Chapter 12

The internationalization of postsocialist economies

(pp. 300-62)

12.1 Transition and globalization: the issue of coordination

International organizations are playing a major part in the attempt to guide the transition endeavour on an international scale. Of special significance have been the Bretton Woods institutions, which have been involved in the transition since the beginning. Other organizations, mainly the European Bank for Reconstruction and Development, the European Union, the Organization for Economic Cooperation and Development, and the World Trade Organization, though their roles and attitudes to transition differ, have also been important in the course of the transformation.

These organizations do not act exclusively on their own account. They are also employed as a means of assisting in the transition by developed market nations, especially the G-7 group, consisting of the seven most advanced market economies: Canada, France, Germany, Great Britain, Italy, Japan, and the United States. The West European nations are engaged through the EBRD and the EU in overhauling the Eastern European economies. These countries are all keen to push the transition forward quickly toward free market systems, but also to integrate the transition nations with the world economy or, in the case of the ‘eastbound’ EU, to integrate leading transition economies with the rest of Europe. It is thus no wonder that key changes in these economies are occurring on terms influenced significantly by the priorities of the advanced market countries.

Surprisingly, there has been little coordination among the postsocialist nations as they implement structural and institutional change. These nations have established no formal mechanism or framework to serve as the focal point for the study and the exchange of views on the transition and on development policy in Eastern Europe and the former Soviet republics. And this is certainly not because there is no perceived need for coordination. On the contrary; it is truly desired within the countries, just as a similar mechanism to coordinate policy responses would be welcome among the crisis-torn Asian nations. Only ex post, since nobody has been able to control the spread of the Asian contagion, has policy coordination been proposed on a global scale through the IMF Interim Committee, especially vis-à-vis capital flows and the performance of emerging markets. This committee may eventually be upgraded and enhanced through periodic meetings of the heads-of-state of the 24 participating countries.

There are two reasons for the negligence. First, according to the neoliberal bias and market fundamentalism, coordination at the regional level is not at all necessary and would only interfere with transition, which is proceeding firmly forward without it. Liberalization and globalization will suffice. Moreover, any policy coordinating institution would presumably resemble the defunct Comecon.

This last is a particularly irrelevant argument since Comecon was dissolved for good reasons, and transition policies ought to be coordinated for another set of good reasons. In any case, there should at least be a periodic conference of key policymakers from those transition countries seeking closer cooperation and policy guidance. This would only help enhance policy efficiency and facilitate the exchange of experiences.

Second, it has been assumed that the coordinating role can be handled adequately by the EBRD and the Bretton Woods institutions. This assumption would be correct if three other conditions were fulfilled. First, the interests of these organizations must correspond closely to the interests of the transition economies. Second, the transition economies must be able to influence the transition policies of these organizations. Third, the transition economies must be able to use these organizations to coordinate their own efforts. None of these conditions has been met.

It would be naïve to expect the rich nations not to take advantage of the collapse of the socialist system. Their insistence that the transition economies should quickly become open must be seen as natural behaviour. The immediate liberalization of capital and financial markets and the rapid privatization of state assets, among other measures, are considered very suitable because they promote not only transition as such, but Western interests, too. As long as they are compatible with the interests of transition economies, then such measures are fine. The problem is that this is not always so.

The emerging middle and upper classes in the transition countries have a strong interest in the success of the liberalization and privatization processes. They support fast ‘Westernization’, but they are not paying attention to the needs at the other end of the social rainbow. They have too much to gain and so little time.

However, healthy Westernization in the positive sense of a well-performing market economy and an active civic society is not feasible if the expansion of the middle class and of its well-being is accompanied by spreading poverty. Poverty is unfair. It also threatens political stability. Anyway, under such circumstances the business climate is not going to be favourable for domestic entrepreneurs or foreign investors. Likewise, if income becomes too unequal and ‘Westernization’ is seen by the new poor as a cause of their impoverishment, then the atmosphere for foreign involvement in overhauling the postsocialist economy is going to be stormy.

Nonetheless, that the new rich are in favour of foreign participation, while the new poor are not, is not always true. It depends. Some new rich are against the participation of foreigners, because without it they can make better deals, for instance through insider trading and connections with cronies who still have influential positions in the state bureaucracy. Some new poor are in favour of growing foreign involvement if only because they can at least afford a little bit of the goods now so readily available without queuing, though not yet available without cash.

A judicious policy would assure that a wide spectrum of the people in transition societies are in favour of growing links with the world economy. To accomplish this, a balance is needed between sharing the costs and sharing the fruits of the transition not only within the societies, but internationally as well. Foreign capital and foreign governments, in sound accord with international organizations, ought to prefer long-term investment and reasonable technical assistance which facilitates transition and serves the purpose of ongoing globalization. This approach works on behalf of all the parties involved. It creates within transition societies, if not support for the internationalization of the economy, then at least a calm climate.

However, if the foreign partners are less interested in long-term investment, the upgrading of industrial capacity, and the provision of assistance in the process of labour redeployment and if they are more interested in quick profits in trade, speculative investment, and non-transparent privatization deals conducted with corrupt local officials and the new rich, then a majority of people, including some of the new middle class, will remain suspicious and resist the more thoroughgoing involvement of foreign partners in 'their' affairs.

It so happens that in the era of the global economy the transition economies are already not exclusively 'theirs' anymore. The opening up of these societies to myriad contacts with the outside world is generating a cultural revolution. This is true even in the more geopolitically remote former Soviet republics. Indeed, the level of 'globalization' is no longer measured in terms of the number of bottles of soft drinks drunk or the dimensions of the market for hamburgers. Nor is it measured by the penetration of the emerging and the developing market economies by industrial machinery from everywhere else. The level of globalization can be measured by the fact that the imported cars, home appliances, and electronic gadgets are threatening trade balances, which have swung from surpluses following early devaluation and stabilization to deficits, especially in quickly growing economies. The level of globalization can be measured by the fact that pension benefits in developed market countries may now depend at least in part on the rate of return from pension funds invested in postsocialist emerging market countries. And the level of globalization can be measured by the fact that sometimes a government in a transition economy may have to increase the pension arrears owed by its own social security system in order to service the mounting public debt due to the interest it must pay on the bonds it has sold to pension funds in developed market nations. Pensioners in Arizona or Florida, like pensioners in Siberia, are blissfully unaware of this, but the economists and policymakers ought to be aware of it.

The way an economy opens up to links with the outside world matters as much for the elites as it does for ordinary people. If the inflow of foreign capital creates new well-paying jobs and if, for some of the new income, one can buy more goods no matter who the buyer, who the seller, and who the producer, then the opening may be healthy. But if the shops are full of goods which have been imported or are made by local firms owned by foreign capital or foreign firms operating locally, and if only a few people can afford the goods anyway, then the opening may not be so sensible, including for the foreign investors.[1]

People in the West may be tempted sometimes to evaluate the efficiency of a country's transition policies not according to GDP growth or the satisfaction of the basic needs of the people, but by the way the downtown streets look in the capital city.[2] Quite often they look pretty good because, unfortunately, the streets everywhere else look pretty bad. Even respected journals publish elaborate accounts of the presumed achievements of infant Russian capitalism because there are now Western-style up-market shopping streets (a sort of Fifth Avenue for Muscovites). However, it should be made clear that the vast corruption and the salary and pension arrears are not on display in the shop windows. Moreover, not only the nice looking, pricey shops, but also the not so nice daily lives of ordinary citizens shape the political environment in which foreign participation in the transition process must occur.

12.2 The role of international organizations

[1] In the aftermath of the financial crisis and the currency devaluation in Russia in 1998, the supply of consumer goods and real household consumption deteriorated rapidly. This occurred partly because a bulk of consumer goods were being imported or were being produced locally using imported intermediate goods. It is thought that prior to the crisis as much as 80% of the consumer goods available in Moscow and more than 40% of the consumer goods available in Russia had been imported.

[2] Asked to name the greatest achievement of the stabilization programme in Poland in 1991, an advisor to the government answered that one could now buy kiwi at fruit stands in Warsaw.

Their attempts to join the World Trade Organization, the Organization for Economic Cooperation and Development, and the European Union have special meaning for the leading transition nations. Of less importance, though not negligible, especially in the aftermath of the turmoil on global financial markets, is the cooperation between the central banks of the transition countries and the Bank for International Settlement, particularly in the areas of banking sector supervision and transparent and prudent banking regulations. This organization can play an even bigger role in institution-building, especially in bank restructuring and consolidation. Healthy banking systems are crucial for stabilization and capital allocation.

The process of joining the World Trade Organization, or a desire to do so, has accelerated trade liberalization in several nations. It has also been used by the G-7 governments to push through systemic and policy changes which have had an impact on international trade and liberalization in some postsocialist countries. The discussions of the WTO and the G-7 with China and Russia have been very influential on the market transformations occurring in these two huge economies. As usual, politics is also involved in these discussions. Thus, non-economic factors, including the status of human and minority rights, have been cited as reasons for the delay in China's membership in the WTO, despite the enormous progress of China in economic liberalization.

Participation in the WTO for all members, including transitional economies, has obvious benefits. First, members have more secure access to global markets. The process of removing trade tariffs and non-tariff barriers enlarges the limits of these markets, thereby enhancing the ability of all open economies to expand.

Second, since member nations must observe the international rules of trade agreed within the WTO, they are more able to resist domestic protectionist pressures. In the effort to prod through unpopular domestic industrial and trade policy measures, it is sometimes very useful to have the ready excuse of international obligations.

Third, member countries, even the relatively weaker ones, may count on fair treatment in any trade disputes with fellow members (Michalopoulos 1997). If, despite the free market ideology and official political support for free trade, a weaker partner is discriminated against or taken advantage of by a stronger one, then WTO arbitrage can come to the rescue.

Fourth, WTO members possess greater credibility in the face of international investors and can thus attract larger inflows of badly needed foreign direct investments.

Membership negotiations with the Organization for Economic Cooperation and Development in 1994-6 led to a great deal of acceleration in liberalization in the Czech Republic, Hungary, and Poland, especially the regulation of capital transfers and foreign investments. The governments of these nations worked with the OECD Committee on Capital Movements and International Transactions, which is responsible for the implementation of and compliance with the organization's Codes of Liberalization of Capital Movements and Current Invisible Operations. The new members are going to adopt these principles, which are legally binding instruments accepted by OECD countries. Certain transitory reservations and exceptions on specific items apply to new members, including those from Eastern Europe, but there is an agreed commitment that these will be lifted in due course (meaning that there will be tough and complex negotiations before any 'lifting' occurs).

Progress toward the gradual liberalization of capital movements and invisible transactions has been achieved in other nations, too. Conscious of the OECD membership requirements, but essentially on their own behalf, the Baltic States, Slovakia, and Slovenia have taken steps to widen the scope of liberalization. An official statement issued by Russia in September 1997 concerning a commitment to apply for association (though this is impossible for the time being) should also be considered through the prism of the readiness to carry out economic liberalization in line with OECD regulations and standards. While Russia's was a political gesture rather than a formal bid for application, the Baltic States and Slovenia have decided not to approach the OECD at this stage of transition. Following the experience of the Czech Republic, Hungary, and Poland, they are aware of the hard conditions which must be met before accession is possible.

The most difficult transition issues negotiated with the OECD by the Czech Republic, Hungary, and Poland have revolved around the liberalization of capital flows and the regulation of foreign direct investments. These are serious issues as far as OECD development policy is concerned. Hence the OECD has insisted very firmly on the need for rapid and far-reaching liberalization and deregulation.

However, in the Baltic States and Slovenia there is some reluctance to lift restrictions on the acquisition of real estate. Rightly or wrongly, for a number of reasons, including political and sentimental ones, they are wary of foreigners making a run on choice properties. The same concern was raised rather loudly within Poland during its negotiations with the OECD. In Slovenia one hears this fear expressed in relation to Italians, and in the Baltic States it arises toward Germans and Russians.[3] There may be no solid economic rationale for these reservations, but they must not be neglected since they can easily shift from simple concerns into insurmountable political challenges.

Another sticking point is the OECD insistence on transparent regulations on bank secrecy. The OECD wants the transparency so as to make price transferring more difficult to use as a means of money laundering or of hiding otherwise taxable profits from tax authorities.[4] However, in transition countries and in many other emerging markets there is strong opposition to such a step from banks and financial organizations with influence in the media and among political parties. To break down this opposition is not easy, and a certain amount of political will must exist to do so. In the case of Poland, if not for the significant pressure from the OECD, the relevant amendments would not have been enacted. Whenever the issue was brought up, there was an attempt to kill it by hostile lobbying, while the central bank hemmed and hawed rather than driving the reforms forward through all political obstacles.

