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# 2 Capital Flows to Eastern Europe

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## 1. *Hans Peter Lankes and Nicholas Stern*

### Capital Flows to Eastern Europe and the Former Soviet Union

#### 2.1.1 Introduction

Net capital flows to eastern Europe and the former Soviet Union built up rapidly during the 1980s, reaching around US$5 billion per annum in the second half of the decade. This was largely in the form of commercial bank loans and trade finance to state-owned foreign trade banks subject to sovereign guarantees. The dramatic changes of the early transition period saw a large rise in the share of Western official lending, while private capital was initially hesitant. Most of the old loans have, indeed, been subject to default. Now, seven or eight years into the transition, capital flows have increased sharply and new flows are predominantly to (and from) private entities.

The Berlin Wall fell in the autumn of 1989 and the countries of central Europe embarked very quickly on programs of liberalization, privatization, and institutional change. Serious attempts at market reform did not take place in the former Soviet Union until after its breakup in the autumn of 1991. Capital flows started to pick up with a two- or three-year delay and were directed to

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those countries that were clearly more successful in their market reforms and at macroeconomic stabilization.[1] Flows to the western parts of the former communist region, indeed to the region itself, have been dominated by those to the Czech Republic, Hungary, and Poland. However, in the past year or two, capital flows to Russia have picked up sharply. For 1997 it is likely that foreign direct investment (FDI) in the region will be around US$15 to $18 billion, with other net private flows around twice that level.

The buildup of FDI has been fairly steady as investor confidence has grown and prospects have become clearer. There have, however, been very strong surges coinciding with major privatizations of infrastructure, for example, in Hungary in 1995. The most recent surge in FDI has been in Poland and Russia. The movement of portfolio investments into the region as a whole has been rather less steady, with very strong acceleration in the past one to two years, as the perception of risk has adjusted sharply.

In this paper, we examine some of the determinants and consequences of capital flows to the region. We conclude that FDI is driven primarily by progress in transition and macroeconomic stability. It is these factors that allow the huge potential of the region to be unlocked. That potential is itself based on strong endowments of human capital and natural resources together with advantageous geographical position. FDI was initially oriented to establishing positions in domestic markets, but as reforms advance, countries attract more FDI and the type of FDI they attract is more integrated into international production networks. Because portfolio flows have grown only very recently, there is less firm analysis of their determinants. They would, no doubt, be influenced by underlying factors similar to those affecting FDI. However, in the case of FDI commitments have responded gradually to the changing circumstances, whereas the recent past has seen some very dramatic changes in perceptions driving portfolio flows. Indeed, movements in the underlying process appear steadier than those in perceptions. It therefore seems unlikely that the recent acceleration in portfolio investment will be maintained, as the adjustment in perceived risk and the rearrangement of portfolios it entailed should probably be seen as a one-off event.

The impact of capital flows to the region is of fundamental importance to the economic transition. These flows bring new methods of business organization, new technologies, and powerful influences on the building of financial, regulatory, and other institutions. They help establish the financial discipline that is crucial to the effective functioning of a market economy. Thus their impact goes far beyond the simple availability of resources.

The structure of the remainder of the paper is as follows. In section 2.1.2 we

1. They were, however, slowed in countries such as Poland, where there were worries about earlier problems of large indebtedness (Poland's gross external debt was almost 80 percent of GDP in 1990). This did not apply to the Czech Republic, where inherited debts were small, or to Hungary, where the perceived probability of default was low (and indeed Hungary has been the only country with heavy debts that has not defaulted).

describe capital flows as they have developed over the past two decades. In section 2.1.3 we look more closely at some of the patterns involved and consider the key determinants of FDI, commercial bank lending, and portfolio flows. In section 2.1.4 we comment briefly on some consequences for the host economies, and in section 2.1.5 we consider prospects and policy questions facing host governments and international financial institutions. Table 2.1 provides summary statistics on the twenty-six countries of the region, which has a population of 400 million people and a combined GDP of around US$1,000 billion.

### 2.1.2 Capital Flows before and after 1989

Pretransition Period

The central planners were no strangers to international capital markets. Since the late 1970s, various governments developed active borrowing programs. These may be seen as part of efforts to sustain consumption in the face of ever-increasing investment targets as the productivity of capital continued its decades-long decline. The USSR, Poland, Yugoslavia, Hungary, and later Bulgaria approached the syndicated loan market, generally through their foreign trade banks, and expanded the use of export credit and short-term trade finance.[2] East Germany relied more on its ability to extract bilateral credits from the Federal Republic. Equity finance was foreign to socialism, and the decentralized nature of bond finance was not in favor with the powers that were. The sovereign risk of these economies was well regarded, as evidenced by their ability to raise rapidly their levels of indebtedness, although Yugoslavia and Poland underwent a series of debt restructurings as early as the late 1970s and early 1980s, respectively. Net medium- to long-term capital flows to the region averaged US$1.2 billion per year in 1976–80, $1.8 billion in 1981–85, and $5 billion in 1986–90 (table 2.2). The USSR continued to have access to large-scale commercial bank lending until its breakup in 1991. Except for Czechoslovakia and Romania, these countries entered the transition process with heavy debt burdens on which—apart from Hungary—they eventually defaulted.[3]

Economic Performance and Risk

The transition process changed radically both the volume and the composition of external capital flows. Capital flows from 1989 to 1993 were shaped by the determination of Western governments to support and protect the profound political and economic changes that were taking place. Private sources of funds, however, understandably took a wait-and-see approach. Country and

2. *Forfeiting*—a way of securitizing trade credit—developed into an art in Comecon trade finance, perhaps more so than in any other part of the world.

