbances in the financial markets of the European Union. One of its causes was a growing external imbalance, demonstrated through lasting current account deficits and a mounting foreign debt of certain member states (Alessandrini, Hallett, Presbitero, Fratianni, 2012). Considering the negative consequences of the crisis, at the end of 2011 the European Union implemented solutions that were to detect and remedy the disturbances of macroeconomic balance, not only in external terms, but also internal ones. One such solution is the so-called Macroeconomic Imbalance Procedure, the objective of which is, inter alia, to facilitate an early diagnosis and monitoring of macroeconomic balance disturbances in all of the EU member states. Within the scope of the procedure the European Commission each year prepares a report in which it evaluates the economic and financial situation of member states based on the analysis of a number of indicators. One of such basic indicators regarding an internal balance is the relation of net international investment position (net IIP) to GDP, for which a threshold value of –35% GDB was adopted.

The use of international investment position for the evaluation of an economy's external balance results from the fact that it reflects a wide scope of a country's financial ties abroad. The IIP value can impact on an economy's capacity to serve its liabilities towards non-residents, to contract new liabilities and it further influences the balance of payments (NBP, 2016, p. 61). A negative net IIP value means that there is an excess of foreign liabilities over assets and it reflects the scale of the demand for an economy's net foreign financing. From the research it follows that a high negative IIP value increases the probability of an economy's financial destabilisation as a result of a sudden foreign capital departure. A crisis typically causes a decrease in economic activity and a growth of the risk of debtors' insolvency on account of their deteriorating financial situation (Fidora, Schmitz, Tcheng, 2017, p. 4). Apart from the value and balance of foreign assets and liabilities, their structure plays a significant role in evaluating the risk resulting from excessive negative IIP (Knap, 2016). The structure divided into functional categories, i.e. a division into direct, portfolio investments, other investments and derivative instruments are, among other things, of significant importance.[1]

In the literature of the subject the dominant view is that direct investments are the most stable element of foreign liabilities (Loungani, Razin, 2001). It results from the long-term nature of those investments as well as their generation of profit from the conducted business activities; hence the probability of a sudden capital departure is relatively lower than in the case of other foreign investments. It applies in particular to the part of direct investments that were made in the form of a contribution of participating interest. It is particularly important at the age of growing attacks from speculative capital.

Differently than in the case of bank loans, or the issue of debt securities, the above-specified type of foreign financing allows for a division of risk between an investor and a borrower, since the investor gains profits from a financial enterprise only when it generates profits, and not

[1] An analysis of a time, object and currency structure also plays an important role; however, on account of the limited scope of the paper, it will not be the focus of this paper considerations.

as in the case of debt financing, where profit is earned irrespectively of the borrower's financial situation (Svrtinov, Trajkovska, Kostadinovski, 2013). From the point of view of a country accepting capital it means that in a situation when unforeseen economic disturbances occur, such as, for instance, a recession or changes in the terms of trade, then a decrease of real income will result in a drop of foreign shareholders' income, and simultaneously payments in the balance of payments on account of a dividend paid to foreigners will be lower as well (Krugman, Obstfeld, 2007, p. 266).

A high share of direct investments in foreign liabilities causes certain indicators, employed to evaluate a country's external balance, i.e. gross and net foreign debt in relation to GDP, to be lower than net IIP, because liabilities of participating nature are not recognized in this category. Nevertheless, such a position results in capital outflow in the item of primary income of the balance of payments, which in turn requires a persistent trade surplus in order to maintain long-term stability (a report of the European Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee, 2015, p. 26).

It is worth mentioning that from certain studies it arises that in the course of the crisis foreign direct investments could become increasingly volatile. The studies of S. Claessens, M. Dooley and A. Warner demonstrate that foreign direct investments do not differ from other forms of capital flows in terms of their volatility and predictability (Claessens, Dooley, Warner, 1995, p. 161). It ought to be associated, inter alia, with the fact that this form of capital flows comprises, apart from share capital, also loans granted by foreign investors. This type of capital is significantly easier to withdraw than stock or share issue is, while at the same time the loans granted are typically short-term in nature. Furthermore, the volatility of direct investments is also affected by their sectoral structure. During the recent crisis FDI turned out to be only slightly more stable than other forms of capital inflow. It could be due to the increase in capital inflows in the categories of finances and real property services, which occurred to be prone to credit booms (Brzozowski, Śliwiński,

Tochorek, 2014, p. 14). Sudden halt in capital inflow in this form may have negative consequences for a country, especially if it is dependent on external financing.