Some nations are not yet ready to accept the OECD requirements regarding capital flows because they are afraid that liberalization would lead to financial destabilization, thereby exposing the economy to the risk of severe external shocks. They are right, since liberalization in this area requires sound financial fundamentals and a sophisticated institutional framework. In its negotiations over this issue with the OECD, the Czech

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[3] Even Denmark maintains restrictions on the sale of land to foreigners because of a fear that Germans would buy up much of the available real estate.

[4] ‘Price transferring’ is the manipulation of price and cost information through accounting tricks carried out on an international level.

Republic was keen to show a willingness to accept very liberal regulations in order to prove its determination to go to the free market as speedily as possible. However, quite soon, only a year and a half after it joined the OECD, the country experienced a currency crisis because it had not been sufficiently concerned about the medium-term effects of the liberalization on current account sustainability and currency fluctuations.

In contrast, Poland was able to negotiate a slightly more gradual path toward the liberalization of capital flows, and this was one reason it avoided a similar crisis. Actually, among new OECD members – Mexico (since 1994), Hungary and the Czech Republic (1995), Poland (1996), and the Republic of Korea (1997) – only Poland has been able to sidestep an economic emergency linked to the poor regulation of capital flows and weak banking supervision. In some countries, the instant the confidence of investors in the economy was shaken by unexpected events, a crisis erupted. This proves only that liberalization and openness to international capital movements can be positive if there is careful policymaking and institution-building.

The series of crises among new members seems to have played a part in the fact that the OECD now appears less eager to take on fresh candidates. Another important cause is the spreading concern about the future of an organization which includes nations at such different levels of development as the United States and Mexico, Japan and South Korea, or Germany and Poland. Even if the liberal regulatory environments are becoming similar in these countries thanks to OECD technical assistance and the leverage it exercises, the development gap remains very large, and real partnership and cooperation are not always so easy within the OECD.

Some countries have found a good reason to join the OECD in the fact that this represents a strong argument for acceptance in the European Union. Naturally, it is possible to join the EU without joining the OECD, as is likely to be the case of Estonia and Slovenia, but this can be a slightly more difficult route. If Bulgaria, Latvia, Lithuania, Romania, and Slovakia had joined the OECD before 1997-8, when the current list of applicants to the EU was determined, then they would have had a better chance of being included on this list. This is not because OECD membership necessarily carries with it a deciding influence, but simply because the procedure leading to OECD membership is an important additional catalyst for certain major structural reforms and institutional changes. In any case, for the Czech Republic, Hungary, and Poland, the process of approaching the OECD was part of the process of approaching the EU. The reforms implemented during that time facilitated the course of the transition to the market economy, as well as of integration with the EU.

12.3 The special mission of the IMF and the World Bank

Conditions are such in the postsocialist nations that the position of certain international organizations is relatively stronger there than it is elsewhere. This is so for many reasons, but especially because of the rather weak penetration of private capital in this area of the global economy. The transition nations are cash starved, but the growth they are seeking needs plenty of capital. Foreign governments are anxious to see the political and economic systems change quickly in these nations, but they do not wish to become entangled in complicated financial, legal, and technical difficulties. This represents an ideal situation for international organizations able to supply capital, expertise on market economy performance, and an arena for the indirect involvement of foreign governments. Hopefully, they will never consider a deserved dose of constructive criticism always out of place, but for once it ought also to be admitted that the contribution of these international organizations has been significant and positive.

The governments of countries in transition have always turned first for money and advice to the International Monetary Fund and the World Bank.[5] Quite soon they realize that from these two they obtain less money than advice on the policies needed to generate more money (and less advice) in due time. Though often they may not apply the policies, the bargaining procedures and the lengthy discussions are very useful in the process of learning by doing. This alone has represented a unique investment in human capital. Owing to the rapid rotation of government officials and higher level civil servants and the fact that many of them have left to work as executives in the private sector, the

[5] In contrast, the European Bank for Reconstruction and Development, for instance, mostly lends to the private sector or for projects enhancing privatization.

quality of the state bureaucracy and of corporate governance throughout the economy has been upgraded through the contacts with these organizations.

Likewise, the persuasion and insistence employed especially by the IMF, but also by the World Bank, to push through certain policies have been important. The arguments on the way structural adjustment policies ought to be framed and implemented have been instructive, and they have influenced policymaking.

Of course, the credit for the policy achievements, as well as the blame for the policy failures, ought to be laid squarely at the door of the governments and the policymakers, but it must be acknowledged that, without the active and capable participation of the Bretton Woods institutions, the transition to the market economy would be more difficult. Despite many false starts, meaningful steps toward a market economy have been taken in the transition region, and, though late in coming, there is a chance for durable growth. Because of the significant involvement of the IMF and the World Bank, the systemic transition has made more overall progress, and sustainable development has become more likely.

Nonetheless, membership in the IMF and the World Bank has not helped the transition countries much in the regional coordination of transition policies and development strategies. Initial discussions between IMF staff and the fiscal and monetary authorities of these nations – the ministries of finance and central banks – were typically a sort of one-way street, without too much attention being given by the former to the views of the latter. The participation of the representatives of the transition economies in the 'constituencies' of Bretton Woods institutions is designed in a way which limits the opportunities for comprehensive coordination among the economic policies of the transition countries, as well as among the policies of these countries toward the organizations. Only China and Russia have been able to afford to establish themselves as single-country constituencies, so that their position is relatively stronger.[6] As for the others, they have been dispersed among various groups, which are sometimes organized so that the transition nations, even if there is a number of them

[6] France, Germany, Great Britain, Japan, Saudi Arabia, and the United States form the other single-country constituencies.

together, do not have much say in the formulation of proposals, let alone the design of policies. A group is usually led by an advanced market country, and the other group members have only a minor influence on the policies of the organization, including the policies toward them.

The most well composed constituency in terms of postsocialist countries is the one led by Finland, since it is established on a clearly regional basis. The other members are the Nordic advanced market countries (Denmark, Iceland, Norway, and Sweden) and the three Baltic States (Estonia, Latvia, and Lithuania, which are transition countries). But for the remaining postsocialist economies, there are no clear links between them and the leaders and other members of their constituencies. For example, the constituency led by Switzerland contains Poland and five former Soviet republics (Azerbaijan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan). The constituency led by Belgium includes three other market economies (Austria, Luxembourg, and Turkey) and six transition nations (Belarus, the Czech Republic, Hungary, Kazakhstan, Slovakia, and Slovenia). The constituency led by the Netherlands consists of Cyprus and Israel, as well as a number of transition economies (Armenia, Bosnia-Herzegovina, Bulgaria, Croatia, Georgia, FYR Macedonia, Moldova, Romania, and Ukraine).

It would be more reasonable and desirable to put transition countries together according to geopolitical criteria so that neighbours are not separated. What may have somehow made sense at the beginning of the transition in 1990 is not necessarily a suitable solution for the situation in 2000. So, why not establish at least one strong and competent constituency, if not exclusively of transition economies, then led by them?

Yet, the postsocialist countries must agree that it should be this way, too. However, there is sometimes an atmosphere of competition and even rivalry among them based upon the false assumption that this is a better method to gain political and financial support. But now more than ever there is a real need for sound policy coordination among these nations.

In the absence of other appropriate institutional arrangements, the creation of task force groups working within the international financial organizations might be a good means to coordinate policies, monitor developments, and funnel advice to transition countries. If it is considered natural that the US executive director in IMF can be called to appear before a Congressional hearing in Washington on support for American interests and policies within the IMF Board, why should it not be possible for Eastern European and CIS governments to have an organizational means to express their views in a coordinated way? If they are too small and too weak to act separately within the Bretton Woods institutions, this is all the more reason for them to seek to act together so that they are neither so small, nor so weak.

The composition of the 24 constituencies in each of the Bretton Woods institutions is determined on the basis of quotas in ‘special drawing rights’ (that is, according to the value of contributions to the institutions). Thus, an individual nation cannot join a constituency as it pleases (unless, of course, it contributes sufficiently to form a single-country constituency). However, a constituency could still be led by a transition country, just as less-developed countries now lead several existing constituencies. For instance, Mozambique currently leads the constituency of 22 sub-Saharan countries, including much stronger and more developed South Africa and Zimbabwe.[7] Kuwait leads a constituency of countries in the Middle East and North Africa.[8] The Philippines heads up a group of countries in South America and the Caribbean.[9] Finally, Bolivia leads a constituency composed of several Latin American countries.[10] In these last two cases, the constituency leadership rotates, so that before the Philippines and Bolivia, the leaders were Brazil and Argentina, respectively. Hence the architecture of particular groups is not solely a matter of financial quotas, but political preferences play a role as well, and there could be a constituency led on a rotating basis by,

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[7] The other 19 countries are Angola, Botswana, Burundi, Eritrea, Ethiopia, the Gambia, Kenya, Lesotho, Liberia, Malawi, Namibia, Nigeria, Seychelles, Sierra Leone, Sudan, Swaziland, Tanzania, Uganda, and Zambia.

[8] Besides Kuwait, this constituency consists of Bahrain, Egypt, Jordan, Lebanon, Libya, Maldives, Oman, Qatar, Syria, United Arab Emirates, and Yemen.

[9] The constituency includes Brazil, Colombia, Dominican Republic, Ecuador, Haiti, Suriname, and Trinidad and Tobago.

[10] In this constituency are also Argentina, Chile, Paraguay, Peru, and Uruguay.

for example, Estonia, Hungary, or Poland, or by the Czech Republic, Kazakhstan, or Ukraine. This would help in the formulation of regional policy and might raise the efficiency of the responses the Bretton Woods institutions address to these countries.

There are reasons for the current constituency structure. It was more comfortable for the IMF and the World Bank to spread the transition countries out among various constituency leaders. Moreover, several serious attempts on the part of these organizations to enhance the cooperation among the transition nations failed because of the lack of interest of these nations, which appear to share only the conviction that there is much more to be learned from the experience of the developed and developing market economies than from each other's failures and achievements.

The process of learning by doing has therefore occurred through an intermediary, since the IMF and the World Bank have not been able to provide sufficient institutional platforms for direct contacts among experts and policymakers from transition countries. Despite the flaws, however, knowledge and experience have been acquired. Moreover, the process of learning by doing is taking place within the Bretton Woods institutions, too, so that these organizations are becoming the international financial intermediaries of the transition, but also the international intermediaries of transition knowledge.

Yet, before these institutions could absorb the lessons, the questionable structural adjustment policies they had framed and proposed were tending to worsen the situation in postsocialist economies. Across Eastern Europe and the former Soviet republics, the once distorted centrally planned economies were becoming 'Latinized', so that the differences between them and distorted developing market economies, mainly those of Latin America, were shrinking. At the onset of the 1990s, these differences were substantial. Now, these two groups of economies, so diverse in background, are a little less distinct. The Russian economy of today recalls not the Russian economy of the beginning of the decade, but the Brazilian economy of the late 1980s. The two differed substantially back then. This is no longer so. The same can be said of a number of other 'Latin-transition' pairs, say, Chile and the Czech Republic, Argentina and Poland, Uruguay and Latvia, or Nicaragua and Georgia.

Two groups of economies that were different at the end of the 1980s and the beginning of the 90s have become similar because the Washington consensus erroneously thought that the transition group required similar policy solutions. A shoulder-numbing shot of good anti-distorted-developing-market-economy vaccine was given to the wrong patient, and, in one of those ironies of nature, the patient has acquired the symptoms of a well-distorted emerging market economy. Indeed, why not compose a new IMF and World Bank constituency from Latin American, Eastern European, and CIS nations?

The Bretton Woods institutions are normally perceived as lending institutions. For obvious reasons, the lending is subject to 'conditionalities' and is tied to numerous structural reforms. Therefore, what matters is how much money is being lent, but also the conditions which apply and the purposes of the reforms.

Whereas the IMF is concerned basically with financial fundamentals such as sound fiscal stance, a balanced current account, a stable currency, and low inflation, the focus of the World Bank is the restructuring of industrial capacity, infrastructure upgrading, and human capital investment. Thus, the IMF aims at stabilization, while the World Bank aims at growth. Each is also involved in structural reform and institution-building, the IMF being oriented to equilibrium and financial stabilization, and the World Bank to long-term development. For these reasons it may be a mistake to put both institutions on the same footing or to speak their names in the same breath, as one might say 'Marx and Engels'.

