V

Integration of the Transition Countries into the Global Economy

The reintegration of the transition countries into the world economy is an essential element of their transformation process. For 50 years or more, these countries were engaged in an experiment in central planning that encompassed not only the domestic economy but also international economic relations. International trade and payments were largely directed by government rather than by market forces, and the group of countries involved limited their economic ties with the rest of the world as they sought to develop their cohesion and interdependence with each other. Trade and financial relations between the centrally planned economies and the market economies atrophied, while among the market economies they burgeoned. The failure of the experiment eventually became clear: before the shift to central planning, a number of countries in central Europe had per capita incomes equivalent to between one-half and two-thirds of those of the most advanced western European economies; by the end of the experiment they had fallen significantly further behind.

The countries in transition are now reversing the inward-looking legacy of central planning as they seek to catch up with a world economy whose performance has demonstrated the benefits of open international economic relations. This process of reintegration, through trade and financial flows, like other elements of the transformation process, is bound to take time, especially given that the dislocation created by central planning and by the isolation associated with it was so great. That dislocation, though not involving the physical destruction of capital, is comparable in some ways with that suffered by western Europe in World War II; in that case, substantial economic recovery may be considered to have taken a decade or more. Most of the countries in transition are now five to seven years into the transformation. How much has been achieved as far as reintegration is concerned? This question forms the main focus of this chapter.

The first part of the chapter examines the progress made in the liberalization of trade and payments arrangements—the policy area most closely connected with the reintegration objective. It is shown that there has been considerable variation across countries in the pace and extent of trade liberalization, that a majority of countries have fully removed exchange restrictions for current account transactions, and that several countries have taken steps to liberalize financial flows.

The second part looks at developments since the beginning of the transition in the growth and distribution of trade. It is shown that for many countries, there has been a massive reorientation of trade flows, as the concentration of trade with former partners in the Council for Mutual Economic Assistance (CMEA) has been replaced by a more balanced and market-determined distribution of exports and imports. In particular, the geographically proximate countries of the European Union now play a much more prominent role. The increasing reintegration into the global trading system has already been accompanied by some growth in productivity and wages in the transition countries, and these trade links represent an important channel through which these countries are gaining technological knowledge and managerial skills. Even though trade restrictions in the advanced economies do not in general appear to form a major impediment to the export of most manufactured goods, restrictions affecting certain "sensitive" industrial products and agriculture, where the transition economies have comparative advantage, have been, and remain, a significant obstacle to the full development of trade links.

The final part of the chapter examines the integration of the transition countries into the global financial system. Progress here is necessarily less far advanced than in trade. This is to be expected because the development of financial relationships and financial flows depends, in a way that trade does not, on such factors as an investor-friendly legal system and framework of property rights, taxation, and governance; macroeconomic stability; political stability; the soundness of the domestic financial system; and investor confidence. As experience in many contexts shows, these take time to build, even with the most sound and consistent policies of stabilization and reform.

The evidence presented in this chapter suggests that the reintegration of the transition economies into the global economy is still very much in progress. And the progress made differs widely among countries, as is indicated by Table 21. This shows that even though the relationship is not tight, partly because other factors are involved, the countries more advanced in transition, in terms of general progress with stabilization and reform policies, tend to be relatively advanced in the reintegration and also relatively advanced in eco-

Table 21. Countries in Transition: Progress in Integration and Economic Performance

	Transition Progress	Date of	Measures of Integration			Economic Performance in 1996	
	Transition Indicators[1]	Article VIII Acceptance[2]	Openness to trade[3]	Credit rating[4]	FDI per capita[5]	Yearly inflation (In percent)	Growth of real GDP (In percent)
Countries more advanced in transition[6]							
Czech Republic	3.4	10/95	60	IG	586	9	4.2
Hungary	3.4	1/96	33	IG	1,198	24	1.0
Estonia	3.3	8/94	80	. . .[7]	573	23	3.1
Poland	3.3	6/95	26	IG	121	20	5.5
Slovak Republic	3.2	10/95	63	IG	130	6	7.0
Croatia	3.1	5/95	49	IG	122	3	5.0
Latvia	3.1	6/94	50	IG	236	19	2.5
Slovenia	3.1	9/95	49	IG	325	10	3.5
Lithuania	2.9	5/94	30	SIG	66	25	3.5
Countries less advanced in transition[6]							
Russia	2.9	6/96	16	SIG	32	48	–2.8
Albania	2.7	. . .	26	. . .	77	13	8.2
Kyrgyz Republic	2.7	3/95	44	. . .	22	30	5.6
Moldova	2.7	6/95	53	SIG	44	24	–8.0
Bulgaria	2.6	. . .	32	SIG	70	123	–9.0
Kazakstan	2.6	7/96	31	SIG	166	39	1.0
Macedonia, former Yugoslav Republic of	2.6	. . .	45	. . .	33	2	1.1
Romania	2.6	. . .	30	SIG	66	39	4.1
Armenia	2.4	. . .	37	. . .	10	19	6.6
Georgia	2.4	12/96	15	. . .	3	40	10.5
Ukraine	2.4	. . .	44	. . .	21	80	–10.0
Uzbekistan	2.4	. . .	30	. . .	8	54	1.6
Azerbaijan	1.8	. . .	40	. . .	69	20	1.3
Belarus	1.8	. . .	39	. . .	5	52	2.0
Tajikistan	1.7	. . .	165	. . .	10	443	–7.0
Turkmenistan	1.1	. . .	177	. . .	84	992	–3.0
Memorandum							
Mongolia[8]	. . .	. . .	38	. . .	13	50	3.0

Sources: European Bank for Reconstruction and Development (EBRD); and IMF staff estimates.
[1]Simple average of the EBRD *Transition Report's* nine indicators of progress in transition.
[2]Formal acceptance of the obligations of Article VIII of the IMF's Articles of Agreement generally represents the culmination of a process of liberalization of payments for current account transactions. Liberalization therefore usually preceded to a substantial extent the dates shown.
[3]Ratio of the average of exports and imports to GDP in 1996.
[4]IG denotes investment grade, SIG sub-investment grade; see Table 25.
[5]Cumulative 1991–96 per capita inflows in U.S. dollars; see Table 26.
[6]The allocation of transition countries to these two groups is an imperfect simplification, since the degrees of progress by different countries are closer to a continuum.
[7]The authorities in Estonia have deliberately not sought a credit rating.
[8]There are no transition indicators available for Mongolia.

nomic performance.[86] The countries that have made the most headway are in general significantly more advanced in trade than in financial flows. But many countries lag behind, and a few have made little progress at all.

[86]The measures used in the table are necessarily imperfect indicators. For example, ratios of trade to GDP reflect not only the degree of countries' integration with global markets but also country size, since large countries, being relatively self-sufficient, tend to have smaller trade flows, relative to the size of their economies, than small countries.

Liberalization of Trade and Payments

International trade played a smaller role under the system of central planning than in the market-based advanced and developing countries. To a large extent isolated from the world trading system and depending on a largely command-driven distribution of production responsibilities among the CMEA countries rather than on comparative advantage, these countries missed out on many of the benefits of trade. Under central planning, countries were also largely cut off from the international financial system. National currencies were not convertible, and domestic financial

sectors and payments systems were not equipped to deal with international transactions. The planned economies had access to international loans, but foreign borrowing was undertaken by state banks on behalf of governments, and there was no direct linkage between this inflow of funds and internal economic activity and financial conditions.

Currency and Payments Arrangements

Orderly currency arrangements and a well-defined exchange rate policy, together with an effective payments and banking system and properly functioning foreign exchange markets, are prerequisites for international financial integration. Central and eastern European countries and the Baltic countries were able to make progress in these areas early in the transition because of the existence or introduction of independent national currencies and a rapid reorientation of trade and financial flows to the advanced economies, particularly in western Europe. Russia and most other countries of the former Soviet Union, on the other hand, were faced with a more prolonged period of uncertainty regarding monetary arrangements.

Most of the central and eastern European economies, which inherited national currencies, moved toward current account convertibility in the initial stages of the transition. Similarly, soon after gaining independence, the Baltic states took steps to introduce convertible currencies; Estonia and later on Lithuania also established currency boards. Estonia and Latvia in fact established fully convertible currencies, with no capital controls; and in practice Lithuania also has not applied such controls. Russia and other countries of the former Soviet Union continued to participate in a ruble area that, de facto, came into existence following the dissolution of the Union at the end of 1991. Attempts to sustain the ruble area failed, as member states could not agree on a workable institutional structure and rules for monetary coordination.[87]

By early 1994, all the countries in the region except Tajikistan had introduced separate currencies or coupons. Tajikistan introduced its own currency in May 1995, while Georgia and Ukraine replaced temporary national currencies with permanent ones in September 1995 and September 1996, respectively. Progress toward current account convertibility has been consolidated by the increasing number of countries accepting the obligations of Article VIII of the IMF's Articles of Agreement (see Table 21).

Several transition countries have also taken steps toward capital account convertibility, the eventual realization of which will allow free movement of capital, and which is a requirement for membership in the EU. As mentioned above, the Baltic countries have not applied capital account restrictions since the outset of the transition. The countries that have become members of the OECD the Czech Republic, Hungary, and Poland—have taken measures to ease restrictions on capital flows, including inward real estate acquisitions and outward long-term portfolio investments. Substantial restrictions on capital flows remain in many of the countries less advanced in the transition—including surrender requirements on foreign currency earnings and prohibitions on ownership of foreign equity—but these restrictions are in practice often circumvented.

The transition countries inherited a settlement and banking system that was not designed to handle decentralized payments across countries. In particular, Russia and other countries of the former Soviet Union were confronted with severe payments problems following the dissolution of the Union, as they unsuccessfully attempted to sustain a ruble area. From the beginning of 1994 on, with the introduction of new currencies and the progressive elimination of controls on correspondent accounts, the opportunities for the decentralized financing of trade in the region improved. Problems remain, however, with clearances sometimes taking as long as two weeks. Trade finance facilities and mechanisms to deal with exchange rate fluctuations and with risks of nonpayment and nonperformance are still missing. Several countries—Belarus, Turkmenistan, and Uzbekistan in particular—continue to impose significant restrictions on their foreign exchange markets.

Trade Liberalization

The pace and extent of trade liberalization have varied greatly across the transition countries, with a number of countries, particularly the Baltics and the countries of central and eastern Europe, moving rapidly toward relatively liberal trade regimes. Contributing to the recovery of trade among these countries themselves following the initial collapse at the start of the transition, but also carrying risks of trade diversion from other partner countries, has been the formation of regional free trade areas. These include the Central Europe Free Trade Area (CEFTA), composed of the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia, and the Baltic Free Trade Area (BFTA), which comprises the three Baltic countries. Attempts at free trade areas within the Commonwealth of Independent States (CIS), which would also carry risks of trade diversion, remain embryonic.

[87]The initial monetary uncertainty in the region is described in Thomas Wolf, Warren Coats, Daniel Citrin, and Adrienne Cheasty, *Financial Relations Among Countries of the Former Soviet Union,* IMF Economic Reviews, No. 1 (February 1994); and in Thomas Wolf, "Currency Arrangements in Countries of the Former Ruble Area and Conditions for Sound Monetary Policy," IMF Paper on Policy Analysis and Assessment 94/15 (July 1994).

Despite the progress that has been made, barriers remain to trade among the transition countries, even for trade within the free trade areas, with restrictions concentrated in goods such as light manufactures and agricultural products, which make up an important part of transition country exports. These import restrictions have taken the form of both nontariff barriers and import surcharges. Although most restrictions on exports have been removed, these have been replaced in some instances by administrative procedures that impede trade. Moreover, protectionist sentiment has grown in countries where recovery has lagged. For transition countries to benefit from a continued expansion of trade, unilateral and multilateral steps will be needed to reduce trade barriers further.