Differently from FDI, two remaining forms of capital flows, i.e. portfolio investments and other investments (mostly bank capital) are perceived as less dangerous forms of external financing of the economy. In the case of portfolio investments, their main objective is investment portfolio diversification aimed at reducing risk and increasing profits. Capital in this form is highly mobile, i.e. it can be easily withdrawn from the country, when the situation in it deteriorates or global investment conditions change. Foreign investors with no capital ties are the most susceptible to agency ratings and herd mentality, owing to informational asymmetry in relation to national investors (Lojsch, Rodriguez-Vives, Slavik, 2011, p. 33). In crisis situations they transfer their capital to foreign markets more quickly. When evaluating risks related to portfolio investments, it is important to differentiate between liabilities of participating nature (which chiefly involve acquisition of stock) and debt liabilities (including mostly the issue of bonds and treasury bills). From the research it follows that debt liabilities may be less stable that the liabilities of participating nature (Brzozowski, Śliwiński, Tochorek, 2014, p. 8). They are more susceptible to global factors, e.g. interest rate differences between countries, which affect their profitability. A sudden assets sale by foreign investors may cause problems with debt refinancing, particularly when information about a growing risk of insolvency becomes public. A significant foreign debt to GDP ratio may be a harbinger of an imminent risk. On the other hand, liabilities in the form of a participating interest involve a lower risk on account of potentially substantial valuation changes during the crisis (COM 2016, p. 13).

Another form of foreign direct investments, i.e. other investments, comprises both non-residents' deposits at national banks, credits and loans granted by non-residents to national entities, as well as commercial credits (i.e. transactions of debt nature). The use of each of these forms exerts a different influence on the economy. For instance, in the case of commercial credits the risk of a drop in foreign financing is lower than

in comparison to different forms of other undertakings, because they are a reflection of the foreign trade exchange conducted by a country, which usually is not subject to significant changes. In turn, bank capital is perceived as one of the least stable categories of foreign investments. Transmission of crises, starting with the Asian crisis, in many cases has occurred through the so-called "infection" in the interbank market (Brzozowski, Śliwiński, Tochorek, 2014, s. 10). The OECD studies confirm that the risk of a crisis increases along with a debt growth in a country's foreign liabilities, particularly the growth of a bank debt (OECD, 2012).

When evaluating a country's susceptibility to limitations in capital inflow, one also needs to take into account the value and structure of foreign assets. A high share of foreign assets reduces the risk of a financial crisis occurring or being transmitted. Official reserve assets, which by definition are characterised by a high degree of liquidity, and the aim of which is alleviating any shocks caused by a significant capital departure, play a significant role in that respect. In the case of other forms of foreign assets, it is difficult to assess to what extent national entities would be able to use the assets allocated abroad as a source of foreign currencies, if demand for them increased.

2. Structure of foreign assets and liabilities in new European Union member states

In 2008, which was at the time of the financial crisis outbreak, net IIP (expressed as % of GDP) assumed high negative values in all of the examined countries (with the exception of Malta), owing to previous current account deficits. A high negative net IIP value indicates these countries' reliance on external financing and it creates an external threat to the economy's macroeconomic stability. After the crisis, a drop in the negative balance or the emergence of current account surpluses resulted in an improvement of that relation, however, in a majority of the states (except for Malta, the Czech Republic and Slovenia) the values persistently exceeding that threshold were still being recorded, which constituted a source of risk for these countries' economies (Table 1). As previously mentioned, the risk related to a high negative international investment

position in individual countries varies, depending on the structure of foreign assets and liabilities. The liabilities related to direct investment and those in the form of participating interests pose a lesser risk.