The financial support provided by the IMF to government budgets and the current account balance and the lending supplied by the World Bank for retraining and manpower redeployment, social security reform, health care upgrading, hard infrastructure, and environmental protection have been remarkably useful to the transition economies. Throughout the region during the early transition, as well as now in several countries with only limited access to private resources, a bulk of the external financing has been provided by these two organizations. Becoming active somewhat later, the EBRD has been helpful, too. Bilateral assistance, though more important for certain countries, has been relatively minor.

It should be remembered that the money comes in loans, not grants. The money is supposed to be allocated efficiently to foster systemic transition and socioeconomic development, but it takes the form of credits which must be paid back and which bear interest. So, the relationship is a business (and political) one, not charity.

The lending is always conducted through phased ‘tranches’ of credit that are to be used for specific purposes which have been agreed upon beforehand. The release of the tranches is usually well publicized. The government authorities take care of the publicity themselves. The conditions for the lending of the Bretton Woods institutions are known to be tough. Of course, in the age of the liberal global economy, a government capable of meeting tough conditions is a good government. If the government is good, everyone should know about it.

This mechanism also operates in another direction. The IMF performance criteria, which are used to assess the fiscal and monetary profile of an economy, are always linked to fiscal stance, the monetary aggregates, and the external financial position. They are well publicized, too, so that, similar to the situation with the credit tranches, there is always much more public debate over meeting or missing the criteria than the issue actually deserves. Often it is difficult to satisfy the criteria, but a government can nonetheless become exposed to strong pressure to succeed. If the government does not succeed, it can still succumb to the temptation to blame the criteria or the policies imposed by the ‘outsiders’.

If subsequent tranches of stand-by credit are not urgently needed, it may be better to take them anyway and try to meet the performance criteria. This is so for three reasons. First, during the troublesome period of structural adjustment the demand for external financing is great, but if a transition economy has no access to private capital markets it can acquire the financing only through the IMF. Then, after achieving some progress in stabilization and structural reform, the country may apply for a credit evaluation, usually to the American rating agencies Moody’s or S&P, or the British agency IBCA. Only with a proper grading is there a chance to approach international capital markets and try to borrow at commercial rates through the Eurobond or global bond issues. Thus, without a good relationship with the IMF, there is little likelihood for a good relationship with capital markets.

Second, reaching an agreement with the IMF is a seal of approval for prudent policies and thus opens up access to additional credits from the World Bank, the EBRD, and private commercial banks. In the early 1990s no postsocialist country could hope to acquire a major foreign commercial bank lending without the endorsement of its economic policies by the IMF. Even today, such a relationship is understood to be necessary.

Third, the IMF performance evaluation is a strong point in favour of or against a government's policies. If the evaluation is positive, this strengthens the government's position and credibility in dealing with other issues. If it is negative, the government's standing is weakened. The effort to fulfil the performance criteria is monitored by the IMF, the business community, and international investors and financiers, but also by the political opposition waiting in the wings. This can render policymaking even more difficult.

There is no doubt that the IMF and the World Bank had more say with governments during the early transition. The paradox is that they had much less of value to say at the time because of their lack of experience with the unique problems of the postsocialist nations. Later, though the Bretton Woods institutions gradually came to learn more through their monitoring functions and to understand which policy proposals had a better chance of working, their influence began to decline, particularly in transition economies doing relatively well. If structural reform has made sound progress, then the technical advice and financing assistance of these institutions, though still sought, are less critical.[11]

Economic recovery and growth encourage more inflows of foreign private investment and commercial lending from the private sector. As growth gains momentum, official lending begins to fall, and private investment and credit begin to increase. Simultaneously, the influence of private entities (investment banks, hedge funds, rating agencies, consulting firms, research establishments) on

[11] One might call the technical advice 'soft' not only because it is abstract, but also because it is always easier to give advice ('tighten your belt', 'cut expenditure', 'withdraw subsidies', 'close state companies', 'fire superfluous workers') than it is to apply it. In the same spirit, 'hard' (because tangible) financial assistance is harder to come by. There is always an excessive supply of easy advice and an insufficient supply of hard financing, but this is especially true during early transition, when the economy is weaker and more vulnerable.

economic matters is expanding, while that of individual foreign governments and international organizations is shrinking.

There can also be turnarounds the instant another severe crisis occurs. The extent to which this is true can be gauged by the shift in relative power between the private sector and official institutions during the Asian crisis. While the crisis was caused mainly by the private sector, it must now be solved mainly by governments and international organizations. There has been a similar, though opposite shift especially in the more successful transition economies, where less and less is depending on governments and more and more on the private sector.

Clearly, if a country is confronted by a deteriorating economy, then the sway of the IMF and the World Bank becomes stronger. Only then is the government obliged – like it or not – to seek assistance; only then is it obliged to listen to the recommendations of outsiders, and only then does it not consider blaming the outsiders for intervening in its internal affairs. Thus, the Bretton Woods institutions have a greater say (and, more importantly, a greater power of decision), for example, in Russia than in China. In 1997-8 they were much more influential in Albania, Bulgaria, and Romania than they were in Hungary, Poland, or Slovenia.

12.4 Integration in the world economy

The amount of its openness toward and the range of its integration with the world economy have a significant impact on a country's ability to expand. Likewise, the more integrated a country is in the world economy, the more its development will follow the overall trend in growth of the global economy. This may not always be good news because of sluggish economic performance occurring from time to time in other regions or among the most advanced market nations. By the same token, because transition countries are trying to catch up with the developed market economies, they may end up growing at a faster rate than these economies, and, owing to ongoing integration, this can favour sustained growth in the global economy, too. Such a phenomenon may already be on the near horizon, since the transition economies are still expanding despite the East Asian contagion and the Japanese recession.

Integration with the world economy has fundamental implications for a country's expansion in trade and capital absorption. Rising exports and imports provide access to new markets, and foreign competition fosters technological and managerial upgrading. The greater openness also promotes the inflow of much-needed capital, which must be attracted for the purpose of closing the gap between the amount of domestic savings and the demand for new investments. The call for fresh capital is so intense in the transition economies that Eastern Europe alone will absorb at least another $150 billion during the first decade of the 21st century. The bulk of this inflow will be supplied by the private sector, and the relative influence of international financial institutions will therefore decline further. Substantial capital will be invested in the CIS if economic reform and political stabilization endure.

The leading transition economies will also be able to integrate rather rapidly with the world economy. Some Eastern European countries will have the option of joining the European Union. Socioeconomic development in the former Soviet republics in Central Asia could be as remarkable as that of South Korea between the 1960s and the 90s. Certain among these countries may eventually join ASEAN or join together in a new association, and for all of them there is the prospect of becoming members of the World Trade Organization fairly soon.

Since the collapse of the Soviet system and the dismantling of the Soviet Union and of Comecon, there has been much unravelling of regional structures, but there have also been new – and sometimes strange – forms of regional 'reintegration'. Four former Soviet republics, Belarus, Kazakhstan, Kyrgyzstan, and Russia, have created a 'common market'; these four countries belong to three different constituencies in the IMF and the World Bank. A socioeconomic union, with a commitment to eventual monetary unification, has been established between Belarus and Russia (two different constituencies). Georgia, Ukraine, Armenia, and Moldova have instituted the GUAM group of countries (a single constituency). In Eastern Europe the Central European Free Trade Agreement is active in the establishment of smooth trade arrangements. Other new regional and subregional organizations will certainly appear to facilitate growth, regional economic integration, and international economic cooperation.

However, such efforts at integration among these nations are not the real answer to the challenge of sound regionwide cooperation. More important at the current stage of development is regional policy coordination vis-à-vis other governments (which do coordinate their policies), other regions, international relations, and the global economy. There is no need for Central Europe to seek close economic ties, lavish trade, and integration with emerging markets in Central Asia, since these have more natural economic partners, but there is a true need to coordinate transition and development policies among all the emerging market countries.

In Denver in June 1997, Russia participated for the first time in a summit of the G-7 group of the world's largest economies. This exercise was repeated at the Birmingham summit in 1998. The invitation to Russia to participate in the economic policymaking deliberations has been forthcoming more because of political factors than because of economic ones. In the not too distant future China may also be invited to participate. However, all this is quite artificial. As long as there was only the G-7, the 'who's who' of the global economy was evident. Now, it is only a matter of time and political opportunity before the G-7 becomes the 'G-9', and the signals become jumbled. Neither Russia, the relative importance of which in the global economy is declining rapidly, nor China, which is enhancing its international economic standing day by day, are suited to the G-7 formula. (The same is true of Brazil and India.) They may be huge economies, but Russia and China are definitely not developed, nor will they be for at least several more decades. In fact, the old G-7 group is still quite alive; it is merely trying out another method to manipulate the course of the global economy according to its preferences and interests. The participation of Russia has been only minor and will not be sufficient to allow that country to influence global issues to any very great extent.

There is a sort of pattern that transition nations follow in becoming integrated in the world economy. They have first joined the Bretton Woods institutions.[12] Several of them, having proceeded rapidly with trade liberalization, have then become members of the World Trade Organization. Among the 134 members of the WTO are Bulgaria, the Czech Republic, Hungary, Kyrgyzstan, Latvia,

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[12] Some were already members of the IMF and the World Bank prior to the transition, for example Romania since 1972 and Hungary since 1982.

Mongolia, Poland, Romania, Slovakia, and Slovenia (as well as Cuba, which was a founder-member of the General Agreement on Tariffs and Trade, the predecessor of the WTO).

Once more, countries which undertook precocious market reform during the central planning period have had an advantage. Thus, their previous participation in the General Agreement on Tariffs and Trade has helped Hungary, Poland, and Slovenia to become members of the WTO without much difficulty.

Even countries which are lagging behind in the transition are finding their way to this institution. Among the 30 applicants to the WTO in 1998 were Albania, Armenia, Belarus, China, Croatia, Estonia, Georgia, Kazakhstan, Lithuania, Moldova, Russia, Ukraine, Uzbekistan, Vietnam, and Yugoslavia. The membership of China and Russia (and to a lesser extent Ukraine) is contingent on conditionalities which are similar to those for the early postsocialist members. Unlike the IMF and the World Bank, in which all postsocialist members have been admitted unconditionally, the WTO imposes economic and political conditions, such as further political liberalization in the case of China or a solution to local conflicts in the case of Croatia.

For some Eastern European countries, success in the attempt to join the European Union is most important. Joining is a long and difficult process, but certainly a most encouraging endeavour in terms of the progress in economic and political transition that can be achieved (Eatwell et al. 1997). The ambition to join the EU undoubtedly arouses efforts to transform economic and political systems.

By 1996, 10 transition countries – Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia – were associated with the EU (Tables 30 and 31). The Czech Republic, Estonia, Hungary, Poland, and Slovenia started negotiations for full membership in March 1998, and there is a chance that they will join sometime after 2003. One may safely assume that in due course there will be a follow-up for the remaining associate countries, Bulgaria, Latvia, Lithuania, Romania, and Slovakia. Considering its progress with systemic transition, Croatia also deserves to be seen as a future member no less than, say, Bulgaria or Romania.

Table 30: Population and GDP in the EU and EU-associated Eastern European economies, 1996

		GDP per capita	
	Population, millions	EU average	PPP Ecu
All EU members	372.1	100	17,300
Austria	8.0	110.4	--
Belgium	10.1	110.8	--
Britain	58.1	95.6	--
Denmark	5.2	115.1	--
Finland	5.1	95.7	--
France	58.1	106.0	--
Germany	81.6	109.0	--
Greece	10.4	65.4	--
Ireland	3.5	96.9	--
Italy	57.2	103.3	--
Luxembourg	0.4	166.4	--
Netherlands	15.5	106.6	--
Portugal	9.8	67.3	--
Spain	39.6	76.4	--
Sweden	8.8	99.4	--
EU-associated countries	108.2	100	5,500
Bulgaria	8.5	18.6	4,200
Czech Republic*	10.3	50.9	9,100
Estonia*	1.5	24.8	3,900
Hungary*	10.1	32.1	6,300
Latvia	2.5	16.8	3,100

Lithuania	3.7	18.1	3,900
Poland*	38.6	32.1	5,300
Romania	22.7	23.6	4,100
Slovakia	5.3	39.1	7,100
Slovenia*	1.9	34.6	10,100

Sources: European Commission and OECD data.

*Countries already negotiating terms of accession.