Securing access to export markets in the advanced economies—the destination for the majority of exports from most non-CIS countries—is also of vital importance for the transition countries. A number of countries in the Baltics and central and eastern Europe received most-favored-nation status under the GATT early in the transition, and many of these enjoy preferential market access under bilateral arrangements such as the "Europe Agreements" concluded with the EU. Membership of the WTO has been extended to the transition countries in central and eastern Europe, with the exceptions of Albania, Croatia, and the former Yugoslav Republic of Macedonia, the applications of which are still being considered, and also to Mongolia. The Baltic countries, Russia, and most other countries of the former Soviet Union have also requested to join the organization. Nonetheless, substantial barriers, particularly import quotas, remain to transition country exports of "sensitive goods," such as agricultural products, iron and steel, textiles and apparel, and footwear, all of which are goods in which the transition countries would reasonably be expected to have comparative advantage vis-à-vis the advanced economies. Transition country exports also continue to be affected by antidumping actions, which often in effect penalize firms that are most successful at exporting.

Following the breakup of the Soviet Union, CIS countries attempted to maintain existing trading partnerships on the basis of government-negotiated, bilateral commodity delivery agreements. With the exception of Turkmenistan, direct state involvement has since been reduced. CIS countries continue, however, to negotiate delivery agreements, and the prices of some traded products remain below world levels, though movement toward market-based pricing continues. This state involvement in trade impedes industrial restructuring, distorts relative prices, and provides incentives for the accumulation of interstate arrears and the creation of fiscal burdens through price subsidies. It is important that it be reduced, with official procurement limited to satisfying government needs.

Revival and Reorientation of Trade

Since the start of the transformation, trade, particularly with the advanced economies, has become an increasingly important part of the transition country economies. In many countries in central and eastern Europe, the ratio of trade to output has risen from only 10 percent or less in 1990 to upward of 20 percent in 1995 (Chart 42). In the Baltics, Russia, and other countries of the former Soviet Union, the share of trade in GDP has fallen, but this reflects the collapse of trade within the former Soviet Union, while trade with the rest of the world has expanded, particularly in the Baltic countries. The average degree of openness to trade in the transition economies today compares favorably with both the advanced economies and developing countries. A word of caution is in order, however, since for a number of reasons output may be understated, so that the ratio of trade to output may be overstated. As discussed in Box 5, for example, there is evidence that official measures of output do not capture burgeoning informal and private sector activity, and thus tend to overstate the ratio of trade to GDP unless trade flows, for which there are typically more reliable data, are similarly understated.

A massive reorientation of trade followed the collapse of central planning, as import demand collapsed with the drop in output in most transition countries, and as the artificial patterns of trade within the former system were replaced by trade relations determined by market forces. This has led to increased trade with the advanced economies, particularly in Europe. This change in trade flows away from former centrally planned partner countries toward the advanced economies is evident in the central and eastern European countries (Chart 43). These countries benefited not only from their geographical proximity to western Europe, which now accounts for 60 percent of their trade, but also from better initial economic conditions, more rapid reform and macroeconomic stabilization, and more rapid improvements in market access granted by the advanced economies. However, this high degree of dependence on western European export markets makes the exports of the central and eastern European countries particularly sensitive to growth in the countries of the European Union, as was seen in the first half of 1996 when exports to western Europe fell as growth there slowed. Trade among the countries of central and eastern Europe has recently picked up, particularly among the CEFTA countries, where trade grew by 6–9 percent in the first half of 1996. Even so, aside from trade between the Czech and Slovak Republics, this trade accounts for only about 6–10 percent of total trade for each CEFTA member. Trade with developing countries has remained roughly constant at between 10 and 15 percent of total trade.

For the Baltics, Russia, and other countries of the former Soviet Union, trade with the advanced economies is also now far more important than during the period of central planning, with substantial changes evident as early as the 1989–91 period of perestroika. Payments difficulties led to a sharp initial fall in ruble-denominated trade among the newly independent states of the CIS. The fall in trade was magnified by the abandonment of the artificial production patterns of central planning, which depended on movements of raw materials and especially energy; the collapse of trade in energy and other commodities led to sharp declines in output and thus in trade of finished products. The removal of trade barriers, liberalization of payments arrangements, and establishment of convertible currencies in many countries of the CIS have led to a recovery of trade within the CIS, as well as between the CIS and the Baltic countries and the countries of central and eastern Europe. The value of intra-CIS trade grew by 25 percent between the first half of 1995 and the first half of 1996 following a 9 percent increase in 1995 from 1994, although much of the growth in the value of trade reflects increases in commodity prices rather than an expansion in the volume of trade.[88]

The Baltic countries rapidly liberalized trade, except for agriculture, which remains protected in Latvia and Lithuania, and have both removed state involvement and substantially reoriented trade toward the industrial countries. Although Russia remains the first or second largest trading partner for all three countries, they largely avoided or rapidly recovered from the collapse of trade between Russia and other countries of the former Soviet Union.

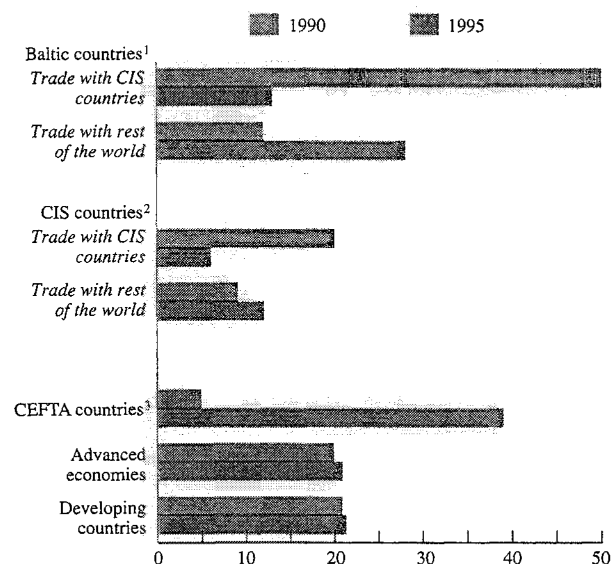
The commodity composition of trade has also changed during the transition. Exports from many central and eastern European countries have gradually changed from consisting predominantly of raw materials to including a significant proportion of light manufactures, such as textiles, footwear, and clothing. This success in manufactured exports reflects both unit labor costs that remain low relative to the industrial countries and country-specific quotas in export markets in both the EU and the United States, which have sheltered the transition countries to some extent from competition with exporters from developing countries. Foreign direct investment has also contributed to export success, with countries such as the Czech Republic, Hungary, the Slovak Republic, and Slovenia now exporting automobiles and other products to the EU from plants constructed with foreign capital and technology. Primary commodities and semimanufactures, however, still account for 40–50 percent of

[88]United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, Vol. 48 (Geneva: United Nations, 1996) provides a detailed discussion of trade in the transition countries.

Chart 42. Countries in Transition: Ratio of Trade to Output

(Average of exports and imports; in percent of GDP)

The transition countries have become increasingly integrated into the global system of trade, although the importance of trade among the countries of the former Soviet Union has fallen.



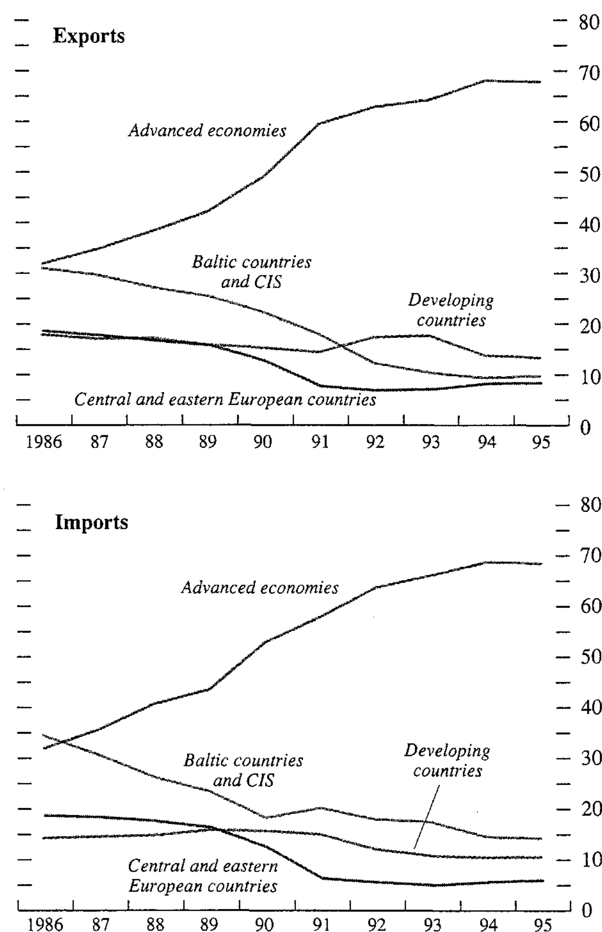
[1]Estonia, Latvia, and Lithuania.

[2]The Commonwealth of Independent States comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakstan, Kyrgyz Republic, Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

[3]The central European free trade area comprises Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.

Chart 43. Central and Eastern European Countries: Composition of Trade by Partner
(In percent of total trade)

The transition countries have reoriented trade to the advanced economies.



Note: CIS denotes Commonwealth of Independent States.

CEFTA countries' exports, and substantially more for the countries less advanced in the transition, such as Bulgaria and Romania. Exports of food and agricultural products to western Europe fell in 1996, but increased sharply to Russia and other CIS countries. Imports of machinery and equipment remained strong even as growth slowed in the countries of central and eastern Europe, a sign of buoyant investment that should bode well for these countries' future growth. Diversifying their production structure remains a challenge for the CIS countries, some of which are highly dependent on exports of a small number of commodities, such as cotton in Turkmenistan and Uzbekistan, and food and other agricultural products in Moldova.

Expansion of Trade: Prerequisites and Consequences

The experience of the transition countries, particularly those more advanced in the transition, points to a number of factors that are likely to have facilitated the expansion of trade. The countries that have enjoyed the most rapid integration into the global trading system have generally been those that early on pursued policies that achieved considerable success in macroeconomic stabilization. Although countries such as the Czech Republic and Poland generally enjoyed more favorable initial conditions than other transition countries, their early success at stabilization provided confidence to domestic and foreign investors that served to stimulate investment and an inflow of foreign capital, which in turn led to increased trade. The experience of the CIS countries highlights the importance of well-functioning multilateral clearing and payments mechanisms; the weakness of the mechanisms that existed often necessitated barter arrangements and stymied trade. Another important step in establishing conditions conducive to the expansion of trade has been the implementation of currency convertibility referred to earlier. This requires macroeconomic stabilization, since poor macroeconomic performance, particularly in terms of high or erratic inflation, leads to instability in open foreign exchange markets.