Table 1

Net international investment position net in 2007–2016 (% PKB)

Specification	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Bulgaria	–81	–98.4	–101.8	–92	–83	78	–73	–75	–64	–51
Croatia	–92	–73	–87	–93	–91	–90	–88	–87	–78	–71
Cyprus	12	–79	–100	–111	–130	–129	–139	–147	–131	–126
Czech Republic	–37	–36	–44	–46	–43	–46	–39	–36	–34	–25
Estonia	–71	–76	–80	–71	–54	–51	–50	–46	–41	–37
Lithuania	–55	–52	–58	–56	–52	–53	–47	–46	–45	–43
Latvia	–69	–74	–83	–83	–74	–67	–67	–64	–62	–58
Malta	22	5	13	12	6	19	21	43	49	47
Poland	–49	–47	–60	–65	–58	–67	–70	–68	–61	–61
Romania	–49	–48	–62	–63	–64	–68	–62	–57	–51	–49
Slovakia	–52	–58	–67	–62	–64	–61	–62	–64	–61	–58
Slovenia	–26	–39	–44	–47	–45	–50	–47	–44	–39	–34
Hungary	–89	–96	–120	–108	–94	–93	–83	–75	–63	–59

The shade areas mark where the indicator value surpasses the indicative thresholds.

Source: Eurostat Database.

Over the course of 2007–2016 direct investments played a substantial role in the structure of foreign liabilities in most of the examined states. At the end of 2007 they constituted the largest component of foreign liabilities in 8 out of 13 states, namely: in Malta (69%), Hungary (64%), the Czech Republic (60%), Slovakia, Bulgaria (57%), Cyprus (56%) as well as in Croatia and in Poland (Figure 1). What is more, after the crisis, in the majority of the researched countries, the share of direct investments in the structure of their liabilities rose. The greatest growth was recorded at the end of 2016 in relation to 2007 and it occurred in Estonia (by 13.6 percentage points [pp]), in Malta (8.7 pp), in Hungary (7.5 pp) and in Cyprus (7 pp). In turn, at the same time their role in Croatia, the Czech Republic, Lithuania, Poland and Slovakia diminished. In the latter country the drop was greater than 10%, but direct investments still