3. The problem of East German debt "resolved" itself with unification.

**Table 2.1** **Economic and Structural Indicators in Eastern Europe, the Baltics, and the Commonwealth of Independent States**

| Country | Population, 1996 Estimate (million) | Real GDP, 1997 Projection[a] | | Consumer Prices (year-end), 1997 Projection (% change) | FDI (net), 1996 Estimate | | External Debt, 1996 Estimate (% of GDP) | Preferred Creditor Debt, 1996 Estimate (% of total) | Country Risk as of September 1997 (S&P's/Moody's) | Average Transition Indicator | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 1989 = 100 | % Change | | Million US$ | US$ per Capita | | | | 1997 | 1994 |
| Albania | 3.3 | 73 | −15.0 | 42 | 90 | 28 | 29 | 35 | n.a. | 2.6 | 2.5 |
| Armenia | 3.7 | 39 | 5.8 | 19 | 22 | 6 | 39 | 54 | n.a. | 2.5 | 1.8 |
| Azerbaijan | 7.6 | 41 | 5.2 | 7 | 661 | 72 | 16 | 26 | n.a. | 2.0 | 1.3 |
| Belarus | 10.3 | 66 | 3.0 | 99 | 75 | 7 | 7 | 57 | n.a. | 1.6 | 1.7 |
| Bosnia-Herzegovina[b] | 4.2 | n.a. | 35.0 | 0 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Bulgaria | 8.4 | 63 | −7.0 | 592 | 100 | 12 | 111 | 18 | n.a./B3 | 2.8 | 2.5 |
| Croatia | 4.8 | 74 | 5.0 | 4 | 349 | 73 | 25 | 14 | BBB−/Baa3 | 3.0 | 3.2 |
| Czech Republic | 10.3 | 97 | 1.0 | 9 | 1,264 | 123 | 38 | 3 | A/Baa1 | 3.5 | 3.5 |
| Estonia | 1.5 | 76 | 7.0 | 12 | 110 | 71 | 8 | 59 | n.a./Baa1 | 3.4 | 3.3 |
| FYR Macedonia | 2.1 | 56 | 2.0 | 8 | 39 | 20 | 32 | 50 | n.a. | 2.6 | 2.8 |
| Georgia | 5.4 | 34 | 10.5 | 9 | 25 | 5 | 30 | 26 | n.a. | 2.7 | 1.3 |
| Hungary | 10.2 | 89 | 3.0 | 17 | 1,986 | 196 | 62 | 8 | BBB−/Baa3 | 3.7 | 3.3 |
| Kazakhstan | 16.3 | 58 | 2.0 | 17 | 1,100 | 67 | 19 | 31 | BB−/Ba3 | 2.7 | 1.7 |
| Kyrgyzstan | 4.5 | 60 | 6.0 | 24 | 31 | 7 | 43 | 50 | n.a. | 2.8 | 2.8 |
| Latvia | 2.5 | 54 | 3.4 | 8 | 230 | 92 | 9 | 55 | BBB/n.a. | 3.2 | 2.8 |
| Lithuania | 3.7 | 44 | 4.5 | 10 | 152 | 41 | 12 | 47 | BBB−/Ba2 | 3.1 | 3.0 |
| Moldova | 4.3 | 34 | −2.0 | 11 | 56 | 13 | 43 | 55 | n.a./Ba2 | 2.6 | 2.2 |
| Poland | 38.6 | 110 | 5.5 | 15 | 2,741 | 71 | 30 | 6 | BBB−/Baa3 | 3.4 | 3.3 |
| Romania | 22.6 | 86 | −1.5 | 116 | 210 | 9 | 21 | 26 | BB−/Ba3 | 2.7 | 2.7 |
| Russia | 147.5 | 57 | 1.0 | 14 | 2,040 | 9 | 28 | 14 | BB−/Ba2 | 3.0 | 2.7 |
| Slovak Republic | 5.3 | 94 | 4.5 | 7 | 177 | 33 | 41 | 9 | BBB−/Baa3 | 3.3 | 3.3 |
| Slovenia | 2.0 | 99 | 4.0 | 9 | 180 | 90 | 22 | 8 | A/A3 | 3.2 | 3.2 |
| Tajikistan | 5.8 | 36 | −3.0 | 110 | 13 | 2 | 93 | 10 | n.a. | 1.6 | 1.7 |
| Turkmenistan | 4.6 | 51 | −15.0 | 44 | 129 | 28 | 26 | n.a. | n.a. | 1.5 | 1.2 |
| Ukraine | 51.2 | 37 | −3.0 | 15 | 500 | 10 | 21 | 36 | n.a. | 2.4 | 1.3 |
| Uzbekistan | 23.0 | 86 | 1.0 | 40 | 50 | 2 | 17 | 27 | n.a. | 2.2 | 2.0 |

*Source:* EBRD.