There is also evidence that the expansion of trade has been positively associated with the growth of productivity, though it is difficult to quantify the relationship meaningfully because the wholesale changes in the structure of the transition economies mean that it is often difficult to obtain reliable measures of productivity growth.[89] Structural reform of the domestic economy is particularly important to encourage the growth of exports, since measures that distort domestic prices are likely to affect productivity adversely

[89] Simeon Djankov and Bernard Hoekman, "Trade Reorientation and Post-Reform Productivity Growth in Bulgarian Enterprises," World Bank Policy Research Paper No. 1707 (Washington: World Bank, January 1997), find that trade is an important source of growth in total factor productivity at the firm level.

and reduce firms' competitiveness in export markets. Even within particular countries there is a substantial degree of dispersion in wage and productivity growth across industries, reflecting uneven progress in privatization and price and trade liberalization. Growth in imports can also lead to increased productivity and output, partly because imports provide a channel through which advanced technology is acquired by countries.[90]

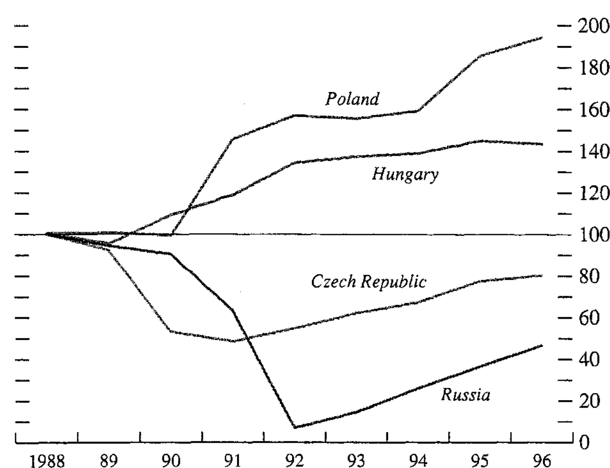
Wages and Competitiveness

Nearly all the transition countries first experienced substantial currency depreciations with the collapse of central planning, and then real appreciations during their respective macroeconomic stabilizations. These real appreciations have occurred as prices have risen faster than in the industrial countries, while exchange rates vis-à-vis industrial country currencies have either remained roughly stable or depreciated more slowly than the inflation differential (Chart 44). Real appreciations are apparent in data both for bilateral real exchange rates vis-à-vis the dollar and deutsche mark and for multilateral real exchange rates based on trade weights. Much of the real appreciations that followed the initial phase of stabilization in most transition countries can be attributed to the undoing of substantial currency undervaluations that had developed earlier, reflecting both the low initial level of wages and adverse developments in the capital account reflecting uncertainty about the prospects for successful stabilization. Nonetheless, the unambiguous and substantial real appreciations that have occurred have raised concerns that transition country goods will lose their international competitiveness and have led to lobbying for import barriers and export subsidies, as well as for relaxation of monetary policies that have relied on a stable nominal exchange rate as an instrument in fighting inflation.

Much of the concern over the loss of competitiveness is focused on the rapid rise of wages measured in dollars, which have increased dramatically in most transition countries (Table 22). Part of the increase reflects the catch-up of undervalued transition country currencies, which translated into dollar wage gains. However, the more recent continuation of this process reflects not only catching up, but also productivity gains that have resulted from the industrial restructuring and deepening of the capital stock over the course of the transition, developments that would be expected to lead to increased wages. So long as the upward adjustment of dollar wages is matched by increased productivity in this way, it does not imply an increase in unit labor costs or a loss of competitiveness, but instead reflects progress made in the transition. While

Chart 44. Selected Countries in Transition: Real Exchange Rates vis-à-vis U.S. Dollar[1]
(1988 = 100)

Most transition countries have experienced real appreciations following macroeconomic stabilization.



[1]In terms of relative consumer prices.

[90]Coe, Helpman, and Hoffmaister, "North-South R&D Spillovers."

Table 22. Countries in Transition: Dollar Wages in Manufacturing or Industry
(In U.S. dollars a month, net of social security taxes)

	1990	1991	1992	1993	1994	1995	1996[1]
Bulgaria	. . .	53	96	123	97	117	126
Czech Republic	. . .	132	162	196	231	296	316
Hungary	176	187	224	237	249	250	246
Poland	107	157	168	175	220	285	329
Romania	. . .	93	61	74	80	101	100
Slovak Republic	. . .	129	161	175	196	242	256
Estonia	. . .	. . .	46	78	137	211	255
Latvia	. . .	. . .	60	73	143	194	221
Lithuania	. . .	. . .	20	48	87	139	170
Belarus	. . .	. . .	27	23	33	74	95
Kazakstan	. . .	. . .	27	70	69	117	152
Kyrgyz Republic	. . .	. . .	14	16	34	53	56
Moldova	. . .	. . .	20	22	37	48	60
Russian Federation	. . .	. . .	32	63	96	115	185
Ukraine	. . .	. . .	28	14	26	47	55

Source: OECD, *Short-Term Economic Indicators: Transition Countries.*
[1]Based on data for the first half of 1996.

dollar wage growth in the more advanced economies of central and eastern Europe slowed somewhat in 1996, this may to some extent reflect the general appreciation of the dollar, particularly against the deutsche mark and other European currencies. (The deutsche mark is the currency of the most important trading partner of most transition countries.) When measured in deutsche mark rather than dollars, wages in most transition countries continued to grow substantially in 1996, pushing up unit labor costs in deutsche mark terms and substantiating concerns about competitiveness.[91]

It would clearly be cause for concern were wages to rise in relation to labor productivity in any transition country to such an extent that the rise in labor costs presaged a substantial deterioration in the trade balance. However, despite the growth of wages in terms of advanced economy currencies, it is not clear that wages have risen to unsustainable levels in any of the transition countries.[92] Given the scope for continued restructuring, capital deepening, and thus productivity growth, further gains in dollar wages are to be expected; they remain substantially lower than in the industrial countries.

Progress with Financial Integration

The breakdown of central planning and the associated trading arrangements among centrally planned economies resulted in substantial external financing needs for several reasons. First, the move to world market prices generated severe terms of trade losses for many transition countries, energy importers in particular. Second, the introduction of currency convertibility on current account also required fairly large foreign exchange support. Third, the strong increase in external borrowing during the 1980s by a number of countries had resulted in unsustainable external debt positions; in several cases, debt-service moratoriums had to be declared. Finally, and more generally, the resources needed to modernize the industrial structure and infrastructure vastly exceeded domestic saving capacities.

The financing problems were particularly severe in Russia and other countries of the former Soviet Union. Within the Soviet Union, an elaborate system of fiscal transfers through the central budget, and of commodity (energy) deliveries at below world market prices had allowed most republics to consume more than they produced, with Russia the main donor.[93] Following the dissolution of the Soviet Union, explicit transfers were eliminated, and the major energy exporters, Russia and Turkmenistan, increased prices for interstate deliveries of oil and gas to near world levels. The result was a severe adverse terms of trade shock for the Baltic countries and the energy-importing countries of the former Soviet Union. The countries benefiting from the highest implicit transfers per capita before the transition, Georgia and Moldova, were the biggest losers, with estimated terms of trade losses of

[91]On the other hand, the fact that export prices in some transition countries, such as the Czech Republic and Estonia, have risen more rapidly than the prices of traded goods in western European trading partners may reflect quality upgrading in these countries' export industries, so that increases in unit labor costs may exaggerate the decline in competitiveness.

[92]Measures of "equilibrium wages" or "equilibrium real exchange rates" are especially difficult to calculate for the transition countries, since their production structures are continuing to undergo substantial changes. See László Halpern and Charles Wyplosz, "Equilibrium Exchange Rates in Transition Economies," IMF Working Paper 96/125 (November 1996), and Kornélia Krajnyák and Jeromin Zettelmeyer, "Competitiveness in Transition Economies: What Scope for Real Appreciation?" IMF Working Paper (forthcoming).

[93]Other countries that were hit by severe financing problems following the breakdown of old transfer systems include the former Yugoslav Republic of Macedonia and Mongolia.

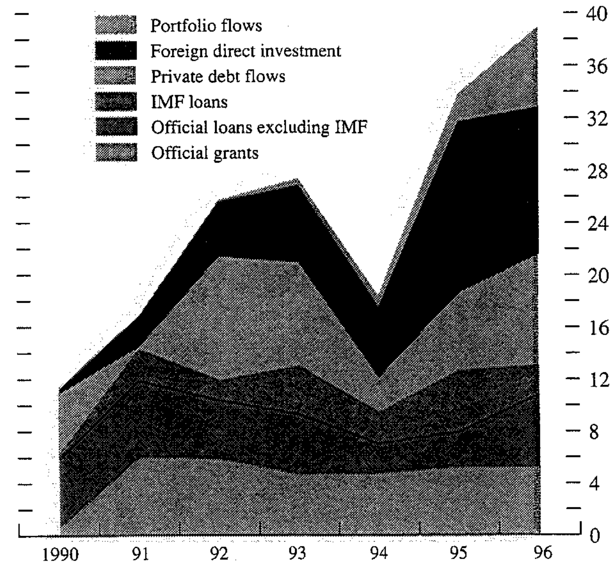
more than 35 percent and more than 43 percent, respectively, in interstate trade between 1990 and 1994.[94]

From the outset of the transformation process, it was recognized that the financing needs of the transition economies could not be met solely by private financial markets. The IMF and the World Bank Group assumed central roles in organizing the efforts to mobilize official financial support, including arrangements for debt relief. In addition to their own financial support, the application of conditionality by the Bretton Woods institutions was the catalytic element for other official financial assistance, including balance of payments support by the EU and other advanced economies.[95] At the same time, it was understood that official financial support would not be available on a large scale and over an extended period. The main purposes of the official assistance were to help transition countries adjust to the external shocks they had suffered, achieve macroeconomic stabilization, and undertake structural reform, thereby creating the conditions that would attract private foreign financing.[96]

By early 1997, almost all transition economies had received financial assistance from the Bretton Woods institutions and other official assistance.[97] Official net medium- to long-term flows into the transition economies during 1990–96 amounted to around $80 billion, including $17 billion from the IMF. Official loans have paved the way for increasing private financial flows, the share of which in total financing has increased from 15 percent in 1991 to 65 percent in 1996, accounted for mostly by an increase in foreign direct investment flows (Chart 45 and Table 23). The share of official financing flows into central and eastern

Chart 45. Countries in Transition: Medium- to Long-Term Net Financial Flows
(In billions of U.S. dollars)

The share of private financing is increasing.



[94]Yuri Dikhanov, "Measuring the Terms of Trade in the Countries of the Former Soviet Union," in *Foreign Trade Statistics in the USSR and Successor States,* Studies of Economies in Transition No. 18, ed. by Misha Belkindas and Olga V. Ivanova (Washington: World Bank, 1995), pp. 55–73; and Wolf, Coats, Citrin, and Cheasty, *Financial Relations.*

[95]The EU organized balance of payments financing for a number of central and eastern European countries. This assistance, which was provided by the 24 OECD countries and the EU as such, was closely coordinated with the IMF. It was put in place to help augment official reserves and thereby facilitate the liberalization of foreign exchange payments and the introduction of convertible currencies. For the rationale behind this initiative, see the contribution by Flemming Larsen to the panel discussion in *Currency Convertibility in Eastern Europe,* ed. by John Williamson (Washington: Institute for International Economics, 1991), pp. 349–53.

[96]For a number of low-income transition countries, however, official assistance will continue to be needed on a longer-term basis; these countries qualify for official development assistance according to the OECD criteria. In addition, substantial official financing will be needed for the reconstruction program in Bosnia and Herzegovina.

[97]Only one member, Turkmenistan, has not received any financial support from the IMF, reflecting both its relatively strong external position and its lack of a comprehensive reform program, while the Federal Republic of Yugoslavia has yet to be admitted to membership.

Table 23. Countries in Transition: Net Medium- to Long-Term Financial Flows
(In billions of U.S. dollars)

	1991	1992	1993	1994	1995	1996
Total flows	16.8	25.7	27.3	18.3	33.8	38.9
Official flows	14.3	11.9	13.0	9.4	12.7	13.1
Grants	6.0	5.8	4.6	4.7	5.2	5.2
Loans	8.3	6.1	8.4	4.7	7.4	7.9
Bilateral	4.1	2.5	1.6	1.0	0.6	2.9
Multilateral, excluding IMF	1.8	2.1	3.1	1.3	2.1	2.7
IMF	2.4	1.6	3.7	2.4	4.7	2.2
Private flows	2.6	13.8	14.3	8.9	21.1	25.9
Debt flows	0.2	9.5	7.9	2.7	6.0	8.5
Guaranteed	0.1	9.1	7.0	1.0	2.1	6.9
Commercial bank loans	–3.7	–0.3	–1.1	–1.8	0.3	. . .
Bonds	1.4	1.0	4.2	2.6	1.6	. . .
Other	3.0	8.5	3.5	0.3	0.2	. . .
Nonguaranteed	0.1	0.4	0.9	1.7	3.9	1.7
Foreign direct investment	2.4	4.2	6.0	5.4	13.1	11.3
Portfolio flows	—	0.1	0.5	0.8	2.1	6.1
Share of private flows (in percent)	15	54	53	49	63	66
Of which: central and eastern European and Baltic countries						
Total flows	8.8	16.1	16.2	10.7	21.1	. . .
Official flows	6.3	3.4	3.7	4.3	1.7	. . .
Grants	3.4	2.1	1.5	2.3	3.7	. . .
Loans	2.9	1.3	2.2	2.0	–1.9	. . .
Bilateral	0.3	0.6	0.2	0.4	0.4	. . .
Multilateral, excluding IMF	0.2	0.2	0.2	1.5	0.4	. . .
IMF	2.4	0.5	1.8	0.1	–2.7	. . .
Private flows	2.6	12.7	12.6	6.4	19.4	. . .
Debt flows	0.2	9.5	7.9	1.8	8.0	. . .
Guaranteed	0.1	9.1	7.0	0.1	4.2	. . .
Commercial bank loans	–0.6	–1.7	–0.8	–2.2	1.7	. . .
Bonds	1.4	1.0	4.2	2.3	2.4	. . .
Other	–0.2	–0.5	0.1	0.1	—	. . .
Nonguaranteed	0.1	0.4	0.9	1.7	3.8	. . .
Foreign direct investment	2.4	3.2	4.2	3.8	9.5	. . .
Portfolio flows	—	0.1	0.5	0.9	2.0	. . .
Share of private flows (in percent)	29	79	77	60	92	. . .

