Integrating Transition Economies into the Global Economy

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The successful integration of transition countries into the world economy will benefit all countries. The transition countries themselves face steep adjustment costs, but these should be outweighed by the benefits of being part of a larger and more competitive global marketplace.

AFTER years of self-imposed isolation, transition economies in Central and Eastern Europe (CEE) and the newly independent states (NIS) of the former Soviet Union are entering into an increasingly integrated and institutionally harmonized world economy. Greater openness will fuel faster growth in productivity, trade volumes, and national income. At the same time, integration helps lock countries onto the path of open trade, while membership in international institutions, such as the World Trade Organization (WTO), spurs domestic institution building.

Ensuring that the transition economies realize their potential as fully integrated and competitive members of the global economy will not be easy—for either the countries themselves or the rest of the world. The transition countries will have to adopt economic, social, and institutional policy reforms to attract foreign investors and foster growth. Those outside, particularly bodies such as the European Union (EU) and the international financial institutions, will need to carefully consider how to support long-term reform. Speeding the removal of existing trade barriers and carrying out further direct integration efforts should bring the largest and most immediate benefits for transition countries. But more support, such as providing short-term financial assistance and helping countries acquire much-needed skills and institutions, can also play an important role.

Capital flows and transition

At the beginning of transition in the countries of CEE and the NIS, everyone thought that huge imports of capital would be needed to finance economic and political transformation. There was concern that such flows would raise world interest rates and divert resources from the developing countries. However, except for the former German Democratic Republic, which has received close to $700 billion from the former West Germany, the CEE countries and the NIS have not absorbed a great deal of foreign capital. Between them, the transition countries in CEE and the NIS absorbed 15 percent of total capital flows to developing countries during 1990–95 (Chart 1). Net resource inflows are much lower and are even negative for some countries, once debt service and capital flight are taken into account.

Private capital flows to developing countries increased dramatically during the 1990s. But the CEE and NIS transition countries together attracted just 13 percent of total private capital flows to developing countries in 1990–95. The distribution of these flows has also been highly uneven—the Visegrad countries (the Czech and Slovak Republics, Hungary, and Poland) received three-fourths of the total.

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Chart 1

Transition economies have absorbed only a modest share of global capital flows

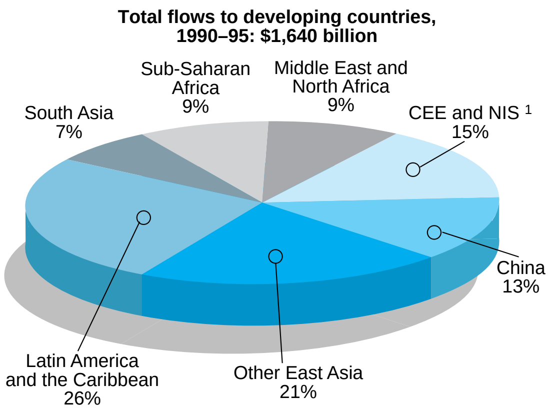
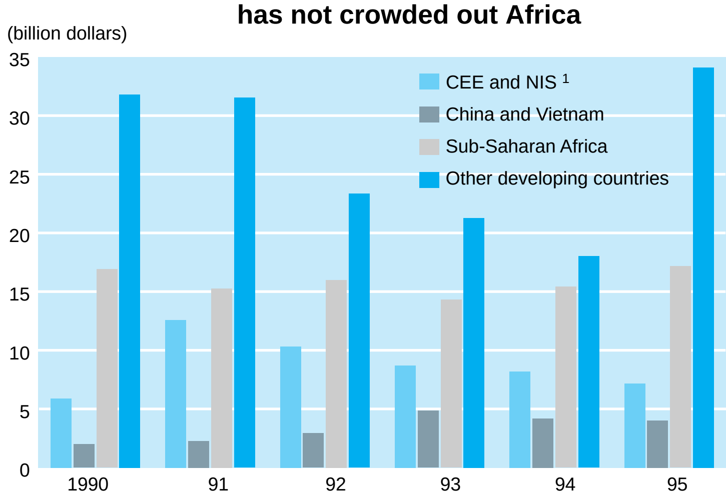


Chart 2

Official assistance for transition economies has not crowded out Africa



Source: World Bank.

Note: Data for 1995 are preliminary. Official development finance consists of official development assistance (grants and concessional lending) plus nonconcessional lending.

