Chapter 5

Implications of Globalization on Growing External Debt in Eight Transition Economies

Marko Jeločnik
Institute of Agricultural Economics, Serbia

Jovan Zubovic
Institute of Economic Sciences, Serbia

Mihajlo Djukic
Institute of Economic Sciences, Serbia

ABSTRACT

External debt accumulation is a common feature of transition economies during the process of economic transformation. Insufficient domestic resources and low savings as typical problems in these countries have to be fulfilled through some form of external capital. This chapter analyzes determinants and trends of external borrowing in eight transition European economies. It is shown that despite a positive correlation between external debt and economic growth in the initial phases of transition, its further accumulation is associated to higher risks in terms of macroeconomic stability. This has also been proved during the recent economic crisis when external debt in most of countries recorded sharp rise. If further trends of rising external debt accumulation continue, observed economies might face serious economic problems related to debt repayment and lower growth perspectives.

INTRODUCTION

After the political changes in 1989, Central and Eastern European countries (CEE) started processes of political and economic transformation aiming to catch up with the developed Western economies. One of the main economic issues that CEE economies faced during the transition period was how to provide financial resources for the economic development. Due to insufficient domestic resources and low savings, those countries were mainly oriented on external sources of capital.

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In this chapter, the authors aim to analyze the external debt dynamics in the eight transition economies – Bulgaria, Croatia, Czech Republic, Hungary, Romania, Slovakia, Slovenia, and Serbia, in the period 1991-2014. The external debt situation within this group of countries differs strongly from the very beginning of the transition period. Poland, Hungary, and Bulgaria were running large foreign debt at the beginning of the 1990s, inherited from the communist period. While Poland owed mainly towards official creditors, Hungary and Bulgaria were indebted to commercial banks (Manzocchi, 1997). Other countries such as Former Yugoslav countries and Czechoslovakia accumulated debt during the communist period, although not having such an unfavourable starting point. Problems in those countries arose later during the transformation period. Croatia is now one of the most indebted countries with a strong reliance on external borrowing from unaffiliated lenders. Croatia, Hungary, and Serbia are demonstrating vulnerability on multiple fronts with an external debt to GDP ratio higher than 90% (International Monetary Fund, 2014a). Romania started transition period with a low external debt to GDP ratio. In fact, Romania used to take credits abroad during the 1970s, but decided to repay external creditors including multilateral lenders in advance, during the 1980s (Buiter & Lago, 2001). During that period, citizens paid terrible price of lowered consumption and imports. However, external sustainability worsened significantly during the period of global financial crisis. In the period 2007–2013, external debt recorded sharp increase while institutional creditors have been replaced by private ones (Milea, 2014). According to International Monetary Fund (2014a) data, Romania had external debt to GDP ratio above 70%. In summary, countries with the highest external debt exposure in the public sector at the moment include Hungary and Serbia, while countries with the highest external debt exposure in the private sector include Hungary, Bulgaria, and Croatia.

It could be noticed that all countries faced serious fluctuations of the external debt in the observed period. Bulgaria for example started its transition period with a ratio of external debt to GDP of over 120% (Buiter & Lago, 2001). Bulgarian government declared unilaterally a moratorium on external debt repayment at the beginning of transition, consequently putting country out of the international market (Mihov, 1999). After economic collapse in 1997, total foreign debt that was mainly coming from government borrowing declined from 100% of GDP in 1997 to less than 60% in 2003 (Ognivtsev, 2005). As a result of recent financial crisis, Bulgarian external debt rose amounting to 95.9% of GDP in 2013, mainly due to private sector external exposure. When considering external debt to GDP, Hungary is the most indebted country. As a result of debt accumulation in the communist period, Hungary had unfavourable starting position. For that reason, policy makers decided to lead outward oriented economic transition (Pogátsa, 2009). After the period of late 1990s and early 2000s, when huge capital inflows were obtained through privatization and country recorded strong and stable economic growth, in the light of economic crisis Hungary started to run high budget deficits and now is facing the highest external debt exposure in the public sector together with Serbia and Croatia.

For the most of the observed countries, private sector is financed by the bank loans as a main form of external borrowing. Public sector on the other hand borrows differently which mainly depends on the level of development of financial markets. For example, due to undeveloped domestic bond market, Bosnia and Herzegovina and Albania mainly borrow through external loans (International Monetary Fund, 2014a).

In this chapter, the authors aimed to investigate on which principles Central and Eastern European countries based their policy of providing financial resources from abroad. Within the analysis, it has been examined whether external debt is a consequence of public or private sector external debt rise. In the Background section, a breakdown of current literature on external debt impact on economic growth,
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