Sources: European Bank for Reconstruction and Development; IMF; and World Bank.

Europe has declined sharply. The countries most advanced in the transition process have full access to private financing and no longer rely on official assistance. A number of countries at intermediate stages of transition, such as Kazakstan, Moldova, Romania, and Russia have raised medium- and long-term funds on the international financial markets while continuing to draw upon official assistance. The increasing role of private financial flows to both groups of countries is discussed in more detail in the next section.

The Increasing Role of Private Financing

Many transition economies have gained substantial access to private financing. As macroeconomic stabilization has typically involved a combination of high domestic interest rates and broadly stable nominal exchange rates, private financing initially took mainly the form of short-term flows, including repatriated flight capital. Such inflows were often substantial compared with the size of the economy, posing considerable challenges for monetary policy.[98] The

[98]For recent discussions of this issue see Guillermo Calvo, Ratna Sahay, and Carlos Végh, "Capital Flows in Central and Eastern Europe: Evidence and Policy Options" in *Private Capital Flows to Emerging Markets After the Mexican Crisis*, ed. by Guillermo Calvo, Morris Goldstein, and Eduard Hochreiter (Washington: Institute for International Economics, 1996), pp. 57–90; Jang-Yung Lee, "Implications of a Surge in Capital Inflows: Available Tools and Consequences for the Conduct of Monetary Policy," IMF Working Paper 96/53 (May 1996); and Pierre Siklos, "Capital Flows in a Transitional Economy and the Sterilization Dilemma: The Hungarian Case," IMF Working Paper 96/86 (August 1996); data on the short-term flows can be found in the 1995 and 1996 *Economic Bulletin for Europe*.

next stage in the development of private financing to these countries has involved an increase in the importance of more stable medium- and long-term flows. This section reviews the transition countries' experience in attracting the three main forms of medium- and long-term private financing: international bonds and syndicated loans, foreign direct investment, and investment from abroad in domestic debt securities and equities.

International Lending and Bond Markets

A number of transition countries have made considerable progress in gaining access to the international lending and bond markets. Access to these markets can help creditworthy borrowers meet financing needs that exceed the capacities of the domestic market, and can act as a valuable source of expertise and financial discipline. The basic economic conditions needed for a transition country to gain access to international financial markets are, in addition to reasonable macroeconomic stability and progress with structural reform, a normalization of relations with creditors in cases of previous debt-service problems and a sustainable external debt position.

For those transition countries that experienced debt-servicing problems before or at the outset of the transformation, agreements with official creditors at the Paris Club and commercial creditors at the London Club have been indispensable for regaining access to the international financial markets. Many centrally planned economies, including the Soviet Union, rapidly increased their external borrowing in the 1980s and eventually were unable to service their debt. Poland already faced difficulties servicing its external debt before the end of the decade, while Bulgaria declared a unilateral moratorium on its external debt in early 1990. The breakup of two relatively indebted countries, the Soviet Union and Yugoslavia, further complicated the external debt problem.

Substantial progress was made in the early years of the transformation process in normalizing relations with Paris and London Club creditors, and this process is now nearly completed. A number of issues remain to be resolved regarding inherited Soviet claims on developing countries, unsettled interstate claims and liabilities among the CIS states, and claims of former CMEA members on Russia. Settlement of developing countries' debt to Russia and of the interstate liabilities incurred by low-income CIS countries will require further negotiations on debt reduction and rescheduling agreements; however, these discussions should not impede the further integration of Russia and other CIS states into international financial markets (Box 11).

The agreements with the London and Paris Clubs and other creditors, together with growth in export revenues, have put most transition economies in a position to service their outstanding external debt with room for prudent additional borrowing. Debt burdens, as measured by the ratio of gross external debt to exports, have improved considerably for Albania, Bulgaria, and Poland, mainly as a result of debt agreements. By this criterion, the debt burden of Hungary, which entered the transformation process as a relatively indebted country but did not seek a rescheduling agreement, has also been eased significantly, while countries such as Croatia, the Czech Republic, Slovakia, and Slovenia have maintained relatively light debt burdens inherited from the pretransition period. Following the agreements whereby Russia assumed all the Soviet external liabilities, the other CIS states started the transition in a favorable position, while Russia itself benefited from a series of agreements with external creditors. On the basis of the gross debt-export ratio and in line with the World Bank's classification criteria, in 1996 four transition countries—Armenia, Bulgaria, Hungary, and the Kyrgyz Republic—were moderately indebted, while Albania and Georgia were severely indebted (Table 24).[99]

Recent progress in gaining access to international financial markets is reflected in the growing number of countries receiving international credit ratings from the major rating agencies and in their upgrading of some countries. In the past two years, the countries more advanced in the transition process also have made the largest gains in semiannual surveys of country risk rankings and accounted for most of the place gainers (Table 25). Seven transition countries—the Visegrád countries (the Czech Republic, Hungary, Poland, and Slovakia), Croatia, Latvia, and Slovenia—are now rated as investment grade. An increasing number of countries and a broadening range of borrowers are raising funds on the international financial markets.[100] At the end of 1994, only three countries—the Czech Republic, Hungary, and Slovakia—had raised substantial amounts in these markets. The number of transition countries borrowing on international markets increased sharply in 1995, as Poland and Romania reentered the market after long absences, and, for the first time, Latvia and Lithuania issued international bonds, while the Kyrgyz Republic obtained its first international loan. The number of borrowers continued to expand in 1996 and early 1997; Croatia, Kazakstan, Russia, and Slovenia launched debut Eurobond issues, and Croatia received its first medium-term syndicated loan. Borrowers were until recently almost exclusively governments and central

[99]According to the World Bank's *World Debt Tables*, a country is moderately indebted when its debt-export ratio exceeds 132 percent, and severely indebted when the ratio is higher than 220 percent.

[100]See United Nations Economic Commission for Europe, *Economic Bulletin for Europe* and *Economic Survey of Europe;* and World Bank, *Financial Flows and the Developing Countries: A World Bank Quarterly.*

Box 11. Normalizing the Transition Countries' Creditor Relations

The transition countries that experienced debt-servicing problems before or at the outset of the transformation have made substantial progress in normalizing relations with Paris and London Club creditors.

A number of *central and eastern European countries* reached agreement on debt-rescheduling arrangements during 1991–95. Between 1991 and 1994, *Bulgaria* obtained three successive arrangements with Paris Club creditors on its official debt, and in 1994, a debt and debt-service-reduction agreement was reached with the London Club of commercial creditors, within the framework of the Brady plan. The Paris Club agreed in 1994 to implement the second stage of a 1991 debt-reduction agreement with *Poland*, and a Brady-style deal with commercial creditors was concluded in October 1994. In mid-1995, *Albania* and its foreign commercial bank creditors signed an agreement that involved a deeply discounted restructuring of the country's bank debt.

Resolution of the debt problem of the *former Yugoslavia* continues to be complicated by unresolved issues relating to the division among the successor states of the so-called unallocated debt.[1] In spite of these unresolved issues, three successor states have successfully normalized their relations with official and commercial creditors. By the end of 1996, *Croatia, the former Yugoslav Republic of Macedonia,* and *Slovenia* had reached understandings with the creditors of both the London and Paris Clubs, each assuming responsibility for a share of the unallocated debt. As far as Paris Club indebtedness is concerned, Slovenia has been negotiating bilateral arrangements with creditor governments following a mid-1993 understanding, while Croatia and the former Yugoslav Republic of Macedonia obtained debt reschedulings in their 1995 arrangements with the Club.

Relations with the official creditors of *Russia and other countries of the former Soviet Union* were clarified in a rescheduling agreement in April 1993, in which *Russia,* under an agreement in principle with other successor states, declared itself solely responsible for the entire debt of the former Soviet Union. Russia has signed three further agreements with the Paris Club on the long-term restructuring of its official debt, the most recent in April 1996, and reached an agreement in principle with the London Club in November 1995, to be finalized in mid-1997. Russia completed the normalization of its financial relations with all the main advanced economies in the fall of 1996, by reaching understandings on unsettled claims by French creditors, including holders of bonds issued under the czarist regime, and by concluding an agreement on the rescheduling of uninsured commercial debt owed by the former Soviet Union.[2]

While substantial progress has been achieved in normalizing relations with commercial and official creditors in the advanced economies, a number of issues remain regarding inherited Soviet claims on developing countries; unsettled interstate claims and liabilities among members of the Commonwealth of Independent States (CIS); and claims of former Council for Mutual Economic Assistance (CMEA) members on Russia and vice versa. Claims on developing countries result from substantial credits extended by the Soviet Union. The exact amount of such claims is yet to be determined, in part because the parties have not agreed on the ruble exchange rate to be used for valuation. All these claims were inherited by Russia following its assumption of sole responsibility for the Soviet external debt in exchange for its external assets. Unsettled interstate claims and liabilities reflect three major types of transactions: official credits, including the balances on bilateral correspondent accounts from the 1992–93 period; arrears on payments for deliveries under officially sponsored bilateral trade contracts, mainly for oil and gas and with Russia and Turkmenistan as the principal creditors; and cross-border interenterprise arrears assumed by governments to provide financial support for particular sectors or industries.[3] Finally, some central and eastern European countries have claims on Russia and vice versa, originating in transferable ruble balances outstanding when the CMEA was dissolved.

Settlement of the developing country debt to Russia and of the interstate liabilities incurred by low-income CIS countries will require further negotiations. During 1996, Russia reached agreements with Nicaragua and Peru, which involved deep discounts on the face value of its claims, and continued negotiations with the other CIS countries and with the Czech Republic and Hungary. Russia is discussing with the Paris Club possible participation in the Club as part of the efforts to normalize its creditor relations with developing countries.

[1]The unallocated debt refers to obligations incurred by the former Yugoslavia and its national bank and which could not be traced to funding of specific projects located in any of the successor republics.

[2]A number of countries of the Commonwealth of Independent States (CIS), which on independence had modest debt obligations, having signed the agreement with Russia on the debt of the former Soviet Union, accumulated sizable obligations toward non-CIS countries during 1991–94, in addition to liabilities toward other CIS countries. From 1994 on, Georgia incurred payments arrears on its external debt service, and during 1995–96 the country concluded a number of bilateral rescheduling agreements, including arrangements with Austria and the Islamic Republic of Iran.

[3]Amer Bisat, "Ukraine's Gas Arrears: Issues and Recommendations," IMF Paper on Policy Analysis and Assessment 96/3 (April 1996) presents an analysis of Ukraine's external gas arrears to Russia.

banks, but have started to include municipalities and regional authorities and private and partially privatized companies.