[1] Central and Eastern European countries and the newly independent states of the former Soviet Union.

Given the relative failure of many CEE countries and the NIS to capitalize on the growth in "emerging market" investment, and their urgent need for capital, the key goals of foreign official assistance must be to help create a more attractive environment for private inflows and to aid restructuring efforts, which should improve international competitiveness. Annual net flows of official development finance (grants and official concessional and nonconcessional loans) to CEE countries and the NIS averaged $8.8 billion in 1990–95. This has not, however, diverted official assistance from the poorest regions (Chart 2).

How can external assistance help transition? In the early stages of reform, a major share of official assistance took the form of balance of payments and budgetary support and debt relief. Official support from the international financial institutions (IFIs) and individual country donors has typically been much larger for rapid reformers, relative to their population or GDP (Chart 3). For example, by the end of 1993 the Visegrad countries—the advanced reformers—had received more than half of IFI disbursements to the region. In 1994, official lending shifted to the NIS as reforms advanced there. Among the NIS, the Baltic states, which have made substantial reforms, received relatively more official assistance in relation to the size of their population and GDP.

Has the volume of external financial assistance been adequate? This controversial question can be answered in a number of different ways. Aid under the Marshall Plan after World War II averaged 2.5 percent of the GDP of recipient countries. Total official disbursements to the CEE economies accounted for an average of about 2.7 percent of their GDP in 1991–93. The fact that GDP in these economies is underrecorded may make this ratio larger than it actually is, but on this measure the Marshall Plan was not materially larger than official flows to transition economies in CEE.

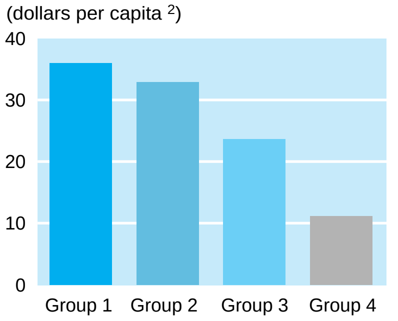
Has the timing of external financial assistance been appropriate? This is another hotly debated issue. External finance has been vital in underpinning a number of stabilization programs, in creating confidence, and in reducing the need for monetary financing to cover budget deficits. Liberalization, stabilization, and structural and institutional reforms have been highly complementary. Macroeconomic pressure often drives microeconomic change. Thus, external assistance programs in transition economies must be developed carefully, to walk the narrow path between facilitating reform and diminishing its urgency, and must lock in reforms through conditionality. Indeed, ill-conceived or premature lending can create large external debts that complicate subsequent reforms. Also, official financing cannot and should not offset massive capital flight triggered by macroeconomic policy, uncertainty, or a desire to evade taxation and regulation.

Even after inflation has been brought down to moderate levels, external assistance may be needed, within limits, to help bridge a transitional fiscal gap. Although government spending as a share of GDP exceeds reasonable limits in some countries, other transition governments are small relative to the core functions they need to fulfill. To address their fiscal problems, some governments have been forced to cut social protection and public investment, probably to levels below those needed to sustain reforms. Some, with limited capacity for administering taxes, end up imposing distortionary taxes to meet their spending needs, with huge costs for economic efficiency. Meanwhile, a number of governments are themselves in arrears, undermining hard budget constraints in the rest of the economy. These areas merit close attention by assistance agencies. However, budget support should always be conditional on policy reforms, notably in the areas of tax policy and administration, budget management, targeted poverty programs, and human resource development.

Institution building

The fundamental element of the transition process is the need to develop market-supporting institutions. Postwar Europe already had long experience with markets, and the associated institutions—private property rights, information, legal systems and courts—and generations of accumulated skills were all in place. Even now, many developing countries have a stronger institutional base for a market economy than most transition economies at similar levels of income. Foreign support therefore needs to focus on technical assistance and institution building in areas that are critical to reform. This involves helping to create

Chart 3
Reforming governments receive the most external assistance [1]



Group 1: The Czech Republic, Hungary, Poland, and the Slovak Republic.

Group 2: Albania, Bulgaria, Romania, and the Baltic states.

Group 3: Kazakstan, the Kyrgyz Republic, Moldova, and Russia.

Group 4: Belarus, Turkmenistan, Ukraine, and Uzbekistan.