*Note:* Data for 1990–96 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon, and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly official government estimates. Data for 1997 represent EBRD projections.

[a]Based on official estimates. Unofficial economic activity has been estimated to account for between 20 percent (eastern Europe) and 45 percent (CIS) of "true GDP," and relative prices have changed radically between 1989 and 1997. These indexes should therefore be interpreted with caution, with relative values across countries probably more reliable than levels.

[b]Population data include refugees abroad (approximately one-third of the total). Inflation figure refers to annual average.

**Table 2.2** Net Capital Flows to Eastern Europe and the Former Soviet Union (millions of U.S. dollars)

| | Annual Average | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1976–80 | 1981–85 | 1986–90 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 Projection |
| *Total flows* | 1,179 | 1,805 | 4,871 | 4,032 | 3,396 | 14,464 | 24,874 | 23,520 | 17,463 | 32,921 | 40,976 | 60,076 |
| *Private flows* | 862 | 973 | 3,935 | 2,866 | −8,355 | −6,409 | 6,213 | 13,947 | 13,620 | 28,427 | 33,653 | 51,997 |
| Equity investment | 15 | 18 | 152 | 458 | 571 | 2,464 | 3,996 | 5,449 | 5,537 | 14,010 | 12,315 | 18,400 |
| Direct equity investment | 15 | 18 | 122 | 187 | 431 | 2,143 | 3,657 | 4,126 | 4,065 | 11,647 | 7,756 | 12,000 |
| Portfolio equity investment | 0 | 0 | 30 | 271 | 140 | 321 | 339 | 1,323 | 1,472 | 2,363 | 4,559 | 6,400 |
| Commercial banks | 694 | 680 | 76 | 908 | −15,089 | −8,226 | 996 | 2,450 | 2,576 | 8,845 | 10,337 | 6,790 |
| Other private creditors | 153 | 275 | 3,707 | 1,500 | 6,163 | −647 | 1,221 | 6,048 | 5,507 | 5,572 | 11,001 | 26,808 |
| *Official flows* | 317 | 831 | 936 | 1,166 | 11,751 | 20,873 | 18,661 | 9,573 | 3,843 | 4,494 | 7,323 | 8,079 |
| International financial institutions | 204 | 625 | −126 | −1,143 | 1,112 | 5,729 | 3,607 | 3,101 | 2,940 | 3,414 | 3,523 | 6,368 |
| Official bilateral creditors | 113 | 206 | 1,062 | 2,309 | 10,639 | 15,144 | 15,054 | 6,472 | 902 | 1,080 | 3,800 | 1,711 |

*Sources:* Institute of International Finance, except direct equity investment from EBRD; portfolio equity calculated as residual.

*Note:* Data cover Bulgaria, the Czech Republic, Hungary, Poland, Romania, and the Slovak Republic.

commercial risk was, and was perceived to be, extremely high. The extreme dislocation meant that the macroeconomic position was very weak. When economic performance improved and the transition progressed, private capital began to enter the market, first timidly, then with great speed. Before discussing the evidence on capital flows it is important to have a picture of the economic circumstances in the early transition years. These varied substantially across countries with strong implications for risk and performance.

In the early years of transition, beginning around 1989–90 in eastern Europe and 1992 in the former Soviet Union,[4] central economic coordination (such as it was) was lost, with markets only gradually taking its place. Macroeconomic conditions were highly unsettled, relative prices adjusted sharply, and political uncertainty was severe, particularly in the former Soviet Union and Yugoslavia. Output contracted until 1993–94 in eastern Europe and the Baltics and until 1997 in the Commonwealth of Independent States (CIS),[5] for cumulative declines of 20 and 44 percent, respectively.[6] In 1992, only six economies in the region, out of twenty-six, recorded inflation of less than 100 percent. Macroeconomic conditions, in terms of inflation, improved rapidly in eastern Europe after 1993, and in the CIS from about 1995. In 1997 economic growth is returning to the region as a whole. Only seven countries are experiencing economic decline—largely those where structural reforms have been lagging—and eleven are experiencing GDP growth in excess of 4 percent. In only three countries is inflation expected to be at triple-digit levels in 1997. The turnaround in growth is primarily due to the end of economic contraction in Russia, the region's largest economy, which is expected to show small but positive growth this year. Performance has not improved consistently across the region. Some major setbacks, for example, recently in Albania, Bulgaria, and Romania, demonstrate the fragile nature of the recovery. Nevertheless, with a combined GDP of around US$1,000 billion—one-sixth of aggregate developing country GDP, or 3 percent of the world economy—the region is rapidly establishing itself as a major "emerging" market.[7]

After some degree of uniformity in the very early transition, individual

4. The initiation of price and trade liberalization is taken here as indicating the "starting point" of the transition.

5. Eastern Europe includes the twenty-six countries in table 2.1 less those of the former Soviet Union. The CIS includes the former Soviet Union less the Baltic countries (Estonia, Latvia, and Lithuania).