Improvements in the terms and conditions on which funds have been made available to some transition countries are a further indication of progress with in-

Table 24. Countries in Transition: Ratios of Gross External Debt to Export
(In percent)

	1991	1992	1993	1994	1995	1996
Albania	602	986	1,810	657	268	242
Armenia	0	0	76	131	195	158
Azerbaijan	0	0	6	29	50	47
Belarus	1	15	34	41	38	52
Bulgaria	387	247	262	208	172	160
Croatia	345	43	46	53	71	70
Czech Republic	71	59	54	65	61	60
Estonia	0	4	7	6	6	11
Georgia	0	35	147	204	259	253
Hungary	219	186	267	320	206	201
Kazakstan	0	32	36	75	62	56
Kyrgyz Republic	0	1	80	113	133	164
Latvia	0	3	15	24	20	23
Lithuania	2	8	14	20	29	32
Macedonia, former Yugoslav Republic of	0	0	0	86	102	129
Moldova	0	2	65	102	105	128
Mongolia	65	79	109	130	115	133
Poland	308	277	276	184	123	112
Romania	51	63	76	77	73	98
Russia	155	183	168	152	128	126
Slovak Republic	81	35	46	44	39	49
Slovenia	0	21	23	25	27	30
Ukraine	0	59	27	49	50	43
Uzbekistan	0	18	34	33	27	38

ternational financial market integration. The interest margin for U.S. dollar-denominated syndicated loans negotiated by Hungary dropped from 180 basis points in the summer of 1995 to 50 basis points in the summer of 1996, and to less than 30 basis points by the end of 1996. Similar margins have been offered on sovereign syndicated loans for Slovenia and to large Czech companies, which now borrow at terms approaching those for corporate borrowers in western European countries. Poland's first Eurobond issue in June 1995 was at a spread of more than 180 basis points; in the fall of 1996, the bonds traded at around 70 basis points. Croatia's early 1997 and Slovenia's mid-1996 debut Eurobonds were issued at similar spreads. The countries at intermediate stages of transition are still facing substantial spreads, however, as indicated by the launch spread of 365 basis points in the case of Russia's first Eurobond.

Role of Foreign Direct Investment

Foreign direct investment (FDI) can potentially play a vital role in the transformation process. The countries in transition need substantial fixed investment, as they inherited an obsolete fixed capital stock and an inadequate infrastructure. From a macroeconomic point of view, foreign direct investment complements domestic saving and contributes to total investment in the economy without adding to the external debt burden. Moreover, it has the advantage of usually bringing with it advanced technology, management, and marketing skills, as well as access to export markets.[101] However, uncertainties regarding property rights and the legal and fiscal environment in which businesses can operate naturally tend to deter foreign direct investment. Reflecting such uncertainties, FDI flows into many transition economies have remained relatively small and often directed at local markets. As the economic transition progresses, foreign direct investment may be expected to gain in prominence and to become more diversified and export oriented.

Although foreign direct investment into transition economies has increased since 1991, the flows have been relatively small compared with other regions and with initial expectations. The annual flow to central and eastern Europe, the Baltics, and the CIS rose from around $2.5 billion in 1991 to about $13 billion in 1995.[102] Partly owing to a slowdown in privatizations, foreign direct investment into these countries is esti-

[101]On the role of foreign direct investment in transition countries see also the May 1995 *World Economic Outlook*, pp. 60–65. Recent surveys include Klaus-Dieter Schmidt, "Foreign Direct Investment in Eastern Europe: State-of-the-Art and Prospects," in *Transforming Economies and European Integration*, ed. by Rumen Dobrinsky and Michael Landesmann (Aldershot: Edward Elgar, 1996), pp. 268–89, and Richard Stern, "Putting Foreign Direct Investment in Eastern Europe into Perspective: Turning a Macroeconomic Failure Into a Microeconomic Success Story," in the same volume, pp. 297–310.

[102]The main data sources for information on the aggregate flow of FDI into transition economies are the yearly issues of EBRD, *Transition Report*, United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, and World Bank, *World Debt Tables—External Finance for Developing Countries*.

Table 25. Countries in Transition: Credit Ratings and Country Risk Rankings

	1993	1994	1995	1996[1]
Credit ratings[2]				
Bulgaria				SIG
Croatia				IG
Czech Republic	IG	IG*	IG*	IG*
Hungary	SIG	SIG	SIG	IG
Kazakstan				SIG
Latvia				IG
Lithuania				SIG
Moldova				SIG
Poland			IG	IG
Romania				SIG
Russia				SIG
Slovak Republic		SIG	SIG*	IG
Slovenia				IG
Country risk rankings[3]				
Czech Republic	43	39	41	35
Estonia	122	102	76	71
Hungary	46	44	44	44
Latvia	132	125	116	75
Lithuania	130	121	118	59
Poland	72	73	72	55
Romania	75	77	64	61
Slovak Republic	63	66	51	49
Slovenia	61	53	50	34

Sources: Moody's and Standard & Poor's press releases; and, for the rankings, *Euromoney* (September 1996).

[1]January–March 1997.

[2]Foreign currency, long-term, sovereign debt ratings. IG denotes investment grade, SIG sub-investment grade, * an upgrade. A sub-investment grade is reported as long as at least one agency assigned such a grade. Transition countries not included in the list did not receive a rating.

[3]The country risk rankings are based upon weighted scores of analytical, credit, and market access indicators in nine categories.

mated to have declined to about $11 billion in 1996, contributing to an FDI-based capital stock of around $42 billion. Transition economies still attract substantially less foreign direct investment than other regions; the cumulative inflow during 1991–96 is estimated to have equaled around 4 percent of the transition countries' GDP, compared with around 6 percent for Latin America and around 13 percent for the East Asian developing countries.

The geographical and sectoral distribution of foreign direct investment in the early years of the transformation has been uneven. In terms of destination, the central and eastern European and Baltic countries attracted more than 70 percent of the cumulative foreign direct investment inflows into the transition economies during the 1991–96 period, with Hungary and the Czech Republic alone accounting for close to 50 percent of total inflows. On average, per capita FDI received by the CIS countries was less than 15 percent of the inflows into the central and eastern European and Baltic countries (Table 26). In terms of countries of origin, Austria, Germany, and the United States have been the main investors, accounting for more than two-thirds of the investment into the transition economies in 1994 and for almost two-thirds of the cumulative investment inflow in 1988–94. Austria and Germany are also the advanced economies with the highest shares of foreign direct investment in transition countries relative to other destinations. In terms of sectoral composition, finally, data through 1994 indicate that a large share of foreign direct investment in the early years of the transition was placed in sectors mainly oriented toward supplying the domestic market, such as the trade and distribution sectors, and, within manufacturing, the food-, beverage-, and tobacco-processing industries.[103]

The uneven geographical and sectoral pattern of foreign direct investment is related to a number of factors that partly reflect the characteristics of the transformation process.[104] First, FDI inflows have tended to be highest in the countries most advanced in the transition process. Second, they have been influenced by the form and timing of the privatization process: countries such as Estonia and Hungary that chose a privatization policy that included major sales to foreign investors, rather than voucher-based mass privatization schemes or management and employee buyouts, have been particularly successful in attracting foreign direct investment. Third, a considerable proportion of direct investment has come from neighboring countries or from countries with historical and cultural ties or existing business and trade linkages. Fourth, early foreign direct investment has often been motivated by opportunities to gain a first-mover advantage in new markets; these incentives have been important for inward-looking foreign direct investment in the larger transition countries and for investment in the trade and distribution sectors and the vehicle-building and food-processing industries.[105]

The Czech Republic, Estonia, and Hungary, have attracted inflows of foreign direct investment comparable with those received by prominent emerging market

[103]Gábor Hunya and Jan Stankovsky, "Foreign Direct Investment in Central and East European Countries and the Former Soviet Union" (Vienna: The Vienna Institute for Comparative Economic Studies, 1996), include data on the sectoral breakdown of FDI for a number of eastern European and Baltic countries. Stefano Manzocchi, "Sectoral Patterns of FDI in Central and Eastern Europe: A Note" (unpublished; Department of Economics, University of Ancona, December 1996), offers a preliminary analysis of the further sectoral breakdown within the manufacturing sector.

[104]For recent studies on this topic see Melanie Lansbury, Nigel Pain, and Katerina Smidkova, "Foreign Direct Investment in Central Europe Since 1990: An Econometric Study," *National Institute Economic Review,* No. 156 (May 1996), pp. 104–14, and Hans Peter Lankes and Anthony Venables, "Foreign Direct Investment in Economic Transition: The Changing Pattern of Investments," *Economics of Transition,* Vol. 4 (1996), pp. 331–47, a study based upon a survey of companies that have planned or undertaken FDI projects in the region.

[105]Most studies based on survey data conclude that market seeking was the prime motive and that factor cost advantages were of less importance for the majority of early investments. See Lankes and Venables, "Foreign Direct Investment," for an overview.

Table 26. Countries in Transition: Net Foreign Direct Investment
(In millions of U.S. dollars)

	Yearly Inflows						Cumulative Inflows	Cumulative Per Capita Inflows[1]
	1991	1992	1993	1994	1995	1996		
Total	**2,374**	**4,195**	**5,950**	**5,412**	**13,082**	**11,250**	**42,263**	**100**
Albania	—	10	45	53	70	70	248	71
Armenia	—	—	—	3	10	23	36	10
Azerbaijan	—	—	—	22	275	601	898	120
Belarus	—	7	18	10	7	12	54	5
Bulgaria	56	42	40	105	165	180	588	65
Croatia	100	13	74	100	100	200	587	123
Czech Republic	393	983	552	749	2,526	1,165	6,368	617
Estonia	—	80	154	212	202	210	859	558
Georgia	—	—	—	8	6	20	34	6
Hungary	1,474	1,471	2,329	1,097	4,410	1,986	12,767	1,256
Kazakstan	—	100	473	635	859	930	2,997	180
Kyrgyz Republic	—	—	10	45	61	31	146	31
Latvia	—	43	51	155	165	200	614	239
Lithuania	—	10	23	60	55	96	244	65
Macedonia, former Yugoslav Republic of	—	—	—	24	12	35	70	32
Moldova	25	16	14	18	72	46	191	43
Mongolia	—	2	8	7	7	7	31	13
Poland	117	284	580	542	1,134	2,205	4,862	126
Romania	37	73	95	347	417	410	1,379	61
Russia	–25	700	900	630	2,000	2,000	6,205	42
Slovak Republic	197	50	134	170	70	66	687	128
Slovenia	—	113	112	140	140	145	650	325
Tajikistan	—	9	12	12	13	13	59	10
Turkmenistan	—	11	79	103	64	80	337	81
Ukraine	—	170	200	91	266	436	1,163	23
Uzbekistan	—	9	48	73	–24	84	190	8

[1]Cumulative 1991–96 per capita inflows in U.S. dollars.

economies in other regions, and since the four influences referred to above are partly temporary, foreign direct investment into other transition countries may be expected at least to some degree to imitate these examples. It may also be expected that foreign direct investment will become more outward looking and generate increased trade flows, as foreign firms take advantage of the transition countries' relatively highly educated and skilled workers and low labor costs. Steps that have been taken in a number of transition countries to allow foreign access to the infrastructure, public utilities, and financial intermediation sectors will offer an additional stimulus to foreign direct investment (Box 12).[106]

Foreign Investment in Domestic Securities and Equity Placements

Foreign investment in domestic securities and international equity placements in the form of depository receipts are an increasingly important source of external finance for some of the transition economies and the fastest growing segment in overall private financing. Progress in the establishment of well-functioning markets for private and government debt securities and for equities, together with initially high yields, have attracted a growing number of foreign investors, specialized investment funds in particular. Demand from investors should in turn help lower interest rates on domestic debt instruments and improve the efficiency and liquidity of domestic stock markets, while encouraging accountability among local firms; foreign investors can provide valuable expertise and exert pressure to bring domestic financial institutions and markets up to international standards.