Source: World Bank, *World Development Report 1996: From Plan to Market.*
Note: Reforms are most advanced in Group 1 countries, least advanced in Group 4.
[1] Net official capital inflows per capita.
[2] Annual averages for 1990–95 (CEE) and 1992–95 (NIS).

institutions that make reforms more effective and harder to reverse. But this takes time and sometimes involves restoring entire professions in areas that are essential to a well-functioning market economy. Also, technical assistance needs to encourage local capacity building through, among other things, more involvement of local participants. Far greater stress is needed on economic education in the broad sense as well as hands-on training in key marketable skills. So far, bilateral assistance, including that from the EU, has had a high component of technical assistance. The activities of the IFIs, such as the IMF and the World Bank, also include a great deal of institution building across a wide range of areas, in addition to the transfer of financial resources.

Reforms to reduce regulatory and other barriers to new businesses, including access to premises, are also important. Carefully designed programs can combine commercial and educational objectives, and some may return more than their cost. Business advice and financial support should come mainly from the private sector itself—business support services, investors in equity, and private lenders of working and investment capital. These services and suppliers exist in embryo in some transition economies, but not at all in many others. Does this justify a role for assistance agencies? It does if they assist in speeding the establishment of prudent and capable lenders and investors and if they help managers and entrepreneurs to overcome years of isolation from market forces. But it does not if they simply finance investment through government restructuring agencies.

Global integration

World Trade Organization. WTO membership is an important step for transition countries, and virtually all have applied to join. WTO membership spurs domestic institution building and is an important step toward successful integration into the global economy. Transition countries stand to benefit as much from the obligations attached to WTO membership as from the many rights it confers. Joining the WTO would consolidate international market access for transition economies, providing them with some protection from the arbitrary imposition of barriers by other countries. Equally important, quick accession to the WTO would greatly enhance the political feasibility of achieving and maintaining liberal trade regimes in the transition economies themselves in the face of the strong sectoral interests that are inevitably emerging.

Transition countries should view WTO membership as an opportunity to further the reform of their trade regimes, not only to meet WTO requirements but also to increase economic efficiency by, for example, reducing distortions in trade policy, eliminating state trading, maintaining low or moderate tariffs, and abolishing nontariff barriers. Relatively strict terms of accession—including comprehensive tariff bindings—can help to reduce the payoff to domestic rent seeking. At the same time, without undermining the pressure on applicants to implement liberal trade regimes, WTO members should do all that they can to accelerate the process of admission. For some transition economies, technical assistance in meeting the extensive information requirements of accession would be helpful. One distraction is that some of the NIS have tried to restore intra-NIS trade through some forms of "free trade arrangements." These countries should instead concentrate their limited administrative capacities on deepening their integration into the world trading system. Forming a regional trading bloc among NIS at this stage not only complicates procedures and delays progress in joining the WTO, but, more important, various estimates show that, under a market-determined trade pattern, much NIS trade would be with countries outside the NIS.

European Union. The process of integrating into the EU has profound implications for the transition countries. The process began with the Europe Agreements and has now entered a new phase. The Europe Agreements signed between the EU and 10 transition countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia) are the deepest and broadest of the EU Association Agreements. They define relations not only for trade but also for financial cooperation and, more important, for commercial practices, harmonization of law, and political dialogue. They also encourage transition countries to liberalize trade among themselves, for example, through the Central European Free Trade Association.

Accession negotiations with some of the CEE countries are expected to start in 1998 after the conclusion of the EU Inter-Governmental Conference. Negotiations for the Union's most recent enlargement (with Austria, Finland, and Sweden) took less than two years, but negotiations with Spain took almost nine years. The benefits to the CEE countries of accession are clear: prospects for political stability, free trade and capital flows, access to common funds, and locking into reasonable market-friendly policies.

A rapid accession would do much to sustain and deepen reforms in transition economies. So what stands in the way? One factor is the need to develop administrative and organizational capacities to implement and enforce the rules of the Union. The biggest economic barrier, however, may lie in the EU budget—some 80 percent is used to finance the Structural Funds that offer aid to poorer EU regions—and the Common Agricultural Policy (CAP). Extending these policies to CEE countries, which are poorer and have larger agricultural sectors than the EU average, without reforming the policies would be expensive. It would also be difficult to get existing members to agree to the transfers under the current EU constitutional structure. The CAP was substantially reformed in 1992, but further reforms are needed. The EU eastward enlargement is therefore likely to involve a phased process that advances certain elements of EU membership (trade, in particular) faster than others while, at the same time, possibly stimulating some helpful reforms in the EU itself. F&D

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