6. This calculation is based on official statistics and covers the period of contraction (1989–93 in eastern Europe and the Baltics and 1989–97 in the CIS). There are, of course, serious measurement issues in terms of earlier rationing, quality change, changes in reporting incentives, changes in official procedures, etc. Informal, mostly private, economic activity was estimated to account for about 20 percent of actual GDP in eastern Europe and more than 40 percent in the CIS (excluding central Asia) in 1995 and is only partly reflected in adjustments to official GDP data; see EBRD (1997, chap. 4).

7. It has around 7 percent of the world's population, and thus GDP per capita a little under half the world average. The countries are all middle income according to the World Bank classification, except for Albania, Armenia, Azerbaijan, Georgia, Kyrgyzstan, Bosnia-Herzegovina, and Tajikistan, which are low income (less than US$755 per capita in 1995).

countries quickly began to differ across the various dimensions of reform. So too did risk perceptions. Most countries moved rapidly to liberalize prices and markets. Progress on privatization was more uneven, but it is now fairly advanced in a majority of countries. In much of the region governments are now engaged in a "second phase" of direct sales of banks, infrastructure, and "strategic" companies, after an emphasis on speed in the "mass privatizations" of the first phase. A few transition economies now have private sector shares in GDP that are similar to many developed market economies. The greatest differences among countries are in the more qualitative aspects of transition, the building of sound financial and other market-supporting institutions, and the restructuring and governance of enterprises. Central European reformers are making some progress on these dimensions. But they still have far to go, and further east and south progress remains limited.

Investment and lending risk are closely associated with progress in transition. Figure 2.1 displays the results of a European Bank for Reconstruction and Development (EBRD) survey among actual and potential investors in the region, conducted in 1995 (for details, see appendix B). Note that, among five sources of risk presented to investors in the survey, regulatory and macroeconomic risks were judged to be most significant (by far) whatever the perceived risk level. It is evident from the figure that there is a close (negative) association between progress in transition and perceived country risk: there is a rank correlation coefficient of −.89 for the host countries included in the survey (see also table 2.1 for recent credit ratings).

## Capital Flows and the Transition

Reflecting Western official support for the transition as well as the developments discussed above, capital flows to the region have followed a distinct sequence, with official funding, FDI, commercial lending not guaranteed in the countries of origin, dedicated equity funds, and finally direct local stock and money market investments entering successively at one- to two-year intervals (table 2.2 and figs. 2.2 and 2.3).[8] In important respects this may be seen as a "telescoped" version of the recent history of capital flows elsewhere, compressed into a much shorter period of time. It must be kept in mind, however, that there are serious data problems with measures of capital flows in the transition economies. Commercial bank syndicated lending and bond issues tend to be reasonably well covered by the Euromoney databases (Bondware and Loanware), but measures of FDI and, in particular, of portfolio equity and money market investments can differ enormously. For aggregate flows we rely here on information on a subset of countries compiled by the Institute of International Finance, but we supplement this with FDI estimates prepared from

8. Note that this sequence refers to increases in net exposure; gross flows of bank lending not guaranteed in the country of origin, largely to refinance existing official debt, were present throughout the early transition phase.