Local markets for government securities are among the most advanced financial markets in a number of transition economies and have attracted considerable interest among foreign investors. High yields in foreign currency terms motivated sizable foreign purchases of domestic government securities in the Czech Republic in 1994–95, Poland in 1995, and, following a partial liberalization of foreign access to the treasury bill market, Russia in 1996. Foreigners invested around $4 billion in the Russian treasury bill market in 1996, and a continuing increase in nonresident purchases is expected as the Russian govern-

[106]The growing importance of infrastructural investment in the transition countries is highlighted in Laurence Carter, Frank Sader, and Pernille Holtedahl, "Foreign Direct Investment in Central and Eastern European Infrastructure," World Bank Foreign Investment Advisory Service Occasional Paper No. 7 (Washington: The World Bank, 1996).

Box 12. Foreign Direct Investment Strategies in Hungary and Kazakstan

Hungary and Kazakstan rank among the transition economies that were most successful in attracting foreign direct investment (FDI) during 1991–96. Of all transition economies, Hungary received the highest FDI inflows in both absolute and per capita terms, with its cumulative per capita inflow of $1250 among the highest in the world. Kazakstan was the leading recipient of per capita FDI among the CIS countries, though the cumulative inflow of less than $200 is small compared with most central and eastern European countries and Estonia. A better understanding of the FDI flows into these two countries also sheds light on patterns of FDI into the transition economies in general, including the significant differences between eastern European and CIS countries. In general, the experiences of Hungary and Kazakstan illustrate both how stabilization and reform are essential for attracting FDI and how country-specific factors can play an important role too.

Hungary's leading position among transition countries in attracting FDI is rooted in the early start and strong outward orientation of its transformation process. The country liberalized prices, foreign trade, and foreign participation in companies ahead of other transition economies and created a stable and transparent legal framework for FDI early in the transition, following the adoption of a new investment law in 1988. Having already developed strong business relationships with western companies and enhanced its creditworthiness by meeting its debt-service obligations, Hungary adopted a general policy of promoting greater foreign participation in the domestic economy. The 1989 privatization program, which involved selling medium- and large-sized state enterprises to foreign investors, was a central element of this outward-looking policy and acted as a major stimulus for FDI inflows, which surged from $300 million in 1990 to $2.3 billion in 1993.[1] Following a slowdown of privatization and FDI inflows in 1994, a revised privatization program was adopted in May 1995 aimed at selling large enterprises in the energy, financial, and infrastructure sectors to foreign investors; as a result, about 95 percent of 1995 privatization revenues were in foreign currency, and FDI peaked at more than $4 billion compared with little more than $1 billion in the previous year. Companies with foreign participation have begun to play a role in the Hungarian economy similar to that in smaller western European countries. Such enterprises now form a very dynamic part of the economy in terms of investment and output performance and account for well over half of the country's exports. According to the Hungarian Privatization Research Institute, at the end of 1996 more than two-thirds of the country's 200 largest companies had foreign participation; foreign investors hold majority stakes in the utilities and banking sectors.

The Hungarian experience also illustrates the shift in the sectoral composition and orientation of FDI as the process of transformation and international integration advances. Initially, FDI was mostly channeled into industry and mainly driven by the motive of securing presence in a new and expanding market.[2] From 1994 on, FDI inflows into sectors other than industry gained in importance, reducing industry's share in cumulative FDI from around two-thirds in mid-1993 to less than one-half by the end of 1996. The move toward sectoral diversification was reinforced following the adoption of the revised privatization program in 1995, as a result of which the private sector share and foreign participation in energy, infrastructure, telecommunications, and banking are now higher than in several western European countries. Foreign direct investment into industry is being reoriented from projects directed at the domestic market to projects involving intrafirm specialization and trade. With the privatization process nearing completion, there has been a growing importance of reinvested profits and investment projects not related to privatization.

Kazakstan followed Hungary's example in creating a legal framework for FDI early in the transition and in targeting its privatization program for major companies toward foreign investors, in particular by seeking foreign participation in the exploitation of the country's vast nat-

[1]For an analysis of FDI during 1990–95, see Gábor Hunya, "Foreign Direct Investment in Hungary: A Key Element of Economic Modernization," Vienna Institute for Comparative Economic Studies Research Report No. 226 (February 1996).

[2]The importance of market access among the factors determining initial FDI into Hungary is reflected in the answers to an investor survey. See Miklós Szanyi, "Experiences with Foreign Direct Investment in Hungary," *Russian and East European Finance and Trade*, Vol. 31 (May–June 1995), pp. 6–30.

ment has announced a further liberalization of foreign access.

Foreign investment in equities, which remained modest until 1995, surged in a number of countries in 1996. Nonresident investors now account for substantial shares of stock market holdings and turnover in the Czech Republic, Hungary, Poland, and Russia and have contributed to very sharp increases in stock market prices in 1996; stock market indices, computed in U.S. dollar terms, rose by almost 100 percent in Budapest, by more than 70 percent in Warsaw, and by more than 150 percent in Moscow. The Hungarian and Polish markets have been included in the International Finance Corporation's investable country indices for emerging markets since 1993, the Czech market since 1995, and the Russian and Slovak markets since February 1997. By the end of 1996, eight more transition economies had functioning stock markets; most of them, however, are still small and fairly illiquid and have not yet attracted strong foreign interest.

ural resources. The first laws on FDI were introduced while the country was still gaining independence, and the first major privatization program, adopted in March 1993, included ambitious plans to sell to foreign investors up to 180 large enterprises, mainly in the raw materials and heavy industry sectors. In the following two years, however, the expected strong increase in FDI inflows did not materialize, and the government made little progress in selling large enterprises to foreign investors.

A number of factors explain why foreigners were hesitant to invest in Kazakstan in the early years of the transition. Macroeconomic instability and frequent changes in the government caused economic and political uncertainty. Additional uncertainty resulted from bureaucratic practices, complicated and erratically administrated tax and investment regulations, and ad hoc changes in laws and contractual arrangements. Finally, the procedures for selling large companies to foreign investors were complex and the valuation of such companies complicated by the absence of internationally accepted accounting standards.[3] In these circumstances, foreign investors were unwilling to commit substantial financial resources, with the exception of a limited number of projects in the oil and gas sectors, characterized by long investment horizons, and in the food-processing and tobacco industries, where first-mover advantages are important.

In an attempt to bring in the management and technological expertise of foreign investors while limiting their financial risk, in late 1994 the Kazak government introduced a management contract scheme for large state-owned enterprises, whereby foreign firms were given the right to manage enterprises for a limited period of time. In exchange for bonuses or shares in profits, or both, and, in most cases, a priority right to purchase the majority of the firm's shares at the end of the contract, management companies were obliged to redeem, up-front, outstanding arrears of the enterprise, implement preprivatization restructuring, or carry out specified investment projects. Starting at the end of 1994, about 60 of the country's largest enterprises, including most of the heavy industry plants, were put under management contracts. In 1995, around 40 percent of FDI was absorbed by enterprises managed by foreign companies, and the share of these enterprises in total exports may have been similar to that in Hungary.

The Kazak experience with management contracts has been a mixed success. Management contracts were often awarded without competitive procedures, on the basis of incomplete and vague legal contracts and with insufficient safeguards against short-term opportunistic behavior; a number of contracts were canceled because of poor performance. On the other hand, in a number of cases these contracts have facilitated more efficient operations and restructuring in preparation for privatization. The contracts should therefore be seen as a temporary solution for the period until uncertainty has been reduced to a degree where foreign investors are willing to commit financial resources. During 1996, the monitoring of contracts was reinforced and direct sales of large enterprises were accelerated; at the end of 1996, the government ceased awarding new contracts. By early 1997, most of Kazakstan's large metal mines and smelters, a number of coal mines, oil producers and power plants, and the country's giant steel factory had been sold off, mainly to foreign investors. The government also initiated the partial sale of the infrastructure, telecommunications, and utilities sectors to foreign investors, thereby imitating the switch in privatization focus in Hungary after 1995. However, geography probably makes Kazakstan less attractive as an FDI destination for small businesses, which typically account for most of the number of FDI projects. By the end of 1996, less than 3,000 companies with foreign participation were operating in the country compared with around 30,000 in Hungary.

A comparison of the patterns of FDI into Hungary and Kazakstan illustrates the fact that a legal framework and an outward-looking economic policy, while necessary, are not sufficient to generate large FDI inflows. Such inflows are impeded if there is a climate of general financial uncertainty and poor implementation of laws and regulations. Once the appropriate legal and economic environment is created, transition countries have the prospect of steadily increasing FDI inflows into broad sectors of the economy. At the same time, the size and composition of FDI will continue to reflect differences in factors such as geography, proximity to major markets, human capital, and natural resources endowment.

[3]In a June 1996 survey conducted by the International Tax and Investment Centre among 46 foreign investors, bureaucratic practices and a nontransparent fiscal and regulatory framework were regarded as major barriers for FDI into Kazakstan.

In light of the practical problems and risks involved in investing directly in the stock markets of the transition countries, corporations in these economies have started to organize international equity placements in the form of American or global depository receipts.[107] Corporations from four transition economies made depository receipt placements of around $300 million in 1994, with Hungarian companies accounting for the bulk of this activity. This amount was doubled in 1995, and the issuer base was broadened to three more countries. Mainly because of activity by Russian companies, which were authorized to place American depository receipts in September 1995, placements again doubled in 1996, including issues by major Russian energy producers Gazprom and Lukoil.

[107]Depository receipts are negotiable equity-based certificates that represent underlying shares listed on the stock markets of the transition countries and are held in custody with a depository bank; they are listed and traded on the stock exchanges of advanced economies.

The integration of the transition countries into international financial markets in many respects is still in its initial stages, notwithstanding the impressive progress of the more advanced countries in gaining and improving access. Private financial flows into these countries remain relatively small. In 1996, foreign direct investment into the transition countries was equivalent to only 14 percent of the inflow into the East Asian and Latin American countries, while international bond issues by transition countries were less than 5 percent of the issues by the other two country groups, and medium- and long-term syndicated loan commitments amounted to less than 15 percent.

Moreover, financial integration has to advance in a number of more qualitative dimensions. First, while some countries can expect to gain access to private financing once delays in macroeconomic stabilization and structural reform have been overcome, some of the smaller economies in southeast Europe, the Caucasus, and central Asia with low incomes and limited natural resources are likely to remain dependent on official financing for years to come. Second, the transition countries need to make further progress toward eliminating capital flight and restoring order to the process of capital outflows, which as such—as legitimate investment abroad by residents of these countries—could bring additional gains from international financial integration. Most transition countries experienced substantial capital flight during the first years of the transformation. In Russia, for instance, substantial current account surpluses were only partially reflected in corresponding reported increases in financial or equity claims on foreign countries. Recently, orderly outflows have started to pick up. Foreign direct investment from the transition economies, Czech and Russian investments in neighboring countries in particular, have been increasing, and the Czech koruna, Slovak koruna, and Croatian kuna have been selected as currencies of denomination for Eurobonds. Third, structural weaknesses in the transition economies' domestic financial sectors have to be overcome to increase the scope for further integration. Factors that inhibit the growth of foreign activity include banking technology below international standards, nonperforming loans, weak regulation, and illiquid and untransparent equity markets.[108]

Regional Integration Initiatives

While making efforts to integrate further into the world economy, most transition economies have at the same time opted for new forms of regional cooperation. In addition to a number of new regional arrangements and institutions, two major integration initiatives are under way: 10 central and eastern European and Baltic countries are making efforts to gain admission to the EU, while 12 newly independent countries of the former Soviet Union have been trying to promote economic and financial cooperation within the framework of the CIS.

The EU has taken a number of steps to prepare the ground for eventual enlargement toward central and eastern Europe. Starting in 1991, the EU signed ten Europe Agreements with transition countries.[109] Under these agreements, the associated countries have committed themselves to adapting their economic legislation to that of the EU, and both parties have introduced free trade, albeit with substantial exceptions in certain sectors such as steel, textiles, and agriculture. The Essen European Council of December 1994 agreed that countries that signed the Europe Agreements would become eligible for membership and outlined the so-called preaccession strategy. To assist the associated countries in preparing for integration into the single market, a white paper setting out guidelines was issued and the Phare support program, initially developed to assist the central and eastern European countries with structural reform challenges, was refocused on integration. Negotiations for membership could start within six months following the current intergovernmental conference, which is discussing reform of the EU decision-making process and is scheduled to complete its work in mid-1997.