Table 31: Agriculture in EU-associated economies, 1995

	% GDP	Share of exports to EU, %
Bulgaria	13.0	56.0
Czech Republic	5.0	58.1
Estonia	7.1	63.1
Hungary	6.0	39.5
Latvia	8.5	59.2
Lithuania	9.5	48.7
Poland	6.6	62.2
Romania	20.0	48.4
Slovakia	5.6	40.3
Slovenia	4.8	68.3
EU 15	2.3	65.0

Source: European Commission.

In inviting the Czech Republic, Estonia, Hungary, Poland, and Slovenia to discuss the terms of integration, the EU stressed that the first round of candidates had been selected on the basis of ‘complete objective criteria. . . . The prerequisites for entry include a functioning market economy, the existence of democratic institutions and respect for ethnic minorities, the ability to compete in the single market, and reasonable public administration’ (Barber 1997). Marketization matters, but democratization is important, too. The eastbound enlargement of the EU is as much an economic endeavour as it is a political venture.

In some cases, there are problems with certain aspects of the introduction of a full-fledged civic society in the EU aspirants. For instance, the treatment of the tiny gypsy minority in the Czech Republic or the attitude toward the large Russian minority in Estonia rubs the wrong way. However, the long process leading to membership by all means contributes to better and faster resolutions of these sorts of problems.

Among the other five nations associated with the EU, only Bulgaria and Romania are lagging behind substantially in the prospects for EU membership, especially with respect to marketization. Slovakia, albeit taking a more radical path toward economic reform and usually reckoned among the nations most advanced in transition (see Table 14), has been omitted from the first round of membership negotiations. So have Latvia and Lithuania, both of which are ranked almost as high as Estonia and Slovenia in terms of institutional transition and GDP growth (see Tables 14 and 28).

One suspects that the selection process has also been inspired by other political and geopolitical considerations which have not been announced openly. The five countries invited to join the EU share borders with members.[13] Among the other postsocialist nations, Slovakia has a common border with Austria, while three Balkan states – Albania, Bulgaria, and FYR Macedonia – have short borders with Greece (which, together with Portugal, is the poorest EU member). In fact, though it is never admitted, the geopolitical factor is of special consequence for the integration of part of Eastern Europe with the European Union, and it has influenced decisions taken by the European Commission on the shadings to be used on the map of Europe should the EU negotiations and the overall transition process be crowned with success. Thus, even if, for example, Moldova were in better political and economic shape than Estonia, it would not necessarily be invited to undertake membership negotiations with the EU.

Meanwhile, many factors have motivated the decision to include Estonia and Slovenia in the earliest wave of negotiations. Estonia and Slovenia are very small countries, with populations of about 1.5 million and 2 million, respectively. It is easier to manage the transition and integration of a small nation than to do so for a large one, say, Romania, with almost 23 million inhabitants. The small size and small population are important elements in view of the EU budget, especially since it has already

[13] Assuming – as the Estonians and Finns do – that the narrow lane of water in the Gulf of Finland is equivalent to a border.

also been determined (finally) that the common agriculture policy and the EU regional aid policy must be reformed before eastbound enlargement can proceed. Slovenia is the only republic of the former Yugoslavia to be invited, and it was the smallest of them all, too. Likewise, if it can fulfil the agreed conditions, Estonia will be the only former Soviet republic with a chance to join the EU in the foreseeable future. By including this country, the smallest among the former Soviet republics, the EU cannot be accused of abandoning the Baltic States to the Russian sphere of influence. Perhaps most significantly, nonetheless, both these tiny countries are relatively well developed. Estonia is the most developed among the former Soviet republics, and Slovenia is the most developed of all postsocialist economies (Table 32).

Table 32: GNP per capita in transition economies and the share in the region's GNP

	Population, millions	GNP per capita, PPP$, 1995		GNP, millions PPP$	% regional GNP	% regional population
		World Bank Atlas	OECD	World Bank Atlas		
Albania	3.3	--	--	--	--	0.8
Armenia	3.8	2,260	--	8,588	0.6	0.9
Azerbaijan	7.5	1,460	--	10,950	0.7	1.9
Belarus	10.3	4,220	--	43,466	2.8	2.6
Bulgaria	8.4	4,480	4,867	37,632	2.4	2.1
Croatia	4.8	--	--	--	--	1.2
Czech Republic	10.3	9,770	--	100,631	6.6	2.6
Estonia	1.5	4,220	4,053	6,330	0.4	0.4
FYR Macedonia	2.1	--	--	--	--	0.5
Georgia	5.4	1,470	--	7,938	0.5	1.3
Hungary	10.2	6,410	6,578	65,382	4.3	2.5
Kazakstan	16.6	3,010	--	49,966	3.3	4.1
Kyrgyzstan	4.5	1,800	--	8,100	0.5	1.1
Latvia	2.5	3,370	3,271	8,425	0.5	0.6
Lithuania	3.7	4,120	4,021	15,244	1.0	0.9
Moldova	4.3	--	--	--	--	1.1
Poland	38.6	5,400	5,482	208,440	13.6	9.6
Romania	22.7	4,360	4,309	98,972	6.4	5.7
Russia	148.2	4,480	--	663,936	43.2	37.0
Slovakia	5.3	3,610	7,371	19,133	1.2	1.3
Slovenia	2.0	--	10,509	--	--	0.5
Tajikistan	5.8	920	--	5,336	0.3	1.4
Turkmenistan	4.5	--	--	--	--	1.1
Ukraine	51.6	2,400	--	123,840	8.1	12.9
Uzbekistan	22.8	2,370	--	54,036	3.5	5.7
Regional total	400.7	4,060	--	1,536,345	100.0	100.0

Sources: World Bank 1997d, OECD 1997c.

The evaluation of GNP or GDP on a PPP basis varies for well-known methodological reasons. Agenda 2000, presented in 1997 by Jacques Santer, the president of the EU, to the European Parliament, shows per capita GDP data for the associate countries that are different from those in Table 32. For instance, the EBRD estimates the per capita GDP of Poland in 1995 at $5,400, while the EU sees it closer to 5,300 ecu (about $5,800-$5,900 at the time). Another evaluation suggests that in 1997 per capita GDP was nearer to $7,000. This seems more reliable, especially considering the growth of about 14 per cent in 1996-7 and the fluctuations in domestic prices relative to international ones. After some tendency toward decline, particularly in 1995, when it fell from above 2 down to about 1.8, the ratio of the official exchange rate over the PPP exchange rate hovered in the range of 1.77 to 1.82 in 1996 and increased again to 1.9 or so in 1997 (PlanEcon 1997c).[14] This sort of problem with the evaluation of GDP on a PPP basis also occurs for all other countries.

Accomplishing the enlargement of the EU may be more difficult than merely accommodating the first five applicants, despite the likelihood that in future the other transition country aspirants will be even better prepared for integration than was the first round in 1998. There will always be questions about the effective limits of eastbound EU expansion and about the point at which adding members might become a disadvantage. So far, geopolitical position (which does not depend on policy) and OECD membership (which depends exclusively on wise reform and policy) have played key roles in the integration process.

From the viewpoint of membership in international economic, trade, and financial organizations, only three transition economies, the Czech Republic, Hungary, and Poland, have been ‘five star’ performers (Table 33). These countries belong to the Bretton Woods institutions, the WTO, and the OECD, and soon also the North Atlantic Treaty Organization. During the Madrid summit in the summer of 1997, official invitations were extended to the

[14] An evaluation at the end of 1998 gave the GDP per capita on a PPP basis at $5,033 for Estonia, $6,540 for Poland, $7,400 for Hungary, $10,521 for Slovenia, and $10,820 for the Czech Republic (The Economist 1998d).

three nations to join NATO in 1999. NATO membership has been much easier to achieve than EU membership is going to be. The entry into NATO can facilitate the process of the economic integration of these three nations with the EU, as well as with the global economy, inter alia through the positive impact on business confidence and foreign direct investment.

Table 33: Transition economy membership in international economic or financial organizations, 1998

	IMF and WB	WTO	EU association	OECD	EU invitation	Rank
Albania	*					*
Armenia	*					*
Azerbaijan	*					*
Belarus	*					*
Bulgaria	*	*	*			***
Croatia	*					*
Czech Republic	*	*	*	*	*	*****
Estonia	*	*	*		*	***
FYR Macedonia	*					*
Georgia	*					*
Hungary	*	*	*	*	*	*****
Kazakhstan	*					*
Kyrgyzstan	*	*				**
Latvia	*	*	*			***
Lithuania	*		*			**
Moldova	*					*
Poland	*	*	*	*	*	*****
Romania	*	*	*			***
Russia	*					*
Slovakia	*	*	*			***
Slovenia	*	*	*		*	****
Tajikistan	*					*
Turkmenistan	*					*
Ukraine	*					*
Uzbekistan	*					*

Source: Author's compilation based on data of various international organizations.

The forthcoming integration with the European Union should be seen as a partnership between the 15 old members and the five new ones, which must make their institutions conform to the demands of the EU and must also upgrade infrastructure and overhaul industries. The whole endeavour is going to be quite costly and must be paid for mainly from the pockets of taxpayers in the new member countries.[15] Before this tax effort can bear fruit, it will cause tensions. However, if these adjustments are not carried out at this stage of transition and integration, the costs may be even higher in the long run anyway.

Vietnam became a member of ASEAN in 1995, and Laos joined in 1997. Because of political turmoil in Cambodia in the summer of 1997, ASEAN has been forced to postpone a decision on that nation’s entry into the organization. Membership in ASEAN is important for these countries, especially considering the wide development gap between them and the more advanced members of the association. The size of the gap depends on the yardstick used, but it is certainly enormous. For example, if calculated in PPP dollars, the figure for the GDP per capita for Vietnam is about four times higher than it is if calculated according to the market exchange rate. For Singapore, the PPP figure is lower by about 25 per cent. Thus, the ratio of the income per head in Singapore and that in Vietnam shrinks from a shocking 100:1 according to current nominal cross exchange rates to a still immense 20:1 according to purchasing power comparisons (Table 34).

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[15] Assistance for upgrading infrastructure is also being provided by the European Investment Bank. This financial arm of the EU has already supplied significant credits (over 3 billion ecu by 1998) for infrastructure development in Central and Eastern Europe.

Table 34: Population and GDP per capita in ASEAN countries and Cambodia, 1996

	Population, millions	GDP per capita, $
Indonesia	196.9	1,150
Vietnam	75.5	311
Philippines	69.8	1,200
Thailand	61.3	2,980
Malaysia	20.6	4,260
Singapore	3.0	30,860
Brunei	0.3	16,427
Laos	4.9	377
Myanmar	45.6	107*
Cambodia	10.7	292

Source: Economist Intelligence Unit.

*At the market exchange rate.

The only way to close such a giant gap is by boosting the rates of growth in the less-developed countries past the rates among the richer nations. A significant means for accomplishing this is increased regional integration, accompanied by trade liberalization, freer capital flows, and the coordination of structural policies. Despite the crisis of 1998-9, or because of it, ASEAN plans to negotiate the Asian Free Trade Agreement and work on a programme called ‘vision for the year 2020’. No mere illusion that the free market can solve all problems, the ‘vision’ is a very long-term horizon for the coordination of development strategies at the regional level. This is the sort of decisive approach which has enhanced the ability of Asian economies to sustain high rates of growth for so long. The recent profound crisis does not negate this conclusion. These economies can hardly fail to rebound. Such a vision is needed in Central Asia, Eastern Europe, and Russia, too.

Will the process of the enlargement of ASEAN contribute to the acceleration of market reform and ultimately the transition to a full-fledged market in the socialist and postsocialist countries of Indochina?[16] In Vietnam price and trade liberalization, as well as a regulatory environment favourable to capital markets and foreign direct investment, have already been pushed forward by the membership in ASEAN, which has therefore had a positive effect on the pace of reform. If a country becomes a member before the economy has been brought up to speed with the association's standards, as was the case of Laos and Vietnam and probably is going also to be the case of Cambodia, than gradual liberalization must follow.

This is the advantage of joining early. (From this angle, it is never too early.) The structural and institutional changes are thus enforced by the membership, which has a strong influence on the policies exercised by the country. The early membership serves to help break down any ideological, political, or bureaucratic resistance to the necessary reforms. Contrary to the WTO, which requires that most reforms be carried out before a country is admitted, ASEAN membership is not based on political and institutional conditionality, but itself is understood as the cornerstone of change. Once a nation is a member, there will always be the time and the means to insist on reforms and adjustments.