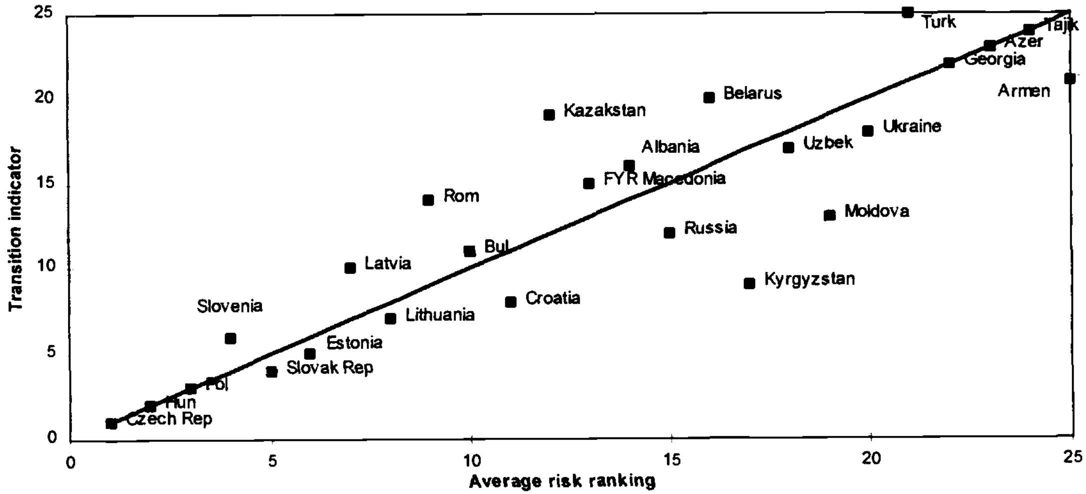


**Fig. 2.1 EBRD transition indicators (1995) versus perceived country risk**

*Note:* Countries are ranked by perceived country risk (*horizontal axis*) and level of transition (*vertical axis*). Interviewees were asked to assign the countries that they felt confident assessing to one of four risk groups ranging from 1 (low risk, comparable to risk in OECD countries) to 4 (unacceptably high risk). The data reported here represent the average of ratings. The measure of progress in transition is taken from the EBRD's annual *Transition Report*, with 1995 results used here for consistency with the risk assessments. The rankings are based on simple averages of scores—ranging from 1 (little progress) to 4 (advanced transition)—on the EBRD's eight transition indicators for 1995: extent of privatization (two indicators), extent of enterprise restructuring, scope and openness of markets (two indicators), progress in financial sector reform (two indicators), and progress in the creation of legal and institutional frameworks supporting private sector activity.

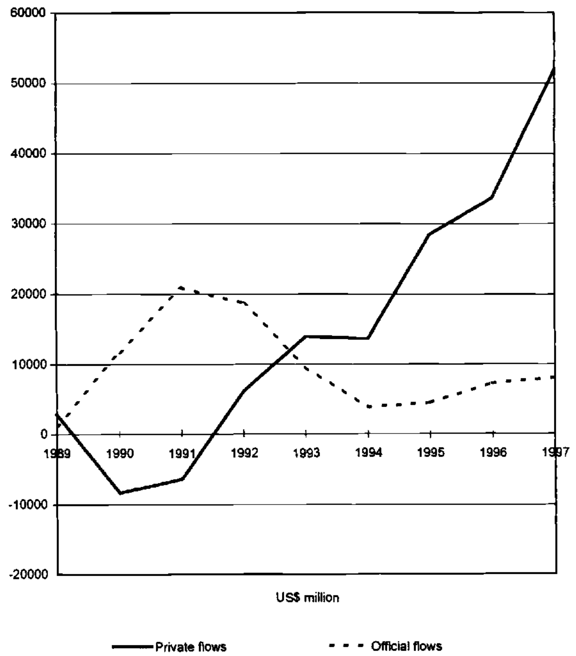


**Fig. 2.2 Eastern Europe and former Soviet Union: net private and official capital flows, 1989–97 (millions of U.S. dollars)**

*Source:* Institute of International Finance.

*Note:* Data cover Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, and the Slovak Republic. The figure for 1997 is a projection.

balances of payments (mostly drawn from the International Monetary Fund—IMF) and EBRD information on equity funds.

Beginning in 1989–90, official funding, and funding guaranteed by Western export credit agencies (ECAs), increased sharply, while private sources of funds were largely absent from the region. A large share of the official capital flows were on account of German transfers to the former Soviet Union as part of the German unification agreement (e.g., housing for repatriated USSR soldiers), but substantial official support was forthcoming from a range of bilateral and multilateral sources (e.g., international financial institution contributions to the stabilization fund for Poland in 1991).[9] Net official flows to the seven largest recipient countries covered by table 2.2 peaked in 1991 at US$21 billion.[10] After 1993, they declined both as a share of the total and in absolute terms. Private flows to these countries began to exceed net official flows in 1993 and

9. In addition, Paris Club reschedulings were granted to Poland (1991, concessional terms), Bulgaria (1991, 1992, 1994), and Russia (1993, 1994, 1995, 1996).

10. Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, and the Slovak Republic. Data from the Institute of International Finance.

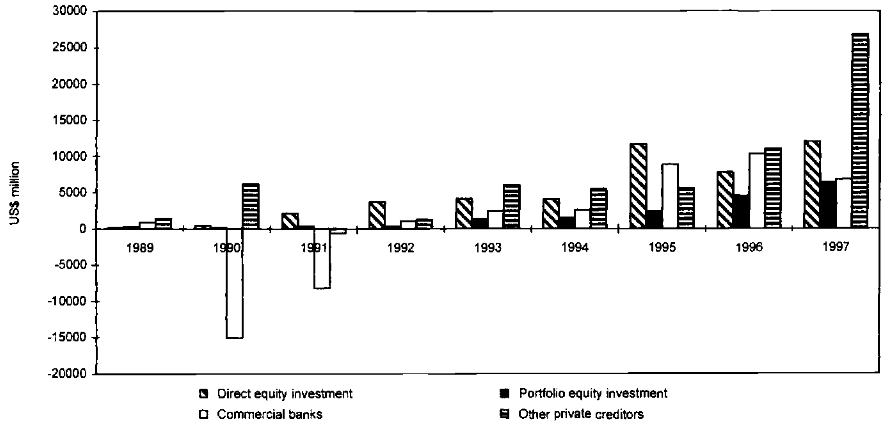


**Fig. 2.3 Eastern Europe and former Soviet Union: composition of private capital flows, 1989–97**
*Source:* Institute of International Finance.
*Note:* Data cover Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, and the Slovak Republic. The figure for 1997 is a projection.