Enlargement of the EU to the East raises a number of major issues.[110] First, enlargement could involve significant and unevenly distributed economic and budgetary costs for both the existing members and the associated countries; the agricultural and structural funds transfer programs would probably have to be reformed if they were to be maintained with full participation of the newcomers. Second, enlargement poses a challenge for the proper functioning of the single market as new members may not be able to fully implement the core legislation, the "*acquis communautaire*," in this area or to face full-fledged competition across all sectors. Third, admitting up to ten more countries may complicate the decision-making process in the Union and may eventually require additional institutional reform beyond what is being considered at the current intergovernmental conference. Fourth, countries wanting to join the Union may also

[108]For a discussion of these issues, see Michael S. Borish, Wei Ding, and Michel Noël, *On the Road to EU Accession: Financial Sector Development in Central Europe*, World Bank Discussion Paper No. 345 (Washington: World Bank, September 1996).

[109]Such agreements were signed with Poland and Hungary in 1991, the Czech Republic, Slovakia, Romania, and Bulgaria in 1993, the Baltic countries in 1995, and Slovenia in 1996.

[110]See Lóránd Ambrus-Lakatos and Mark Schaffer, eds., *Coming to Terms with Accession*, Forum Report of the Economic Policy Initiative No. 2 (London: CEPR and Institute for East-West Studies, 1996), and Chapter 1 of United Nations Economic Commission for Europe, *Economic Bulletin for Europe* (Geneva: United Nations, 1996).

want to participate in the planned monetary union; the permanent fixing of exchange rates may, however, be particularly difficult for these countries as long as they are continuing to undergo rapid and extensive structural change.

Uncertainties surrounding the conditions and timetable for EU admission notwithstanding, the associated countries' best strategy is to strive for progressive reintegration with the world economy, including western Europe. Policies required for further progress in transition to a market economy and international integration in general will at the same time help to satisfy the conditions for accession to the EU.

* * *

After decades of central planning, the transition economies were left with highly distorted trade patterns and inadequate financial systems largely cut off from international capital flows. Since the beginning of the transformation, they have made substantial progress in reorienting trade and have started the process of reintegration with international financial markets. This process, which requires investor confidence and an appropriate financial infrastructure to be built, will be prolonged. While the most advanced transition countries in central and eastern Europe have become emerging market economies, a number of countries less advanced in transition have only begun to gain access to international financial markets. Countries that have delayed stabilization and reform efforts still have little prospect of receiving significant private financing in the near future.

The record of the early years shows that progress in transition policies generally is clearly associated with increasing integration with the world economy and that both are associated with economic performance, as reflected in growth and inflation rates. The question remains as to where further progress in the transformation process will take these countries, and what their role in the global economy eventually will be. The primary aspiration of the transition countries is to enhance their long-term prospects for growth and prosperity, while more particular aspirations include integration with, and eventually achieving, the living standards of western Europe for the central and eastern European economies, establishing itself as a major player on the world economic scene for Russia, and exploiting the opportunities offered by vast energy resources for countries in the Caucasian and Caspian region. As was discussed in the October 1996 *World Economic Outlook,* transition countries face the prospect of achieving quite high growth rates in the medium term, provided they persevere with policies of macroeconomic stabilization and structural reforms, including opening up to the world economy. Increasing trade and international financial flows will be essential to bring about the growth that will allow these countries to realize their aspirations.

Annex

Globalization in Historical Perspective

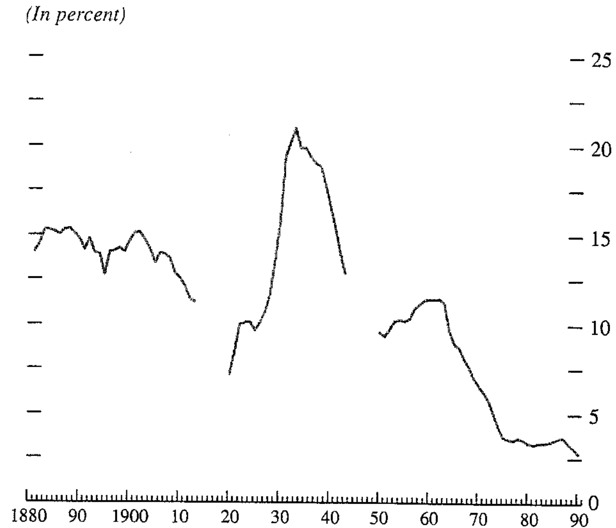
The post–World War II phenomenon of globalization—the increasingly close international integration of markets both for goods and services, and for capital—may in many ways be viewed as a resumption of a trend observed in the world economy a century ago. By some measures, international economic integration increased just as much in the 50 years before World War I as in recent decades, and reached comparable levels. Then, as now, integration was driven in large part by the proliferation of markets and rapid technological change. The process was interrupted and reversed from 1914 to after World War II.

The process observed before 1914 could hardly be called "globalization," however, since large parts of the world did not participate and also because the speed of transport and communication was such that it was much less feasible than it is today to organize markets, or to operate firms, at the global level. Furthermore, international financial markets today are characterized by much larger gross flows, with a much larger variety of financial instruments being traded across borders. Nevertheless, the trends we have been observing in recent decades are in a sense taking us back to the future.

International Trade

The period from the mid-nineteenth century to World War I exhibited relatively rapid growth in world trade, as the expansion of exports (3.5 percent a year) significantly outpaced that of real output (2.7 percent a year). The share of exports in world output reached a peak in 1913 not surpassed until 1970.[1] Growth in trade occurred partly as a consequence of reduced tariffs (Chart 46) and greatly reduced transportation costs, reflecting the proliferation of railroads and

Chart 46. Advanced Economies: Effective Tariff Rates
(In percent)



Sources: Brian Mitchell, *International Historical Statistics: Europe, 1750–1988* (Houndmills, Basingstoke, England: Macmillan, 3rd ed., 1992); Angus Maddison, *Dynamic Forces in Capitalist Development: A Long-Run Comparative View* (Oxford: Oxford University Press, 1991).

Notes: Effective tarriff rates are calculated as the ratio of customs revenues to the value of total imports. Data are GDP-weighted averages for the following countries: Belgium, Canada, Denmark, France, Germany, Italy, the Netherlands, Portugal, Spain, Sweden, the United Kingdom, and the United States.

This Annex was prepared by Professor Michael Bordo, Rutgers University, and Kornélia Krajnyák, World Economic Studies Division, Research Department.

[1]Paul Bairoch and Richard Kozul-Wright, "Globalization Myths: Some Historical Reflections on Integration, Industrialization, and Growth in the World Economy," United Nations Conference on Trade and Development Discussion Paper No. 113 (March 1996), p. 5.

steamships.[2] The period also witnessed a marked convergence of commodity prices across countries.[3]

The process of trade liberalization in Europe began with Britain's unilateral movement to free trade with the Abolition of the Corn Laws in 1846.[4] It spread to other countries with the Cobden Chevalier Treaty of 1860 between Britain and France. This Treaty, in addition to reducing French tariff rates, incorporated a most-favored-nation (MFN) clause in which each contracting party agreed to extend to the other any reduction in tariff rates it introduced vis-à-vis a third party. Because France reduced its tariff rates only with Britain, this gave other trading partners an incentive to sign similar treaties with it. Within the next two decades virtually all of Europe reduced tariffs (to the 10–15 percent range from above 35 percent) in a series of bilateral agreements with MFN clauses.[5]

Combined with the fact that nontariff barriers were of secondary importance and foreign exchange transactions were not controlled under the classical gold standard that prevailed before 1914, the network of bilateral commercial treaties constituted, de facto, a liberal multilateral trade regime. However, the system suffered from two drawbacks: it did not guarantee tariff reductions, and the treaties were subject to renegotiation upon expiry. These two defects were rectified in the multilateral arrangements instituted after World War II.[6] Although the liberalization process was reversed after 1879 with the institution of tariffs by Germany and then other countries, the level of effective protection (with the principal exception of the United States) remained low by twentieth century standards until 1914.[7]

The outbreak of World War I led to a series of quantitative restrictions on trade by the belligerents. After the war, many countries reduced their restrictions but substituted tariffs instead. A renewed movement toward liberalization under the Gold Exchange Standard (1925–31) ended with the Great Depression. In the face of plummeting agricultural prices a number of countries raised tariffs in 1929. In June 1930, the United States passed the Smoot-Hawley tariff, which raised duties on imports by 23 percent; most countries retaliated. In addition to tariffs, countries instituted quantitative restrictions and other trade barriers in an attempt to stimulate their economies.

In the face of deflation, some countries—the United Kingdom and the sterling area and the United States—left the gold standard, devalued their currencies, and pursued expansionary policies; others (the gold bloc—France, Italy, Belgium, the Netherlands, and Switzerland) stayed on gold but raised tariffs. A third group—Germany, Austria, and other central European countries—used exchange controls to create a series of bilateral (barter) trade agreements. As a result of these obstacles, world trade plummeted even faster than real output. By the mid-1930s, tariff protection was reduced somewhat following the U.S. Reciprocal Trade Agreement Act of 1934, under which the United States negotiated a series of bilateral agreements.

After World War II, the General Agreement on Tariffs and Trade (GATT) was created by the international community, along with the IMF, the World Bank, and other international organizations. Based on the principles of multilateral cooperation, the GATT had a mandate to roll back tariffs from their prewar peaks and to continue reducing them in the future. The GATT was extremely successful in 1947 in the first Geneva Round in reducing tariffs by 35 percent. Successive rounds in the 1950s, 1960s (the Kennedy Round), and the 1970s (Tokyo Round) and the recent Uruguay Round have virtually eliminated tariffs on manufactured goods. The World Trade Organization (WTO), which succeeded GATT in 1994, is currently engaged in reducing nontariff barriers and protection, including in areas not covered by the GATT.[8]

Capital Market Integration

In the 50 years before World War I, there was a massive flow of capital from the core countries of western Europe to the rapidly developing economies of the Americas, Australia, and elsewhere. At its peak, the net capital outflow from Britain represented 9 percent of GNP and was almost as high from France, Germany, and the Netherlands.[9] This compares with the peaks in Japan's and Germany's current account surpluses in the mid- and late 1980s of 4–5 percent of GDP. Before

[2]Douglas A. Irwin, "Multilateral and Bilateral Trade Policies in the World Trading System: An Historical Perspective," in *New Dimensions in Regional Integration,* ed. by J. De Melo and A. Panagariya (Cambridge, England; New York: Cambridge University Press, 1993), pp. 90–119.

[3]Douglas A. Irwin, "The United States in a New Global Economy? A Century's Perspective," *American Economic Review, Papers and Proceedings* (May 1996), pp. 41–46.

[4]The British reduction in tariffs reflected a shift in political and economic power as a consequence of the Industrial Revolution, which began around 1750. An emerging coalition between manufacturers and industrial workers who would benefit from low tariffs on grain in the years after the Napoleonic wars wrested control over Parliament from the large landowners who had earlier benefited from protection. See Douglas A. Irwin, *Against the Tide: An Intellectual History of Free Trade* (Princeton: Princeton University Press, 1996).

[5]See Irwin, "Multilateral and Bilateral Trade Policies."

[6]Ibid.

[7]Forrest Capie, "Tariff Protection and Economic Performance in the Nineteenth Century," in *Policy and Performance in International Trade,* ed. by J. Black and L.A. Winters (New York: St. Martin's Press, 1983).