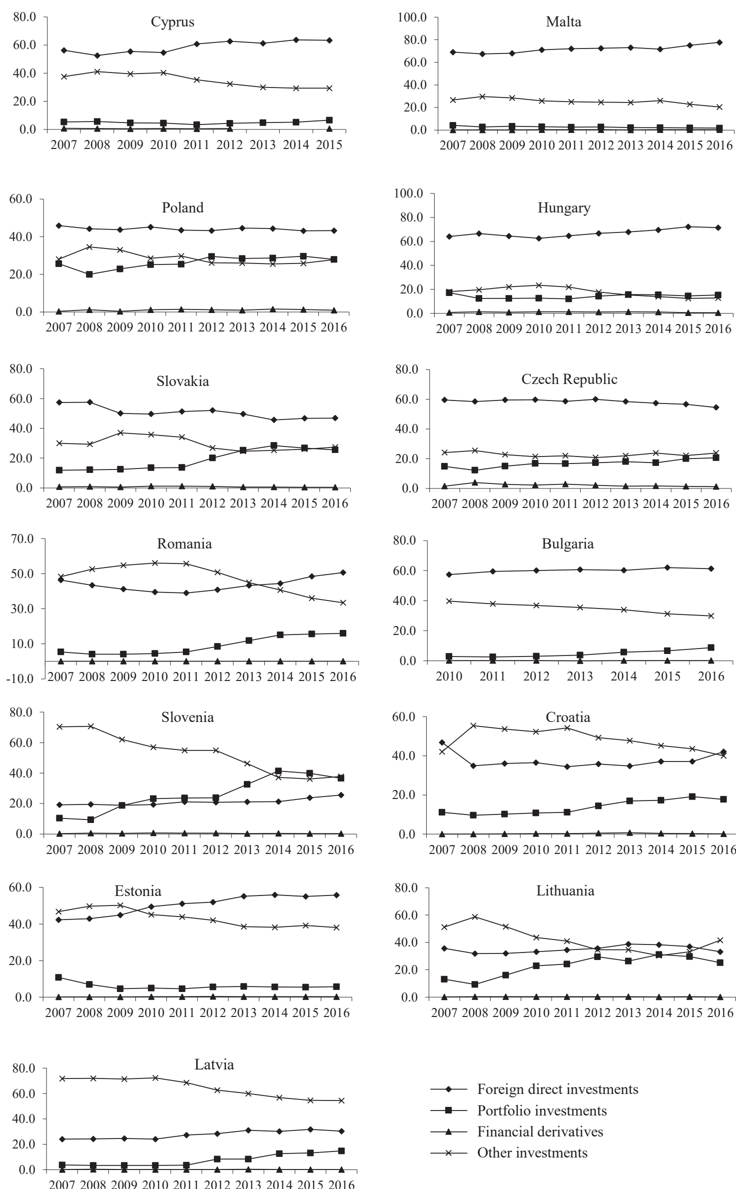

Figure 1. The structure of external liabilities of new EU member states

Source: own estimates based on the Eurostat Database.

remained a dominant component of the structure throughout the entire analysed period, similarly to the case of Poland and the Czech Republic, where such drops were smaller. At the end of 2016 direct foreign investments were the main liabilities components in 10 out of 13 states (apart from those stipulated for 2007, additionally in Estonia and Romania). Such structure of foreign liabilities reduced the risk associated with a high negative net IIP value. On the other hand, in the period between 2007 and 2016 direct investments played a relatively minor role in the structure of foreign liabilities in Slovenia and Latvia (less than 30%) and in Lithuania (35%), which could have increased the risk of a sudden capital departure, yet their share in the liabilities structure in the two former states did not grow during the examined period.

Despite many an advantage that financing in the form of direct investments offers and a growing significance of this form of foreign liabilities, debt capital, i.e. other investments and portfolio investments into debt instruments, constituted a significant portion of foreign liabilities for certain countries. At the end of 2007, other investments were the main component in 5 out of 13 examined states, namely: in Latvia, in Slovenia (in these two states they constituted over 70% of total foreign liabilities). After the crisis the share of liabilities on account of other foreign investments in total fell in all of the analysed countries. The greatest decrease of more than 30 pp was recorded in Slovenia. Two-digit drops also occurred in Latvia, Romania and Bulgaria. In 2016 liabilities on account of other investments dominated in total liabilities only in three countries, i.e. in Slovenia, Latvia and Lithuania, but their significance was substantially lesser than in the pre-crisis period. In the remaining investigated countries they typically ranked second in the liabilities structure.

Reduction of the role of other investments in the liabilities structure of the countries studied has largely resulted from a decrease in bank liabilities, thanks to credits and loans received by banks as well as funds allocated by non-residents at bank current and deposit accounts after the crisis. At the end of 2008, in a majority of investigated states, bank capital held a dominant position in other foreign investments (Table 2). Its share was particularly high in Latvia and Estonia, where it exceeded

70%. It increased the countries' susceptibility to external threats. In the post-crisis period the role of bank capital in other investments has diminished in all the countries apart from the Czech Republic. Although at the end of 2016 substantial differences existed in terms of the share of bank capital in foreign liabilities, in all the countries (except for the Czech Republic) that figure no longer exceeded 50% of foreign liabilities on account of other investments.

Table 2

Share of banking capital in other investments (%)

Specification	2008	2016
Bulgaria	32	19
Croatia	31	18
Cyprus	58	27
Czech Republic	43	53
Estonia	72	47
Lithuania	68	25
Latvia	71	45
Malta	65	56
Poland	44	34
Romania	45	23
Slovakia	60	29
Slovenia	51	13
Hungary	51	32

Source: own estimates based on the Eurostat Database.