by 1996 accounted for $34 billion out of $41 billion in total net capital flows (excluding net resident lending abroad). This represented 14 percent of aggregate net private flows to developing countries.[11] In 1997, net private flows are projected to rise to $52 billion, or more than 5 percent of the GDP of the region. After a relatively minor presence as a destination in earlier years, Russia has, since 1996 and especially in 1997, increasingly dominated private flows of all types and may at present account for more than half of all flows. While foreigners have invested in Russia, however, Russians have increasingly transferred funds abroad, an estimated total of $29 billion in 1996. The main channels have been the nonrepatriation of export proceeds (accounting for perhaps $18 billion) and currency purchases by the population (IMF 1997).

The following provides a brief description of developments in different categories of private capital flows.

*Foreign Direct Investment*

The entry of private nonguaranteed capital was led by FDI (table 2.3). Hungary was the first country to receive significant FDI flows in 1991, mostly in the form of acquisitions under the Hungarian privatization program, and to a lesser extent Czechoslovakia (whose primary method of privatization was through vouchers). Poland, Russia, and Kazakhstan, and some smaller countries (Estonia and Slovenia) began to attract FDI over the period 1992–94. In 1995–96, FDI flows surged and began to cover a broader range of countries. In those two years (cumulatively), FDI in the transition economies accounted

11. With the transition economies included in the total for developing countries.

**Table 2.3** **Foreign Direct Investment (inflows recorded in the balance of payments)**

| | Total (million US$) | | | | | | | | | Per Capita (US$) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 Revised | Cumulative FDI Inflows, 1989–96 | Cumulative FDI Inflows, 1989–96 | FDI Inflows, 1996 | FDI Inflows as a Percentage of GDP, 1996 |
| Albania | — | — | 8 | 32 | 45 | 53 | 70 | 90 | 298 | 93 | 28 | 3 |
| Bulgaria | — | — | 56 | 42 | 40 | 105 | 82 | 100 | 425 | 51 | 12 | 1 |
| Croatia | — | — | — | 13 | 74 | 98 | 81 | 349 | 615 | 129 | 73 | 2 |
| Czech Republic | — | 120 | 511 | 983 | 498 | 1,024 | 2,720 | 1,264 | 7,120 | 692 | 123 | 2 |
| Estonia | — | — | — | 58 | 156 | 212 | 199 | 110 | 735 | 477 | 71 | 3 |
| Hungary | 187 | 311 | 1,459 | 1,471 | 2,339 | 1,097 | 4,410 | 1,986 | 13,260 | 1,300 | 195 | 4 |
| Latvia | — | — | — | 43 | 51 | 155 | 165 | 230 | 644 | 258 | 92 | 5 |
| Lithuania[a] | — | — | — | — | 30 | 31 | 72 | 152 | 285 | 76 | 41 | 2 |
| FYR Macedonia | — | — | — | — | — | 24 | 13 | 39 | 76 | 38 | 20 | 1 |
| Poland | — | — | 117 | 284 | 580 | 542 | 1,134 | 2,741 | 5,398 | 140 | 71 | 2 |
| Romania | — | 18 | 37 | 73 | 97 | 347 | 404 | 210 | 1,186 | 52 | 9 | 1 |
| Slovak Republic | — | — | — | — | 134 | 178 | 134 | 177 | 623 | 117 | 33 | 1 |
| Slovenia | — | −2 | 41 | 112 | 111 | 131 | 170 | 180 | 743 | 372 | 90 | 1 |
| Eastern Europe and Baltics | 187 | 447 | 2,229 | 3,111 | 4,155 | 3,997 | 9,654 | 7,628 | 31,408 | 273 | 66 | 2 |
| Armenia | — | — | — | — | — | 3 | 19 | 22 | 44 | 12 | 6 | 1 |
| Azerbaijan | — | — | — | — | 20 | 22 | 284 | 661 | 987 | 130 | 87 | 19 |
| Belarus | — | — | 50 | 7 | 18 | 10 | 7 | 75 | 167 | 16 | 7 | 1 |
| Georgia | — | — | — | — | — | 8 | 6 | 25 | 39 | 7 | 5 | 1 |
| Kazakhstan | — | — | — | — | 473 | 635 | 859 | 1,100 | 3,067 | 187 | 67 | 5 |
| Kyrgyzstan | — | — | — | — | 10 | 45 | 61 | 31 | 147 | 33 | 7 | 2 |
| Moldova | — | | — | — | 14 | 18 | 73 | 56 | 161 | 37 | 13 | 3 |
| Russia | — | — | — | 700 | 498 | 584 | 2,021 | 2,040 | 5,843 | 40 | 14 | 0 |
| Tajikistan | — | — | — | 8 | 9 | 12 | 13 | 13 | 55 | 10 | 2 | 1 |
| Turkmenistan | — | — | — | — | 79 | 103 | 233 | 129 | 544 | 118 | 28 | 5 |
| Ukraine | — | — | — | 170 | 200 | 100 | 300 | 500 | 1,270 | 25 | 10 | 1 |
| Uzbekistan | — | — | — | 9 | 48 | 73 | −24 | 50 | 156 | 7 | 2 | 0 |
| CIS | — | — | 50 | 894 | 1,369 | 1,613 | 3,852 | 4,702 | 12,480 | 44 | 17 | 1 |
| Total | 187 | 447 | 2,279 | 4,005 | 5,524 | 5,610 | 13,506 | 12,330 | 43,888 | 110 | 31 | 1 |