Is the coming process of liberalization and regional integration going to mean that growth will be more rapid in the less-developed markets of ASEAN than it is in the developed ones? Despite the 1997-8 East Asian crisis and its impact on close neighbours, economic growth rates among the new ASEAN members have not decelerated significantly. In the long run the membership in ASEAN will also promote economic stability. One may therefore anticipate that, if there is continued cooperation and if the political dilemmas in Cambodia are solved, then the Indochinese economies will grow quickly. This will occur because these economies will become more open to foreign investment and technology transfers, but also because these processes will open up new markets for Cambodia, Laos, and Vietnam. This combination of the greater absorption of foreign capital and improved access to new markets

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[16] This question is even more relevant vis-à-vis Myanmar, which joined ASEAN in 1997. Though poorer than Vietnam and not a transition economy, Myanmar must take a similar road of political and economic liberalization in order to achieve development.

will enable these economies to allocate resources better and expand through export-led growth.

12.5 The two faces of emerging markets

The markets in all postsocialist nations are ‘emerging’ in two senses. First, these markets are in statu nascendi and can be considered as ‘emerging’ because they are rooted in the centrally planned economy and are gradually becoming part of the integrated world market economy. This means that policymakers must be determined to foster mature market behaviour and institutional arrangements so that the market system can evolve in a healthy fashion.

Second, the postsocialist nations possess financial and capital markets which are ‘emerging’ because they are opening up to the world economy and thereby represent fresh investment opportunities (Mobius 1996). These opportunities are being keenly taken up, mainly by rich countries with extra savings which are not being absorbed by domestic investment. The propensity to save and the capacity for capital formation in these rich countries surpass their current domestic investment needs. Some savings therefore flow out in search of opportunities in other nations. Whereas in mature markets the supply of capital exceeds the demand, in emerging markets the demand for capital outstrips the supply. Since capital tends to flow from places where it is abundant to places where it is scarce, the spare capital is invested in emerging markets, where there is a chance of obtaining unusually high profits (and where the risks are also unusually high).

In 1997, the year before the crash, the shares traded on stock markets in emerging market economies were worth a very significant $2.7 trillion, or 14 per cent of the $19.3 trillion traded worldwide. The stock markets in the more advanced transition countries – the Czech Republic, Hungary, and Poland – had a higher turnover than did the stock market in Russia, but this time first place in the league of transforming countries was definitely held by China. The stock market turnover in China represented about 230 per cent of that nation’s market capitalization, which means that the average share changed hands between two and three times. Along with South Korea and Taiwan, China was therefore among the most active emerging markets in 1997. In terms of activity, Poland and Hungary, with turnover close to 80 per cent, were, respectively, between the United States and Brazil and between Malaysia and Greece. Russia was close to the bottom of the league, with turnover at about 25 per cent of market capitalization, placing it between Israel and South Africa.

A unique feature of the small infant postsocialist stock markets is the fact that they have provided remarkable profits to portfolio investors even when output within the economies has been severely contracting. These people may be considered to have taken greater risks in order to reap greater profits, but from a macroeconomic viewpoint there has simply been an outward transfer of part of national income to the accounts of foreign investors. The profits have not always been due to increased productivity resulting from the investments, and often they have not been reinvested locally, but have been quickly moved elsewhere.

A majority of transition economies have been able to attract healthy inflows of foreign direct investment, and emerging financial and capital markets generally facilitate capital formation and allocation, thereby contributing to postsocialist recovery and growth. However, in some countries the level of capital flight has risen above that of foreign lending and investment, including private capital inputs and the financial assistance of governments and international organizations. This would not have been possible had appropriate regulations been adopted. Instead there has been deregulation and a renunciation of the tools available for controlling cash flows. This occurred not because no one knew how to regulate capital flows, but because of weak political commitment and the lack of the courage necessary to carry out the reforms. No wonder the markets in some of these economies have emerged in a very awkward manner. In nations such as Albania and Russia for quite some time the interests of informal institutions were preferred over the needs of stabilization and national economic development, and the emerging markets were used as instruments to favour these interests.

Policies should therefore focus on guiding foreign capital inflows into long-term, preferably direct investments. These sorts of outlays encourage microeconomic restructuring and competitiveness and thus contribute to recovery and growth, which help both the foreign investors and the local recipients of the capital flows. If this policy approach is not adopted, the liberalization of financial and capital transfers may generate capital drainoff instead of more capital injection.

The best example of this last scenario is the Russian economy, which shrank in 1996 by 6 per cent, bringing GDP down to about 50 per cent of the pre-transition (1989) level. Simultaneously, the rate of return in dollar terms on the Russian stock market was 113 per cent. This trend continued through 1997. During that year the drop in GDP did not bottom out, while the rate of return was still a recklessly high 111 per cent. The gains available in other emerging markets, including the leading transition economies, were not so spectacular, but they were still large and in most cases much greater than those accruing in advanced market countries (Table 35).

Table 35: Stock market rates of return: postsocialist markets and selected developed markets, $

	1996, % change on 29.12.95	1997, % change on 31.12.96	1996-7, % change on 29.12.95
Emerging markets			
China	77.1	30.7	131.5
Czech Republic	10.0	-27.7	-20.5
Hungary	121.4	53.6	240.1
Poland	57.6	-16.8	31.1
Russia	112.6	110.2	346.9
Average*	75.7	30.0	128.5
Developed markets			
United States	24.0	22.8	52.3
Germany	15.2	26.5	45.7
Britain	17.3	20.6	41.5
Italy	14.6	36.2	56.1
Japan	-8.2	-29.5	-35.3
World†	10.0	13.8	25.2

Sources: Stock exchanges, national statistics, Reuters.

*Unweighted average. †Morgan Stanley Capital International index includes the OECD markets, except for Greece, Mexico, Portugal, South Korea, and Turkey, and except for the Czech Republic, Hungary, and Poland, which, although members of OECD, are included in the emerging markets group.

Then reality struck; the pendulum started to swing in the opposite direction after the onset of the Asian crisis, and the investors feeding off emerging markets worldwide began to panic. In the first half of 1998 the index for the Moscow stock exchange fell by 63.3 per cent, meaning that in dollar terms the value of shares had plunged by nearly two-thirds in the space of six months. By the end of the year the index had dropped by a staggering 96 per cent. How extremely hectic the stock market was can be seen by the drop of 18.2 per cent in just one week in June. Indeed, Russia's has become a 'gambling casino' economy. Many investors, including renowned foreign investment banks and hedge funds, have lost substantial sums.

Nonetheless, the blame for Russia's stock market swoon ought not to be directed at foreign investors and speculators, who were not acting out of character, but at government macroeconomic mismanagement and malfunctioning structural reform policies, mainly in privatization and corporate governance (Kolodko 1998d).

For several years the government had been selling assets below the market clearing price. Nonetheless, the increase in the stock market index by around 450 per cent in just two years, 1996-7, was irrational. Only to a certain extent was it due to a natural catching-up process involving the search for and the reestablishment of stable market value levels. The gap between the nominal prices on the primary market and the real value and profitability of the physical assets as expressed in the long run on the secondary market was closing, but most of the great leap skywards on the stock exchange was due to a bubble which was being pumped up by constant speculation and even intentionally by some investors, especially by insider traders. In turn, the bubble encouraged senseless expectations about the capacity for further growth. That the bubble would burst – that is, that the capitalization of the stock market would bring the market back down to the level it should have been at because of the performance of the real economy – was inevitable. Whereas real output halved in six years, it took only six months for the average value of stocks on the capital market to plummet by half.

While those six months were very bullish on stock markets in the advanced countries (the Dow Jones average on Wall Street rose by 14.4 per cent, and the Morgan Stanley Capital International index, which included the 23 most developed countries during that period, increased by 17.4 per cent), it was a very bearish six months for all but a few markets elsewhere. Over the same six-month period, the loses varied from 56.9 per cent in Indonesia and 49.6 per cent in Venezuela to 6.2 per cent in Brazil and 0.9 per cent in South Korea. On the major postsocialist markets, the loses were from 8.6 per cent in Hungary to 1.7 per cent in the Czech Republic. Only five of the 'smaller' markets registered positive returns from investments on the stock exchange during the first half of 1998: the three older markets of Greece (a gain of 50.9 per cent), Israel (5.2 per cent), and Portugal (39.5 per cent), and the transforming markets of China (11 per cent, despite a decline of 6.1 per cent in the last week of June) and Poland (9.6 per cent), the most stable and steadily growing emerging capital market.

China and Poland demonstrate that relatively firm macroeconomic fundamentals and well-designed structural adjustment policies do make a difference. They show that it is possible for an emerging market – whether in a reformed socialist economy or in an open postsocialist economy – to avoid financial crisis if only liberalization, stabilization, and institution-building are properly managed. China and Poland can continue this sort of performance in the future if the liberalization and deregulation of capital flows remain subordinate to development strategies, not the other way around.

In the case of Russia, the greed of portfolio investors for quick profits – regardless of financial instability, growing inequality, and spreading poverty – and the weak fundamentals, the inadequate regulation, and the inconsistent policies of the government created a bubble, which was readily burst by a market panic. The consequences were certainly negative for the real economy, output, and living standards. The only way to have avoided the bursting of the bubble was to have avoided the bubble. But the only way to have done that would have been to step on the toes of the financial interest groups. In effect, the 'tycoons' have not wanted the government to regulate capital flows and take care of adjustment properly, also because for some time there has been a little bit of fog surrounding the tycoons and the government. It is not surprising that there was a bubble which could burst and a severe crisis waiting to happen. In the meantime, there was an enormous redistribution of stocks and capital flows nationally, as well as internationally. Once more, the few became richer, and many became very poor.

The evaluation of the profits earned on emerging stock markets depends on the time span examined. For instance, in 1996, although the capitalization of stock markets in transition economies was relatively quite low, the real rate of return on these markets was more than seven times higher than the corresponding rate on developed markets. However, the index of emerging stock markets, including those in transition economies, compiled by the International Finance Corporation fell by 15 per cent in dollar terms between the end of 1993 and September 1997. Over the same period, the capitalization of Wall Street, that is, the Dow Jones average, more than doubled. Whereas from 1990 until September 1997 the average annual rate of return on all emerging markets was a mere 3.5 per cent, Wall Street yielded around 13 per cent. The postsocialist markets were more profitable until the bearish year of 1998.

The emerging capital markets have clearly been more profitable, but more chaotic and unpredictable, too. To a certain extent, this has been due to the advice coming from people in developed market nations. For quite some time, nobody on Wall Street had any sound understanding of how the Russian capital market ought to be developed from scratch and what the regulatory environment should be like. Still worse, the knowledge which has been applied has been more useful for the exploitation rather than the protection of the emerging markets. Even official aid designated for technical assistance in carrying out privatization and the establishment of capital markets has sometimes been redirected toward other, less socially justifiable purposes (Blasi, Kroumova, and Kruse 1997, Wedel 1998b). According to USAID, the US government agency which administers American foreign aid, some American advisors to Russia's privatization programme 'used information gained from their programme activities . . . to make further private investments in the Russian securities market' (The Economist 1997h). Unfortunately, insider trading, sometimes also involving foreigners, is quite common in transition economies. However, because of the participation of influential, well-connected investors with media contacts, cases of conflicts of interest and the use of confidential information for private gain have not received much public attention and the notoriety and criticism they deserve.

The emerging markets and the postsocialist economies should not be seen only as a field of action for financial speculation for international investors. Yet, owing to the foreign capital inflows they facilitate, these investors are important for transition countries, all of which possess insufficient domestic savings resources. Thus, a key to the development of these countries is the ability to attract as much long-term foreign investment as possible. In this respect, the situation in transition economies is very dynamic, since foreign direct capital investments, unlike the portfolio transactions, are expanding all the time.

12.6 Economic aid, direct investment, and foreign capital

At the onset of transition, the main source of foreign capital was international organizations, especially the IMF, the World Bank, and the EBRD. However, in the long run it will be the private sector. Initially, aid provided by the governments of advanced market countries also played a relatively larger role, though not everywhere. The recipients of the highest relative amounts of economic aid were Albania, Kyrgyzstan, and Poland. Relatively high per capita assistance was also received by the Baltic States (Table 36).[17]

[17] This does not include military assistance, which, though ‘unproductive’, appreciably increases the aid figures, particularly for countries involved in local conflicts, such as Armenia, Azerbaijan, Georgia, and Tajikistan.