At the same time, in all the countries under investigation (with the exception of Estonia, Malta and Hungary) portfolio investments, which, as was already mentioned, are easily disposable, started to gain significance. In the years 2007–2016 their importance grew the most in Slovenia (26.0 pp), Slovakia (13.6 pp), Lithuania (12.2 pp), Latvia (11.2 pp) and in Romania (10.5 pp). Despite that, at the end of 2016 they did not play any significant part in the liabilities structure of the majority of the states. Their share was the highest in Slovenia, followed by Poland, Slovakia, Lithuania and the Czech Republic (and it was equal to, respectively, 36.5, 28.0, 25.5, 25.2 and 20.5%). Debt securities in the countries listed constituted a principal part of non-residents' portfolio. Furthermore, their share

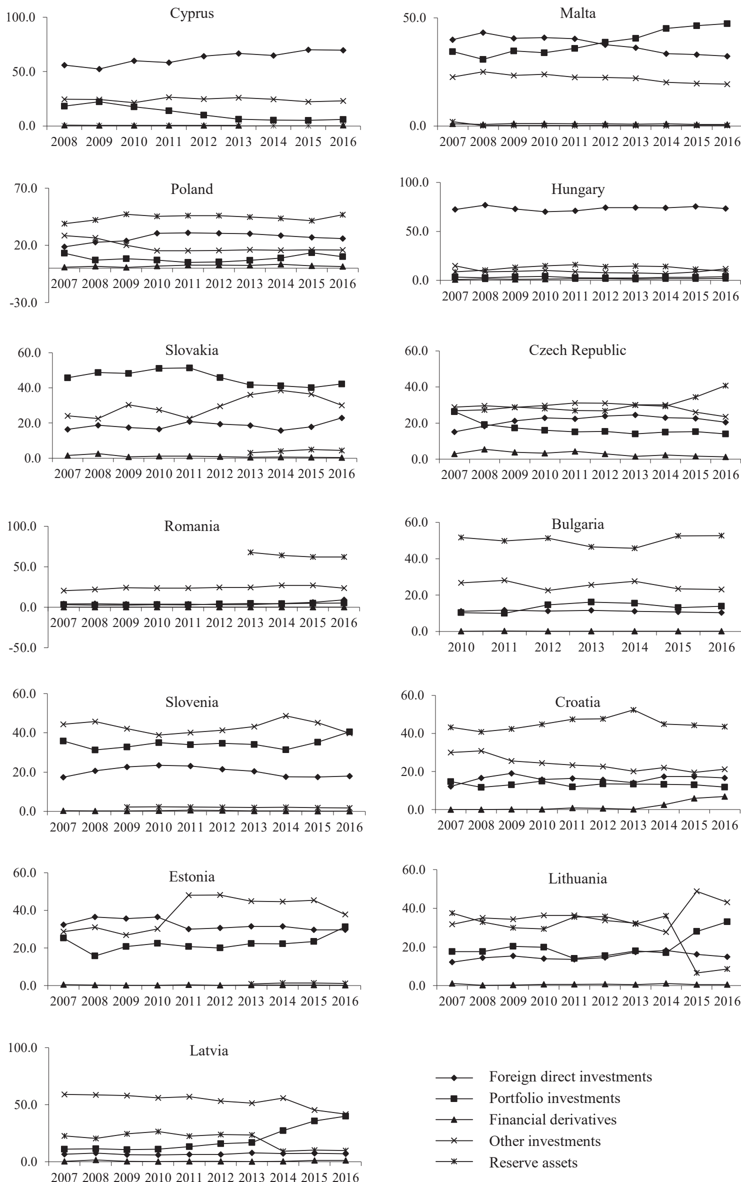

Figure 2. The structure of external assets of new EU member states

Source: own estimates based on the Eurostat Database.

after the crisis grew and at the end of 2016 it exceeded 75%.[2] It means that the role of participating interest, which is less dangerous from the point of view of an economy's financial stability, was indeed smaller.

However, when evaluating the structure of the new EU member states' foreign assets, in terms of their external stability, it becomes evident that in all the countries not belonging to the euro zone, i.e. in Poland, the Czech Republic, Romania, Bulgaria and Croatia (with the exception of Hungary), official reserve assets played a substantial part in the entire researched period (Figure 2). A high level of reserve assets was the factor reducing high negative net IIP values. An insignificant role of currency reserves in the remaining examined countries was owed to the fact that by accessing the monetary union they transferred their contribution in reserve currency assets to the ECB.