*Sources:* IMF, central banks, and EBRD estimates.

[a]FDI figures for Lithuania are only available from 1993. For 1993 and 1994, figures cover only investment in equity capital.

for about 13 percent of aggregate FDI outside the developed market economies. In 1995, Hungary attracted the largest amount of FDI per capita of any country outside the developed market economies, and the share of FDI in its GDP exceeded 10 percent. Poland developed into the top destination in 1996 (with FDI doubling two years in a row), and large privatizations with foreign participation in the telecommunications and oil sectors have strongly increased inflows to Russia in 1997. One-quarter of the region's total FDI in 1997, which we expect to reach US$15 to $18 billion, is likely to flow to each of Poland and Russia. There is also concentration among countries of origin. By 1996 about one-third of cumulative FDI flows to eastern Europe had originated in Germany, while a similar proportion of the flows to the CIS is of U.S. origin (with hardly any German investment at all).

*Commercial Bank Lending and International Bond Finance*

By 1993, commercial bank lending and international bond issues began to pick up. Figures 2.4 and 2.5 provide a graphic representation of developments in these markets by subregion. After an initial "getting-to-know" period, these flows have surged in 1997. The share of the former Soviet Union in the total, large in 1990 and 1991 before the breakup of the USSR, remained relatively low from 1992 to 1996 but has been rising very strongly in 1997. Funding for the more advanced countries of eastern Europe grew at a more steady rate over the same period.[12] While sovereign and other public sector issuers have been particularly prominent on international bond markets—with Russia, the cities of Moscow and St. Petersburg, Ukraine, Lithuania, Moldova, and Kazakhstan making debut public offerings since the beginning of 1997—significant issues have also been made by "blue chip" commercial entities and banks, especially in the advanced countries of central Europe. Several Russian regional authorities, municipalities, and enterprises are expected to launch international bonds during the remainder of 1997. Since 1995, private borrowers have dominated the commercial loan market, the vast majority in the form of bank-to-bank loans and project financing. Again, borrowers from Russia have been particularly active on this market recently. Syndicated loans to twenty-one Russian banks for a total value of US$1.2 billion were registered in the first half of 1997 alone, usually with maturities of one year or less.

Along with rising volumes, terms have generally improved, but there are cases of rapid reversal that demonstrate the fragility of these markets and the information problem still faced by investors.[13] Issue spreads of 375, 325, 100, and 80 basis points over U.S. Treasury bills were recorded in 1997 bond issues by Russia (June, ten-year maturity), Ukraine (August, one year), Poland (June, twenty years), and Croatia (February, five years), respectively. As of mid-September, effective spreads were 312, 283, 120, and 152 basis points, sug-

12. The "blip" in bond issues to eastern Europe in 1993 is due to the Bank of Hungary's issuing twenty-one bonds to finance growing current account deficits.

13. Information on terms is drawn from the Euromoney Loanware and Bondware databases.

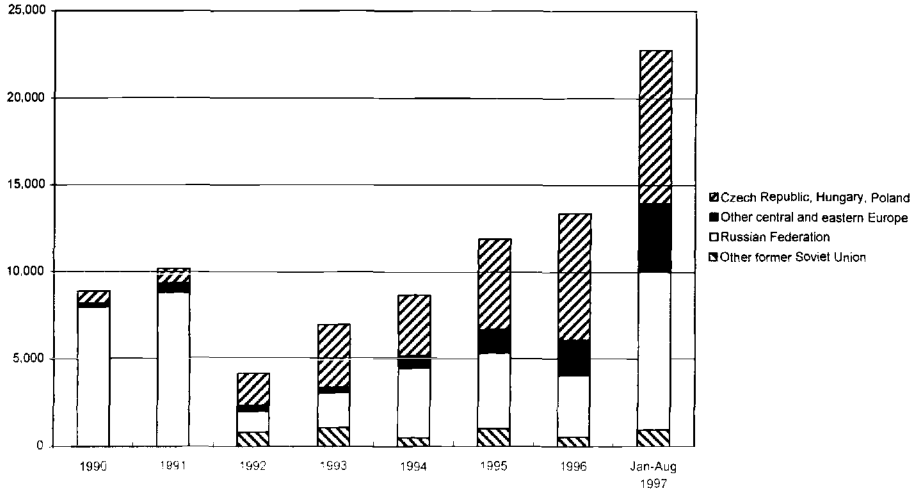


**Fig. 2.4 Syndicated lending by commercial banks by subregion (millions of U.S. dollars)**
*Source:* Euromoney Loanware.
*Note:* "Other central and eastern Europe" includes the Baltics.