Table 36: Economic aid in transition economies, 1994-6*

	% GDP	Per capita, $	Openness
Hungary	-0.1	-3	1
Uzbekistan	0.3	2	0
Kazakhstan	0.2	3	0
Turkmenistan	0.6	6	0
Ukraine	0.4	6	0
Romania	0.6	9	1
Russia	0.5	11	0
Tajikistan	3.2	11	0
Moldova	1.5	13	1
Czech Republic	0.4	14	1
Belarus	0.8	16	1
Bulgaria	1.3	16	1
Slovakia	0.6	16	1
Azerbaijan	3.4	17	0
Latvia	1.0	22	1
Estonia	1.2	33	1
Lithuania	1.8	33	1
Georgia	8.2	35	0
Kyrgyzstan	7.4	51	1
Albania	8.5	53	1
Armenia	8.7	54	0
Poland	2.6	72	1
Croatia	--	--	1
Slovenia	--	--	1
FYR Macedonia	--	--	1

Source: Burnside and Dollar 1997.

*'Aid' is defined as official development assistance grants, plus lending, minus repayments from OECD sources. The figures in the 'per capita' column are annual averages for 1994-6. '1' indicates an open economy. '0' indicates a closed economy.

The explanation for the preference for these countries is simple. Except for Poland, these are all small economies. To provide aid at $100 per head in Estonia in three years' time is about 35 times less costly than to deliver the same level of aid to Ukraine. Whereas aid worth about $33 per person per year over 1994-6 would have amounted altogether to around $150 million for Estonia, in Ukraine the same level of aid would have cost over $5 billion. The aid of over $50 per person in Albania and Kyrgyzstan may seem impressive in comparison to the meagre $2 or $3 for much bigger Kazakhstan and Uzbekistan, but in fact the total aid sent to these latter two dwarfs that received by the two former nations. Once more we see that, in regard to transition, 'small is beautiful'. It is cheaper to give many dollars to a few than to give a few dollars to the many.

Poland is an exception. A significant debt reduction was the reward to Poland for its pioneering role in the transition and in overhauling the socialist system.[18] If the postsocialist revolution had started in Hungary, then the debt of that country might have been lightened, while Poland would be choking under an unmanageable debt burden for years. Yet, Poland happened to be the first to start to turn the wheel of history.

Already in 1991 the Paris Club of official creditors took an initial decision regarding the outstanding debt of Poland, but the debt reduction scheme continued for several more years. The second major cut was agreed with the creditors from the London Club in 1994. In both cases the debt was pared by 50 per cent, and the deal was contingent on the strict conditionality of further progress with structural reform. Because this progress was achieved,

[18] Contrary to what was being claimed at the time, the Gulf War in 1990-1 helped the transition in a certain sense, at least in Poland. The debt reduction for the benefit of Poland that was agreed with Western governments in 1991 was catalysed by the decision to cut by half the debt of Egypt. For strictly political reasons, it was virtually impossible to forgive Egypt's debt without doing the same for Poland, considering the crucial role the latter had played in the overthrow of the socialist system.

the debt was forgiven. In this sense, among all postsocialist countries, Poland has obtained by far the largest amount of financial assistance from the developed market nations.[19]

One might view this assistance to Poland not only as a reward, but also, given the relative health of the emerging Polish market, as a good investment. Likewise, in terms of the economic rationale of the allocation of international aid among transition economies, assistance has been mainly forthcoming for countries which are more advanced in or at least committed to structural reform and which exhibit a better record with reform. For several years now, these countries have been enjoying stronger economic growth than have other emerging markets. This is good not simply for the sake of the nations receiving the assistance, but also for those providing it, for this means that the climate is favourable for investors from these nations. If, for example, assistance has been supplied to support institution-building, then the new market organizations which are established serve not only local businesses, but also foreign investors.

This sort of give and take is well known from the experience with technical and financial aid in the less-developed countries. It is easier to get foreign aid (or, shall we say, a ‘foreign indirect investment’) to finance feasibility studies, privatization schemes, stock exchanges, the training of banking personnel, or the purchase of computer hardware manufactured in the aid-giving country than it is to get foreign aid to finance poverty alleviation programmes, job creation schemes, cultural institutions, the training of hospital personnel, or the development of a local computer industry. There are no relevant studies, but anecdotal evidence suggests clearly that much more foreign aid has been channelled into the development of the financial sector than into antipoverty programmes. Assistance should therefore not be seen as charity, but as an investment, often in human capital. In fact, this bias can help the country absorbing the extra capital recover sooner and grow more quickly, so

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[19] Without this assistance, the prospects of Poland would not have become so bright since 1993. An overwhelming burden of unpayable debt – whether in Poland or Russia – renders successful transition impossible. For this reason, much of the outstanding debt of Russia should also be written off (Kolodko 1998e).

that the country may be able to gather independent resources to meet its needs in other areas, such as poverty alleviation, at a later date.

Like commercial lending from international financial institutions, the foreign aid is often conditional. The transfers of capital are frequently subject to the implementation of certain specified programmes or particular reforms. This sort of conditionality is rigorously practised by the EU, which sometimes cancels planned aid allocations because of it. For instance, over 34 million ecu in grants to Poland under the PHARE initiative were rescinded in 1998 because the government could not meet certain requirements.[20] The fact that this kind of conditionality is tied to progress in structural reform and institution-building partly explains why nations which are further along in transition are able to absorb more aid. It also shows why more aid tends to help transition go forward more smoothly in these nations. Aid cannot be used more efficiently in these nations than in lagging countries because the former possess more effective institutions. <u>Foreign aid has a positive influence on economic policy, and, even if the amounts are small, they can accelerate growth if they are mainly employed for investments rather than for consumption</u> (Blustein 1997).

Before the collapse of its economy in 1997, this was the case of Albania, the most backward country in Europe. The politics and economics of foreign aid had functioned in such a way that, due to the progress it had achieved in stabilization and liberalization, Albania was for a time the recipient of the most foreign aid both as a share of GDP and on a per capita basis. Since then it has continued to benefit from relatively important assistance despite policy failures, mainly the mismanagement of institutional reform in the financial sector and in capital markets. However, this has been the exception which has proved the rule, since the significant aid is now being provided for geopolitical reasons linked to the fighting in the

[20] PHARE was created in 1989 specifically as a way to furnish financial and technical assistance to Hungary and Poland in the reform process. Hence the acronym, which stands for ‘Pologne et Hongrie Action pour la Reforme Economique’ (‘Poland and Hungary: Action for Economic Reform’). PHARE was eventually expanded, and it is now being run in a majority of postsocialist countries.

Balkans, religious-ethnic considerations, and the Albanian immigrant problem in neighbouring countries. In the case of the best performing small former Soviet republics of the Baltic region and Central Asia, the link between aid and reform is unmistakable: more aid is supplied to the countries more advanced in institutional transition. And here, too, there is a positive feedback loop between the level of foreign capital inflows, including aid, and overall economic attainment.

It is a fortunate historical coincidence that the postsocialist transition is occurring during a period of swelling savings in developed market economies. With more than one and a half billion people, the emerging markets in Europe and Asia represent a vast potential arena for foreign investment and the expansion of market capitalism. In a certain sense, they are fulfilling a function for global capitalism that is similar to the one performed for European capitalism by the New World after 1492. Likewise, even in the early 1990s the postsocialist region seemed terra incognita for the major investment banks and investment funds.

However, the foreign investors were quick to set up shop. The investors are of various sorts, but the major sorts are the investment banks and the aggressive hedge funds which are managing mutual and pension funds. Unlike the postsocialist economies, which still rely heavily on the old pay-as-you-go public pension systems, in the advanced economies social security arrangements have evolved mostly toward market-based, funded systems. According to InterSec Corporation, a research company, the total value of the world's pension assets grew by almost 60 per cent, from $5.4 trillion to $8.5 trillion, between 1991 and 1996. It was being anticipated that these assets would at least double over the next five years and exceed $17 trillion in 2001, although this may be exaggerated in light of the stock bubble in the developed market countries (except Japan) in 1995-7 and the turmoil on capital markets worldwide during 1998. During the second half of 1998 pension assets were depreciating owing to the corrections on these markets. In any case, because they represent so many additional investment opportunities for these assets, the transition nations, together with other emerging markets, have seemed like a newly discovered America.[21]

[21] Hopefully, this time, there won't be so many Indians wiped out.

If there had been no capital in search of markets, the situation would have been even more difficult for the transition countries. As it is, the rapid changes taking place simultaneously in other regions of the world – especially in Latin America and Asia, but also in Africa – mean that the transition economies must compete for foreign investment. The Washington-based Institute for International Finance, a research group of private commercial and investment banks, estimates that net private capital flows to major emerging market economies dropped to $261 billion in 1997 from a record high of $281 billion in 1996. This was mainly the result of a contraction in the flow of investment into Asia by about $35 billion (from $142 billion down to $107 billion) and a decline of about 10 per cent in Latin America, while the capital flows to economies in transition continued to expand. In 1998 private capital flows were still falling and, because of the Russian 'syndrome', were beginning to affect negatively the postsocialist emerging markets, too.

Nonetheless, the postsocialist nations are clearly capable of competing for the attention of world capital markets. A new stage in this competition was reached in 1998 owing to the crisis in East Asia. As part of this competition, the postsocialist economies are trying to become viewed as 'emerging markets' by foreign investors and, moreover, to be referred to in this way. In 1995-6 Poland was the only postsocialist economy to be included on the list of the so-called 'Big Ten emerging markets' (Garten 1998).[22] This was a US government initiative to draw more American investors and exporters toward these markets.

The portfolio investors turned out to be the most active, followed by the direct investors, then the exporters, and only at the very end the importers. A more healthy sequence for the transition economies would have been the direct investors, followed by the importers, and then the exporters, with the portfolio investors bringing up the rear. Then growth would likely have been more robust, the current account deficits smaller, and the cumulative profits of foreign investors larger.

Transition economies have also started to compete among themselves to gain the biggest possible piece of the pie. The heads-of-state of transition countries eagerly attend vast numbers of conferences, gatherings, and other events to push the advantages of their markets.

[22] The other nine 'big' markets on the list are Argentina, ASEAN, Brazil, China, India, Mexico, South Africa, South Korea, and Turkey. Russia is noteworthy for being absent.

They entertain international bankers and fund managers and encourage them to invest in their countries. Such meetings were first organized mainly in relatively advanced Eastern European nations, but soon other countries, including the bigger economies among the former Soviet republics, also joined this ‘club’ of the emerging markets. They were launching vast privatization programmes and issuing Eurobonds and global bonds to finance their fiscal deficits. As a consequence, not only their markets ‘emerged’, but also their current account deficits, since the exports from these countries to advanced market nations were not growing quickly enough, while the portfolio investment flows in the opposite direction were growing too quickly.

On a cumulative basis, foreign direct investments in the transition economies of Eastern Europe and the CIS reached over $60 billion between 1989 or 1990 and the end of 1997 and $90 billion to $100 billion by the end of 1998. Around two-thirds of this was absorbed by Eastern Europe, and the other one-third by the CIS. This is quite a small amount relative to the needs of these countries and to the level of direct investment in other emerging markets.

Overall (not cumulative) foreign direct investments in 1996 totalled $349 billion according to the United Nations Conference on Trade and Development, but the share going to the transition economies was estimated by the EBRD at only about $15 billion, a meagre 4 per cent of the total. Most went to developed market economies, although the share received by developing nations, especially those in Asia and including China and Vietnam, was rising.

China was the largest recipient of foreign direct investment among emerging markets in terms of both flows and stock. It had taken in $169 billion on a cumulative basis through 1996.[23] In 1996 alone China received $42.3 billion, that is, about three times more than Eastern Europe and the former Soviet republics combined. However, since there are more than 1.2 billion Chinese, this otherwise remarkable inflow adds up to only about $35 per person, which was comparable to the per capita share for the transition economies that year.

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[23] The recipient of the next largest amount among the emerging markets was Brazil, which had absorbed $108 billion through 1996.

The following year (1997) the per capita average for the transition countries was $43, of which $86 per head went to Eastern Europe and $26 to the CIS. By the end of 1997 cumulative foreign direct investments in China had exceeded $200 billion. Approximately 230,000 enterprises backed by foreign capital had received authorization to operate in China, and 145,000 of them had started business. Enterprises supported by foreign capital employed 17 million people and accounted for more than 10 per cent of the industrial and commercial taxes collected by fiscal authorities and for about 40 per cent of China's total exports.[24] All these achievements resulted from a steadily growing commitment, since foreign direct investment, unlike portfolio flows, cannot pack up and go in the aftermath of shocks or radical local policy shifts.