Conclusions

From the conducted analysis it follows that external threats related to a high negative net IIP value decreased in most new EU member states during the examined period:

1. In 2007, in all the analysed states (with the exception of Malta) net IIP (expressed as % of GDP) featured high negative values. As a consequence of the crisis the relation has improved, yet in most countries (apart from Malta, the Czech Republic and Slovenia) values persistently exceeding the threshold were recorded, which constituted a source of risk for these countries' economies. In 2016 the burden of net foreign liabilities was especially high in Cyprus.

2. Nevertheless, the risk related to a high negative net IIP value was being reduced by favourable structure of foreign liabilities in a majority of the investigated countries, where foreign direct investments played a substantial role. The share of foreign direct investments after the crisis increased and at the end of 2016 they constituted the main component of liabilities in 10 out of 13 analysed states. The growth of importance of

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[2] Own calculations based on the Eurostat Database, http://ec.europa.eu/eurostat/data/database (10.09.2017).

foreign direct investment occurred chiefly at the expense of other investments, particularly bank credits, which from the standpoint of financial stability of the examined countries ought to be considered as beneficial.

3. In the analysed group of countries, Slovenia, Lithuania and Latvia featured a high share of debt liabilities, which could have increased the risk of sudden capital outflow from those countries. The structure of those countries' foreign liabilities was dominated by liabilities on account of other investments, however, after the crisis their importance diminished, similarly as in the remaining countries, owing to a reduced commitment of capital in the banking sector. Nevertheless, at the same time the importance of portfolio investments, particularly debt investments, featuring a high degree of mobility, increased, which may have intensified their susceptibility to external risks.

4. Official asset reserves of the central banks had a significant impact on foreign asset structure of the analysed countries (the ones not being part of the euro zone), the share of which in total foreign assets amounted to approximately 40%, which served as a security against any crisis phenomena.

5. Although the external position of the sates has improved, efforts to reinstate the balance ought to be continued, as it is the external stability, among other things, that will determine whether these economies will be able to continue the catching-up process.

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Structure of the international investment position of new European Union Member states in 2007–2016

Summary. The objective of this paper is to demonstrate the impact of the financial crisis on the structure of international investment position of the states that acceded the European Union in 2004 and later. The study was conducted for the years of 2007–2016. The paper is divided into two parts. The first part presents the role of the structure of foreign assets and liabilities for the stability of external financing of an economy, while the second part demonstrates the structure of net international investment position (net IIP) of those countries and its changes after the crisis. From the study conducted it follows that in a majority of the researched countries the share of foreign direct investments within their foreign liabilities increased after the crisis. As a result, the risk related to their high negative net IIP diminished. Reserve assets dominated in the structure of foreign assets of the states that are not part of the euro zone.

Keywords: net IIP, international investment position structure, financial stability, new European Union members

JEL classification: F36

Struktura międzynarodowej pozycji inwestycyjnej nowych krajów członkowskich Unii Europejskiej w latach 2007–2016

Streszczenie. Celem opracowania jest ukazanie wpływu kryzysu finansowego na strukturę rodzajową międzynarodowej pozycji inwestycyjnej krajów, które przystąpiły do Unii Europejskiej w 2004 roku i później. Badanie przeprowadzono dla lat 2007–2016. Pracę podzielono na dwie części. W pierwszej przedstawiono rolę struktury rodzajowej pasywów i aktywów zagranicznych dla stabilności zewnętrznego finansowania gospodarki, w drugiej zaś strukturę międzynarodowej pozycji inwestycyjnej netto (MPI netto) tych państw oraz jej zmiany po kryzysie. Z przeprowadzonych badań wynika, że po kryzysie w większości badanych krajów wzrósł udział zagranicznych inwestycji bezpośrednich w strukturze zobowiązań zagranicznych. W efekcie zmniejszyło się ryzyko związane z ich wysoką ujemną MPI netto. W strukturze aktywów zagranicznych krajów niebędących członkami strefy euro dominowały aktywa rezerwowe.

Słowa kluczowe: MPI netto, struktura międzynarodowej pozycji inwestycyjnej, stabilność finansowa, nowe kraje Unii Europejskiej

Klasyfikacja JEL: F36