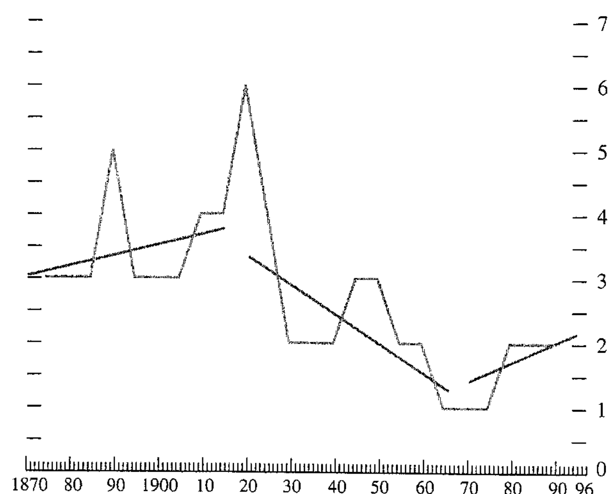
[8]Douglas A. Irwin, "The GATT in Historical Perspective," *American Economic Review, Papers and Proceedings,* Vol. 85 (May 1995), pp. 323–28.

[9]See Bairoch and Kozul-Wright, "Globalization Myths."

World War I, private capital moved without restrictions. Much of it flowed into bonds financing railroads and other infrastructure in the new world and into long-term government debt, although there also was substantial foreign direct investment. The extent of net capital flows is illustrated in Chart 47, which shows a five-year moving average of the mean absolute value of the ratio of the current account balance to GDP for 12 countries, and Chart 48, which shows the current account balances for one large capital exporter (the United Kingdom), one large capital importer (Canada), and a country with smaller imbalances (the United States).[10] Evidence of tight capital market integration from 1850 to 1913 is also provided by low and declining onshore and offshore interest differentials between the United Kingdom and the United States, and by the low dispersion of real rates of interest (Chart 49).[11]

Free capital mobility before 1914 was closely related to the fact that much of the world was on the gold standard, the key role of which was to maintain convertibility of national currencies into gold. A credible commitment to gold in turn meant that monetary policy could not be used extensively to stabilize the domestic economy in the event of either internal or external shocks.[12] The credibility of the commitment to gold by the core countries was reinforced by stabilizing flows of short-term capital, and, in turn, long-term capital flowed from the core to peripheral countries adhering to gold because adherence to gold served as "a good-housekeeping seal of approval"—as evidence that countries followed standards of financial probity.[13]

Chart 47. Selected Countries: External Capital Flows[1]
(In percent of GDP; five-year moving average)



[1]Five-year moving average of the mean absolute value of the ratio of the current account balance to GDP for Argentina, Australia, Canada, Denmark, France, Germany, Italy, Japan, Norway, Sweden, the United Kingdom, and the United States.

[10]Maurice Obstfeld and Alan Taylor, "The Great Depression as a Watershed: International Capital Mobility over the Long Run," in *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century,* ed. by M. D. Bordo, C. Goldin, and E. White (Chicago: University of Chicago Press, forthcoming).

[11]Obstfeld and Taylor, "The Great Depression." Other evidence includes low correlations between investment and savings ratios, Alan Taylor, "International Capital Mobility in History: The Saving-Investment Relationship," NBER Working Paper No. 5743 (Cambridge, Massachusetts: National Bureau of Economic Research, September 1996); purchasing power parity tests, Alan Taylor, "International Capital Mobility in History: Purchasing Power Parity in the Long Run," NBER Working Paper No. 5742 (Cambridge, Massachusetts: National Bureau of Economic Research, September 1996); and uncovered interest parity, Charles Calomiris and Glenn R. Hubbard, "International Adjustment Under the Classical Gold Standard: Evidence for the U.S. and Britain, 1879–1914," in *Modern Perspectives on the Gold Standard,* ed. by Tamim Bayoumi, Barry Eichengreen, and Mark P. Taylor (Cambridge, England; New York: Cambridge University Press, 1996).

[12]A commonly referred to proposition in international macroeconomics is that only two of the following three objectives can be met simultaneously: capital mobility, monetary policy independence, and fixed exchange rates. The gold standard encompassed the first and third.

[13]See Barry Eichengreen, *Globalizing Capital: History of the International Monetary System* (Princeton, New Jersey: Princeton University Press, 1996); and Michael D. Bordo and Hugh Rockoff, "The Gold Standard as a Good Housekeeping Seal of Approval," *Journal of Economic History,* Vol. 56 (June 1996), pp. 389–428.

International capital markets disintegrated from the outset of World War I until the mid-1960s, as can be seen in Charts 47 and 49. With the outbreak of World War I, the gold standard was suspended by the belligerents, and capital and exchange controls were imposed. After the war, controls were removed and the reinstated gold standard was characterized by virtually free capital mobility. However, the Gold Exchange Standard was not as credible or viable as the prewar standard, and countries following macroeconomic policies inconsistent with maintaining gold convertibility became subject to destabilizing capital flows. With the onset of the Great Depression, many countries imposed extensive and increasingly binding capital controls in an attempt to use monetary and fiscal policy to insulate themselves from deflation and depression. By the eve of World War II, capital flows had dried up.

After the war, the international monetary system created at Bretton Woods in 1944 attached the highest importance to restoring multilateral payments and current account convertibility, but enshrined restrictions on capital movements as a key element of the adjustable peg system. Based on the perception that floating exchange rates in the interwar period had been excessively volatile and subject to destabilizing speculation,[14] and on their own experience of those years, it was the view of the principal architects of the Bretton Woods system, John Maynard Keynes and Harry Dexter White, that resort to capital controls had to be allowed if, with fixed (though adjustable) parities, domestic stabilization policy was to be used to maintain full employment.

Once current account convertibility was achieved by the major European countries by 1959 (even though the obligations of the IMF's Article VIII were not formally accepted until early 1961), the currencies of countries following policies inconsistent with the maintenance of their parities were subject to speculative attacks as private agents devised ways to circumvent capital controls.[15] As the Bretton Woods system became more fragile and U.S. gold reserves were threatened, the United States began imposing restrictions on capital outflows in 1965. Despite the attempt to quell speculation, the Bretton Woods system collapsed in August 1971 and the world shifted to a floating exchange rate regime among the major currencies in 1973.[16]

[14]This perception was strongly influenced by Ragnar Nurkse's study for the League of Nations, *International Currency Experience* (Princeton, New Jersey: League of Nations, 1944).

[15]The method often used was referred to as "leads and lags"—the practice of accelerating payments in domestic currency and delaying foreign currency receipts in the expectation of a devaluation of the domestic currency (see Obstfeld and Taylor, "The Great Depression").

[16]See Michael D. Bordo, "The Bretton Woods International Monetary System: A Historical Overview," in *A Retrospective on the Bretton Woods System: Issues for International Monetary Reforms*, ed. by M.D. Bordo and B. Eichengreen (Chicago: University of Chicago Press, 1993), and Margaret Garritsen de Vries, *The IMF in a Changing World, 1945–85* (Washington: IMF, 1986).

Chart 48. Selected Major Industrial Countries: Current Account Balances

(In percent of GDP; five-year moving averages)

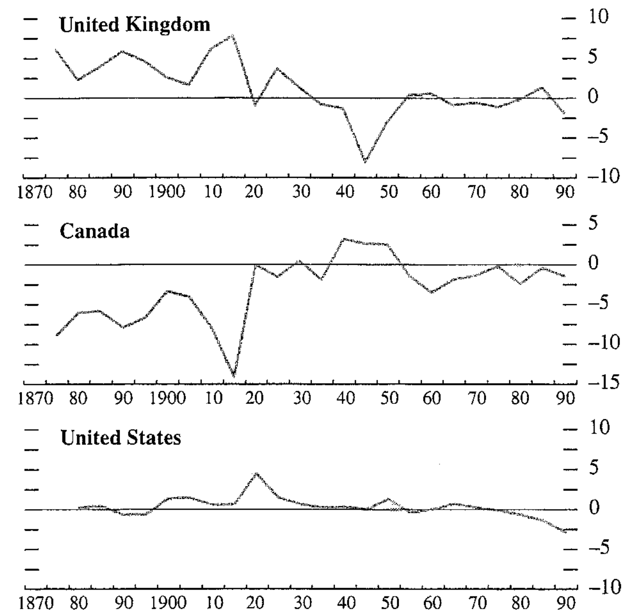
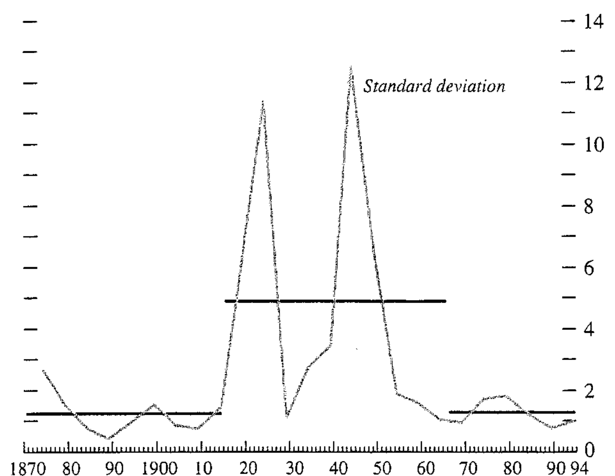


Chart 49. Selected Countries: Dispersion of Real Interest Rates[1]

(In percent)



[1]Five-year averages for the United States, Germany, France, Italy, the United Kingdom, Canada, and Sweden. Data prior to 1955 exclude Germany and prior to 1911 exclude France, Italy, and Sweden.

Within a decade, major countries dismantled their capital controls—the United States and Germany by 1974–75, the United Kingdom by 1979, Japan largely by 1980, and the rest of Europe by the end of the 1980s. Policymakers came to appreciate that with floating exchange rates, capital mobility was not incompatible with independent monetary policy conducted to stabilize domestic economic activity. Also in the past decade or so a number of developing countries have also opened up their capital accounts, extending the geographical limits of capital market integration beyond those prevailing in the pre-1914 period. The decline in the dispersion of real interest rates for select countries also suggests (Chart 49) that the world has been moving back to a regime of more tightly linked capital markets. This time, however, capital market integration is characterized by much larger gross flows, though not by larger net flows, than in the pre-1914 era.

Goods and capital market integration before 1914, combined with a high degree of labor mobility, led to considerable convergence in living standards among the industrial countries.[17] Not all segments of society, however, gained from greater integration and openness. Thus, trade liberalization in the nineteenth century induced a political reaction by those harmed by reduced protection, leading to calls to raise tariffs. At the same time, reductions in the rate of growth of real wages in countries with massive immigration before 1914 led to sharp restrictions on the movement of people.

Free capital mobility was incompatible with monetary policy independence under the interwar gold standard and was jettisoned in the face of depression. Even today under floating rates, capital mobility can create difficulties, not only for countries following inconsistent policies, but also for countries with sound fundamentals that may experience large-scale capital inflows and associated overheating pressures as witnessed in many emerging market countries in recent years. Such difficulties have led some to call for restrictions on the free movement of capital. For developing countries and economies in transition, fully opening the capital account is likely to take some time and will need to be preceded by adequate progress in liberalizing the domestic economy and establishing a sound banking system. However, for advanced economies whose capital markets are already highly integrated, the costs of retreating from integration would today be considerably higher than in the past. In capital markets, new technologies have created a vast network of interlocking arrangements within and between firms as well as new international financial instruments and new markets. Also, international deregulation has occurred hand in hand with deregulation in domestic financial markets. Attempts to restrict international capital mobility would not only increase the costs of financial intermediation but would likely prove futile. In goods markets, extensive integration at the firm level of multinational sources of supply and production processes, as well as the spread of multinational corporations, makes it more difficult to erect trade barriers. These factors are recognized by policymakers across the world. The lessons from history suggest that globalization, although driven in large part by technological advances, is not simply a product of technical forces. Policies too have a major role to play by fostering and maintaining open trade and payments arrangements.

[17]See Jeffrey G. Williamson, "Globalization, Convergence, and History," *Journal of Economic History,* Vol. 56 (June 1996), pp. 277–306.