Yet, the amount of money being invested in particular countries sometimes fluctuates significantly from year to year, since, for example, a privatization programme in a single industry can alter the picture substantially. The link between privatization and the foreign direct investment absorbed is not always obvious. Even if the overall pace of privatization is slow, significant injections of foreign direct investment can be attracted if the incentives to undertake new ventures and green field projects are strong enough. Usually this sort of equation involves foreign capital penetration in natural resources and large individual investment projects in the energy sector. Big privatization schemes in the banking sector, energy, and telecommunications have caused particular economies to move up on the list of the recipients of the most foreign direct investment. Thus, in 1997 Poland surpassed Hungary in terms of the Eastern European nation receiving the most cumulative foreign investment (Table 37).

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[24] Based on data in Jie Fang Daily (Beijing), 8 September 1997.

Table 37: Foreign direct investment*

	1991	1992	1993	1994	1995	1996	1997†	Cumulative FDI inflows, 1989-97		FDI-inflows per capita, 1997, $
								Total	Per capita, $	
Albania	--	32	45	65	89	97	33	369	115	10
Bulgaria	56	42	40	105	82	100	575	1,000	121	69
Croatia	--	13	72	95	83	509	500	1,276	267	105
Czech Republic	511	983	517	749	2,526	1,388	1,275	7,473	726	124
Estonia	--	58	160	212	199	111	131	809	557	90
Hungary	1,459	1,471	2,339	1,097	4,453	1,986	2,100	15,403	1,519	207
Latvia	--	43	51	155	244	379	415	1,287	515	166
Lithuania‡	--	--	30	31	72	152	327	612	165	88
FYR Macedonia	--	--	--	24	13	12	16	65	31	8
Poland#	117	284	580	542	1,134	2,741	3,044	8,442	218	79
	305	662	1,775	1,846	3,617	4,445	6,600	19,250	497	171
Romania	37	77	94	347	404	415	998	2,389	106	44
Slovakia	--	100	156	203	183	177	150	912	912	169
Slovenia	41	113	112	128	176	186	321	1,074	538	161
Eastern Europe	2,184	3,216	4,196	3,753	9,657	8,252	9,885	41,111	357	86
Armenia	--	--	--	3	19	22	26	70	19	7
Azerbaijan	--	--	20	22	284	661	1,006	1,993	262	132
Belarus	50	7	18	10	7	75	100	267	26	132
Georgia	--	--	--	8	6	25	65	104	19	12
Kazakhstan	--	--	473	635	859	1,100	1,200	4,267	272	76
Kyrgyzstan	--	--	10	45	96	46	50	247	54	11
Moldova	--	--	14	18	73	56	71	249	58	17
Russia	--	700	400	584	2,021	2,040	3,900	9,743	66	26
Tajikistan	--	8	9	12	17	20	20	86	14	3
Turkmenistan	--	11	104	103	233	129	108	652	139	23
Ukraine	--	170	200	100	400	526	700	2,096	41	14
Uzbekistan	--	9	73	73	-24	50	60	216	9	3
CIS	50	905	1,321	1,613	3,991	4,750	7,306	19,900	70	26
Total	2,234	4,121	5,517	5,366	13,648	13,002	17,191	61,100	153	43

Source: EBRD 1998.

*Net inflows recorded in the balance of payments. In millions of dollars unless otherwise indicated. †Estimated. ‡FDI figures for Lithuania are only available from 1993. For 1993-4, figures cover only investment in equity capital. For 1995-6, equity and reinvested earnings are covered, but inter-enterprise debt is excluded. #The second series for Poland supplements the data with information from a survey of foreign enterprises that was provided by the State Agency for Foreign Investments. The differences arise, in part, from investments in kind and reinvested earnings.

Among the former Soviet republics and the countries of Eastern Europe, Russia is bound to lead in this respect eventually, considering the enormous sums to be invested, for example, in the energy sector, which has yet to be privatized. Although the investment per capita is relatively small, only about $13 and $26 in 1996 and 1997, respectively, Russia absorbed around $6 billion altogether during that time. This is still less than the total investment in Poland in 1997 alone ($6.6 billion), but almost three times as much as that in Kazakhstan in 1996 and 1997, where average per capita inflows were three times higher (about $73 and $76, respectively).[25] In Eastern Europe at the end of 1997 the stock of foreign direct investment per capita was highest in Hungary ($1,519), followed by the Czech Republic ($726), and Estonia ($557). In Russia and Ukraine, the biggest countries in terms of population, the per capita stock was $66 and $41, respectively.

The best measure of relative foreign direct investment is not the amount per capita, but the share of GDP. According to this measure, Azerbaijan and China lead the way in Asia. It is believed that in 1997 foreign direct investment in Azerbaijan represented a remarkable 24.4 per cent of GDP (Table 38). In Eastern Europe, the most was absorbed by Latvia (7.6 per cent) and, despite the severe contraction there, Bulgaria (5.6 per cent). At the other end of the scale were Uzbekistan (0.4 per cent) in Central Asia and FYR Macedonia (0.5 per cent) in Eastern Europe.

[25] According to current account statistics, foreign direct investments in Russia in 1997 were valued at $3.9 billion, which was the highest inflow in any postsocialist country. Calculated on the same basis, the absorption in Poland was $3 billion (see Table 37).

Table 38: Foreign direct investment in transition economies, 1989-97

	Cumulative, % total investment, 1989-97	% GDP, 1997
Hungary	25.2	4.7
Russia	15.9	0.8
Poland	13.8	2.3
Czech Republic	12.2	2.4
Kazakhstan	7.0	5.7
Romania	3.9	2.9
Ukraine	3.4	1.4
Azerbaijan	3.3	24.4
Latvia	2.1	7.6
Croatia	2.1	2.7
Slovenia	1.8	1.8
Bulgaria	1.6	5.6
Slovakia	1.5	0.8
Estonia	1.3	2.8
Turkmenistan	1.1	4.7
Lithuania	1.0	3.6
Albania	0.6	1.4
Moldova	0.4	3.4
Kyrgyzstan	0.4	3.1
Belarus	0.4	0.7
Uzbekistan	0.4	0.4
Georgia	0.2	1.3
Tajikistan	0.1	1.8
Armenia	0.1	1.6
FYR Macedonia	0.1	0.5

Sources: EBRD 1998, Economist Intelligence Unit.

Because of the generally positive outcomes produced by foreign investment, the earlier fears and the reluctance of certain political circles have waned. This shift in attitude is also due to the changed environment, since a portion of the political class is now tied to foreign capital, whether through the endeavours of individual entrepreneurs, financial intermediaries, or direct investors in green field projects or joint ventures. There has been a significant change in public opinion, too. More and more people are in favour of the absorption of foreign capital. Contrary to what they were led to believe during the socialist era, they generally experience these investments not only as harmless, but also as the means for the supply of new products and services and even as a chance for skill upgrading and eventually well-paying jobs. Thus, they are coming to perceive these investments as beneficial to overall economic performance at the workplace and to the standard of living at home.

12.7 Openness, capital flows, and four policy dilemmas

Governments are still hesitant to open up all industries and sectors to the unbridled penetration of foreign capital. This is the case of the automobile industry in China, banks in the Czech Republic, tourist services in Hungary, the energy sector in Russia, land in Slovenia, and so on. There are many concerns, depending on the time and the place and what segment of public opinion and the political spectrum one has in mind. There are also certain policy dilemmas with significant financial and economic implications and important political, psychological, and moral consequences. Four are worth particular note: the risk of dependent capitalism, the instability of portfolio investments, the redistribution of global wealth and income, and capital flight.

The first dilemma is the risk of 'dependent capitalism'. How are the governments of transition economies to hand over national assets to foreigners without handing over the independence and freedom of action of their countries, too? Postsocialist economies are often short on resources, and vast privatization therefore means that a significant portion of assets will be acquired by foreign capital. Unlike the case in other economies, the middle class and even the very wealthy often have no meaningful outward foreign investments and do not usually possess property in other countries. Thus, while people in other nations may come to own a growing part of the economy's assets, nationals of the transition country own little or nothing in the other nations. If the scales tip too far, then the transition country may become subject to a sort of 'dependent capitalism', with all the negative political implications.

Vis-à-vis capital flows there is also a risk of asymmetry between the usually stronger foreign partner who brings the capital and the transition economy governments, industries, and domestic financial intermediaries, which, being in need of cash, are usually the weaker partners. Of course, the ideal policy response is to prefer the formation of national capital, but this takes more time, and an ever-growing share of extremely important activities is meanwhile being oiled by foreign capital, which therefore is also working on behalf of national welfare. However, predator foreign investors may attempt to take control of certain industries by acquiring assets – which the transition nation sells off for the purpose of microeconomic restructuring and to sustain employment – and then crushing any local competition by using the assets to introduce to the domestic market the products they manufacture elsewhere.

The hedge funds aim at speculative profits. In a situation of financial instability, they may therefore be very vigorous. By allowing profits which are sufficiently high to maintain aggressive competition, but not too high to permit a net transfer of national wealth, governments must try to use the hedge funds on behalf of financial stability.

International financial institutions work on behalf of global financial stability and liquidity, but they must also take into account the expectations and interests of the largest and strongest economies. Less influential nations and their governments must nonetheless try to employ these institutions to attract reasonable amounts of long-term capital which is not too dear.

An indispensable part of any financial deal, conditionality is a trump card in the possession of the supplier of the capital and thus a means to guarantee the realization of his targets. However, the recipient of the capital flow must stand tough in the negotiations. The investor may have far-reaching preferences such as tax holidays, fiscal allowances, or customs duties which must be imposed on competitive imports, but the government must not accept awkward concessions exposing consumers and other producers to unfair competition and the state budget to unnecessarily low revenues.

From this perspective, the government should favour foreign direct investment because this type of capital inflow is subject to national laws, as well as regulations and policies, albeit in a roundabout way and only to a limited extent. Moreover, foreign direct investments are usually long term and stable and can therefore enhance the economy’s growth potential by contributing to the restructuring of industrial capacity, which in turn supports competitiveness. Foreign direct investments are oriented not only toward the domestic market. Indeed, often foreign direct investors are seeking to take advantage of competitive local labour costs in order to produce for export. This can foster export-led growth, which in the longer run is beneficial for all concerned.

There is a strong and positive feedback loop between the scope and pace of privatization and the amount of foreign capital investments in a transition economy. It is true that the more rapidly state assets have been privatized, the more cheaply they have been sold off. However, this has also usually meant that a relatively larger amount of foreign capital is quickly injected into the economy. If the privatization programme is accompanied by steady progress in institution-building and financial stabilization, then the feedback loop can facilitate significant growth.

All in all, wise liberalization policies and the establishment of effective institutions are more important for recovery and growth than is privatization or foreign investment linked with denationalization. Yet, if all these elements are at work at the same time, then the risk of ‘dependent capitalism’ is greatly reduced, and transition growth can be accelerated. Privatization and liberalization encourage foreign investment. When supported by maturing institutional arrangements, this process can boost growth. The growth then secures increased domestic capital formation and additional absorption of portfolio investments and foreign direct investments. This stimulates more privatization and streamlines liberalization. Growth which is high quality, that is, fast, durable, and equitable, thereby gains momentum.

The existence of this interrelationship among liberalization, privatization, foreign investment, and institution-building explains why countries with relatively larger private sectors and relatively greater absorption of foreign capital can show a lower rate of growth (or higher rate of contraction) than countries with smaller private sectors and relatively less foreign capital.

A simple comparison, for instance between the Czech Republic and Slovenia in Eastern Europe or between Russia and Uzbekistan in the CIS, supports this claim. In the Czech Republic in 1994-8 the average rate of GDP growth was below 3 per cent, while in Slovenia it exceeded 4 per cent. In Russia during the same period GDP was shrinking annually by an average 4.2 per cent, while in Uzbekistan it was growing by an average 0.7 per cent. Yet, the share of the private sector in the economy was greater in the Czech Republic than it was in Slovenia, and it was greater in Russia than it was in Uzbekistan. Likewise, the stock of per capita foreign direct investment at the end of 1997 was higher by almost half in the Czech Republic than it was in Slovenia ($726 and $538, respectively), while it was over seven times higher in Russia than it was in Uzbekistan ($66 and $9, respectively).

The second dilemma is the instability of portfolio investments. This can persuade even the most liberal governments and policymakers to be reluctant to permit foreign capital free access to all sectors. The liquidity of portfolio investments is much greater than that of direct investments. Portfolio investments are thus more ‘easy come, easy go’. It is prudent not to let them flow in too easily, since later it may be very difficult, if not impossible, to prevent them from doing damage by flowing out equally readily. Unlike direct investments, which are tied to fixed assets, portfolio investments, because of the liberal regulation of capital markets, can be pulled out with shocking speed.

Furthermore, secondary capital deficits (financial ‘holes’ left after the escape of capital which was invested and circulating in the economy) impair performance much more than do primary capital deficits (shortages of capital for planned investment and reform projects). Secondary capital deficits lead to more underutilization of existing capacity and thence to contraction in national income and the spread of poverty. Primary capital deficits mean only that industrial capacity cannot be raised. Therefore, they do not necessarily generate a reduction in economic activity, which is unavoidable in the case of the withdrawal of capital. In other words, the economic consequences and policy implications of each type of capital deficit are different. Portfolio capital may later return and often does (though still later it may again be pulled out). This is why portfolio capital investments represent a risk in terms of continuity and stability in the process of capital formation and hence the sustainability of growth. It was precisely the sudden flight of portfolio capital that has turned this risk into disaster in East Asia, where, instead of fresh foreign investment, there was a massive foreign divestment.

Thus, policy should focus not only on attracting investment capital, but also on keeping it in the country as long as possible. The more reinvestment there is of speculative capital and the profits earned from it, the more growth becomes stable and durable and the more development becomes sustainable. Sound fundamentals, attractive interest rate differentials, and a stable financial and political climate can encourage speculative capital to become long-term capital. So, transition countries should aim at constant institutional improvements, circumspect structural policies, and the consolidation of stabilization into stability. Then they will earn the growing confidence of international partners, including portfolio investors.

Of course, policy is handicapped in this endeavour. Owing to the speculative nature of portfolio investments, they often fluctuate and flow in and out in any case. The young postsocialist markets, being more volatile and chaotic, are more vulnerable to such fluctuations. Their financial and capital markets and other market institutions are still emerging, and so they have relatively weaker fundamentals and less effective regulations and cannot easily resist a capital market panic (though even mature capital markets sometimes panic, such as Wall Street in 1987).

If the investors panic, no official policy statement or significant economic argument is going to calm them down immediately. Since the market itself has no appropriate emergency mechanism, investors will tend to follow the herd. If worse comes to worst, capital will begin to flow out of the economy like water out of a sieve, and neither the market, nor the government is going to be able to plug the holes. Even the IMF (presumably nearer the angels) will be helpless.

There was the 'tequila effect' of the Mexican crisis and then the East Asian 'contagion', but there has not yet been a distinguishable 'vodka effect' from the turmoil on Russian markets, although there have been negative repercussions in several transition countries. In some nations, for instance in Poland, the government tried to draw political advantage from the Russian crisis by blaming it for the slowdown in growth, even though this was due to deliberate government policy.[26]

Meanwhile, in Estonia in 1998 growth slipped by about 1.5 percentage points in the aftermath of the events in Russia. Unfortunately, in the era of globalization, it may happen that other countries, even those with relatively healthy and mature fundamentals, institutions, and policies, will not be entirely immune to a similar 'effect'. All the more reason for transition economies to be attentive in the liberalization of foreign capital flows. If it is possible to launch a speculative attack on an exposed economy (and the postsocialist nations definitely belong in this category), then one will be launched, very much as wolves will attack sheep at any opportunity.

Nonetheless, in seeking profits on volatile markets, hedge funds and institutional investors also add liquidity to these markets, and this tends to reduce unpredictability and lessen the chances for speculation. Moreover, for the time being, there is a need for these funds on both the supply side and the demand side. They contribute to the development of world financial markets and to the market fluctuations which are part of the global financial and economic game.

Though the hedge funds will not be driven out of the market altogether since they are too powerful and enjoy the strong support of influential interest groups in the most advanced countries, at least the risk they represent to market stability may diminish. Yet, this will happen only if they are subjected to the sort of regulation applied to investment banks. Despite the sense of urgency due to the world financial crisis in 1998, a consensus has still not been reached (in Washington, of course) on how the re-regulation ought to occur.

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[26] The government mistakenly assumed that the economy was overheated and – almost a year before the crash in Russia in August 1998 – decided to contain domestic demand. As a result the rate of growth dropped from an average 6.3% in 1994-7 to 5.8% in 1998 and was expected to fall further, to around 5%, in 1999.

It has been claimed that 'The hedge funds legitimize the role of the IMF in the eyes of its obstinate clientele. The hedge funds, in turn, depend on the IMF as a clean-up brigade' (Götz-Richter 1997). Hedge funds and the globalization of financial markets have certainly not lessened the role of the IMF. Indeed, they have enhanced it, including in the transition economies. Private financial intermediaries alone are clearly not capable of acting as watchdogs over capital flows on emerging markets. There are even cases in which these particular watchdogs have taken from the pantry.

Greed and the desire for big profits are powerful among some investors. If this causes problems, to shout at the market does not accomplish anything, but to deal with it wisely can be helpful. The governments of emerging market countries are looking increasingly to international financial institutions, like the IMF and the Bank for International Settlement, and to regional development banks, such as the EBRD, the Asian Development Bank, and the Inter-American Development Bank. Nations faced with the instability of capital inflows and outflows rely on these organizations for assistance.

Besides sound fundamentals and wise policies, cooperation with international financial organizations is the only remedy for the attacks of speculators that is available to transition nations, which must continue to open up to the global economy and accept the impact on their markets of global capital transfers. In fact, these organizations represent the market as much as they do governments, and there is no way to bring governments and the market together without their (official or secret) mediation. The influence of these organizations can make the task of hostile speculators more difficult.

Ironically, one outcome of transition has been an entirely unplanned interdependence among the once centrally planned economies. What is happening in Hungary or Poland depends to a certain extent on what is happening in Russia or Ukraine, the core republics of the former Soviet Union. The emerging capital markets are linked, and the turmoil among the biggest former Soviet republics is generating storm-clouds in other markets. Of course, this is at least as true of Hungary or Poland as it is of Argentina or Brazil. Without the worldwide coordination of policies toward financial and capital markets that is promoted by international financial organizations, a single country may be unable to resist market pressures, even if the fundamentals and the policies are sound.

The third dilemma is related to the redistribution of global wealth and income. Together with globalization, labour mobility, advanced information networks, and wise government policies (often guided by international organizations), the emerging markets may be viewed as buffers for the richer part of the world against the severe effects of sharp fluctuations in the business cycle (Weber 1997). Policies designed by the rich countries from this perspective may tend to ignore the impact of the global economy on working and living conditions elsewhere, thereby 'instrumentalizing' the transition economies. If transition economies are merely cushions against the business cycle for the advanced market countries, what does this say about the significance of the business cycles in the transition economies? How much does it matter? Who cares? The lack of a sound partnership might mean that, for example, the Czech economy could be used as a backup for German business whenever the German economy slows down, but that the German economy would never be available to Czech business in a like circumstance.

If this sort of arrangement is a logical consequence of the relative value of particular economies in international terms, then all the more reason it should be an issue in international policy discussions. This is yet another demonstration of the usefulness of the leading international economic and financial organizations. Without the support of these organizations, the transition economies cannot be sufficiently protected from exploitation by other players, be they hedge funds, investment banks, or foreign governments.

If the efforts of transition countries to establish a market economy and achieve high-quality growth are only a means to boost the well-being of people in other countries, then something is wrong with the world system. The problem is more serious than merely the success or failure of a raid by speculators on the peso or baht, ringgit or koruna, forint or rouble. Emerging capital markets, which the cash-poor economies wish to rely on as a stable instrument for the absorption of foreign savings and for capital formation, may be used by rich-country investors and governments as vehicles to transfer assets and income to themselves from emerging markets, including the transition nations. What starts out as investments in the poorer countries by a richer one ends up as capital divestment or asset stripping. As a result, income inequality increases, but this time the global economy is the scene of the 'old rich' taking from the 'new poor'. This is a serious challenge for international policy coordination.

The fourth dilemma is capital flight. Due to the denationalization of state assets, capital liquidity is rising. If this is accompanied by poor financial fundamentals and the flimsy regulation of capital transfers, then capital flight may be facilitated. The money is not always taken out of the economy because of a lack of prospects for profitable local investments or because the prospects are better elsewhere, but rather because of political and economic instability and unpredictability and sometimes simply because of the shadowy if not plain indecent way the assets have been accumulated, including illegal activities in the parallel economy, corruption, and organized crime.

Though it is impossible to gauge precisely the amounts of capital that have been transferred out of transition economies, they have certainly been large. Jacques de Larosière, the former managing director of the EBRD, claimed at the 1997 annual meeting of the bank that, with respect to Russia and other former Soviet republics, 'In 1996 alone the outflow of capital from the region probably exceeded the total invested by the EBRD since its creation' (Financial Times 1997c).

The Russian case is an extreme one, if it is possible to believe that \$60 billion or \$70 billion (The Economist 1997d) or even (up to the end of 1998) as much as \$150 to \$180 billion has left the country. These sums surpass the total foreign direct investment in Eastern Europe and the CIS over 1990-7. While capital flight and crossborder transfers have occurred elsewhere, too, they have not been of the same orders of magnitude as in Russia. It may be too much to believe (as an estimate of Deutsche Morgan Grenfell suggests) that in 1996 alone the capital outflows reached about \$22 billion and therefore exceeded the amount of foreign direct investment absorbed by a factor of 10, but it does seem possible that the average level of capital flight has hovered around \$12 billion annually since the onset of the transition.

If so much capital has been pulled out of Russia, one may ask whether the rates of return on investment were too high. The answer is that not all investors have acted the same. Some domestic investors, though not ready to take the risks foreign investors have taken, have kept their money in the country.[27] Of course, often domestic investors have simply lacked sufficient capital to bid for privatization deals. Many have lost money through financial intermediaries, including pyramid schemes, and this money has been transferred abroad as someone else's profits anyway.

A significant portion of the outflowing capital has been illicit money which could not be recirculated in the country without first being laundered somewhere else. By the same token, a small fraction of the foreign direct investment in Russia has been money in need of 'washing'. Poor regulation and inadequate commitment to fight money laundering make such activities possible. At least some of the capital leaving the country certainly finds its way back in, whether or not it left for laundering. A not negligible share of the inflows of both portfolio and direct investments (especially investments from the Cayman Islands, Cyprus, and Switzerland) is believed to be returning capital (Robinson 1997). In the meantime, the ownership of assets has changed, and privatization has continued. The capital and market position of the financial intermediaries who have transformed the capital from dirty domestic savings into clean foreign investments has been transformed, too.

So, in Russia, ill-advised privatization and organized crime have been the main sources of capital flight. Meanwhile, in Albania financial pyramids have been directly responsible. On the input side was a massive (and naïve) investment of savings in these fraudulent schemes. On the output side were the attempts to channel the money abroad. Inadequate regulations and weak institutions, as well as the inability if not unwillingness of the government to put a stop to the course of events, allowed the pyramids to grow so big that they were bound to collapse. Estimates of the losses vary, but according to the most credible ones about one-third of GDP was funneled out of the pyramids. Obviously, a great deal of this money has flown out of the country. None of these financial pathologies – not the Russian,

[27] Often such 'investors' have not invested all their money or even put all of it to productive use. Most estimates place the amount of hard currency 'under the mattress' in Russian households at around $40 billion.

not the Albanian, not any other – would have been possible without the active participation of third (foreign) parties.

It is very bad that such indecent methods of capital accumulation, capital concentration, and capital transfer have been tolerated by these countries, foreign governments, and international financial circles, or at least that they have not been halted by appropriate means in a timely way. International organizations, influential media professionals, research entities, and advisors have not reacted promptly even to diminish the losses once the problem has become visible. In each case too little came too late (though this is clearly not the view of those reaping the profits).

In a rather bizarre way, this financial hocus pocus has helped postsocialist countries accelerate primary capital accumulation and improve the links to global capital markets. The creation of a new class of entrepreneurs has been catalysed; capital has become more concentrated, and international ties have been established. However, the negative political and psychological effects have damaged the goodwill which is so important to the transition. Some may believe that liberalization, privatization, and internationalization have been accelerated, but institution-building, behavioural change, and the development of market culture have been delayed. In the end, this sort of redistribution of capital may have led to the emergence of new 'capitalists' and the concentration of assets, but it has also handicapped the formation of financial and human capital. It should have been possible to achieve more of both.