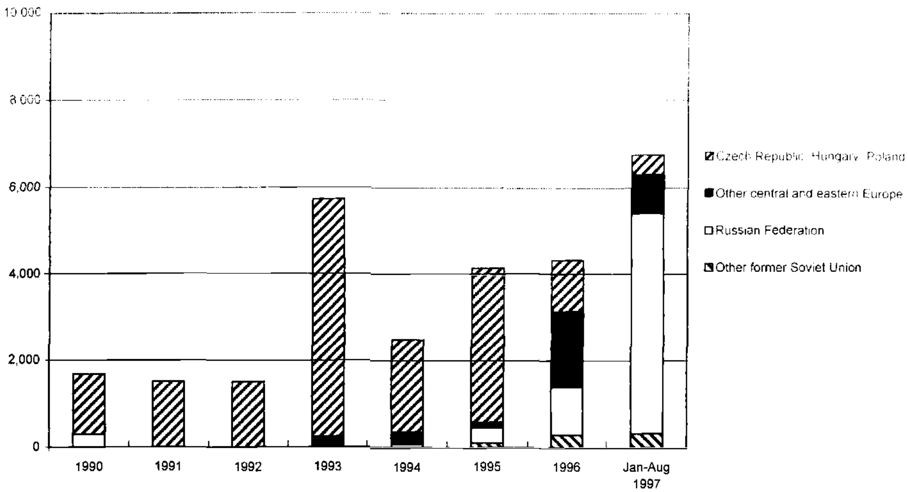


**Fig. 2.5 International bond issues by subregion (millions of U.S. dollars)**
*Source:* Euromoney Bondware.
*Note:* "Other central and eastern Europe" includes the Baltics.

gesting improved confidence in the former two countries and slightly deteriorating confidence in the latter two. Figure 2.6 describes the movement over time of average maturities and spreads of syndicated loans to public sector borrowers in the Czech Republic, Hungary, Poland, Romania, and Russia.[14] It shows that spreads fell first in the Czech Republic in 1994–95, whereas a more generalized decline in spreads came only in 1996–97.[15] It is interesting to note that Russian public sector borrowers continue to pay a far higher premium than the old Soviet Vneshekonombank used to be charged in 1990–91.

*Portfolio Equity*

Dedicated country and regional equity funds entered the region quite early, focusing primarily on central Europe, but their period of rapid expansion came in 1993–94 (table 2.4). As of September 1997, there were 170 portfolio funds (investing in listed securities) and 64 direct equity funds (unlisted shares), with cumulative investments of US$11 and $2.2 billion, respectively.[16] The vast majority of funds, including regional funds, have been invested in Russia and Poland, with estimates of around one-half and one-fifth, respectively, of the total. Closed-end funds were prevalent in the earlier stages of transition, but an increasing number are now open ended. While Western pension funds and other institutional investors account for much of the capital of the portfolio funds, the capital of private individuals is more prominent in funds specializing in unlisted shares.

Over recent years, eastern European and Russian corporates and banks have increasingly taken the direct route to overseas equity markets, although this group still represents a small share of aggregate flows. Issues have generally taken the form of ADRs/GDRs and private placements,[17] but there have also been direct listings on the London Stock Exchange. International equity issues, primarily in conjunction with privatization, were initially dominated by Hungary, which issued US$837 million in shares abroad over the period 1994–96. Poland had issues of $218 million in 1995, but it was in 1996 that this form of finance took off, with a total of $1.3 billion in share issues from seven countries. Russia ($800 million) again dominated this segment.[18] Overseas issues are viewed increasingly as an attractive option by large companies in the region

14. Fig. 2.6 only draws on those commercial bank loans for which pricing information is available on Euromoney Loanware.

15. Data refer to the first half of 1997.

16. Disbursements as measured in the EBRD Database, Early Stage Equity team.

17. American and Global Depository Receipts spare nonresident investors the settlement and custody problems of what are still weak institutional infrastructures for capital markets in the region.

18. The largest single issue in a transition economy was from Russia's Gazprom (US$430 million ADR). Lukoil of Russia plans to raise $1 billion in New York this year. In central Europe, MATAV, the Hungarian telecommunications company, will likely be the largest issue so far, with a value of perhaps $0.5 billion.

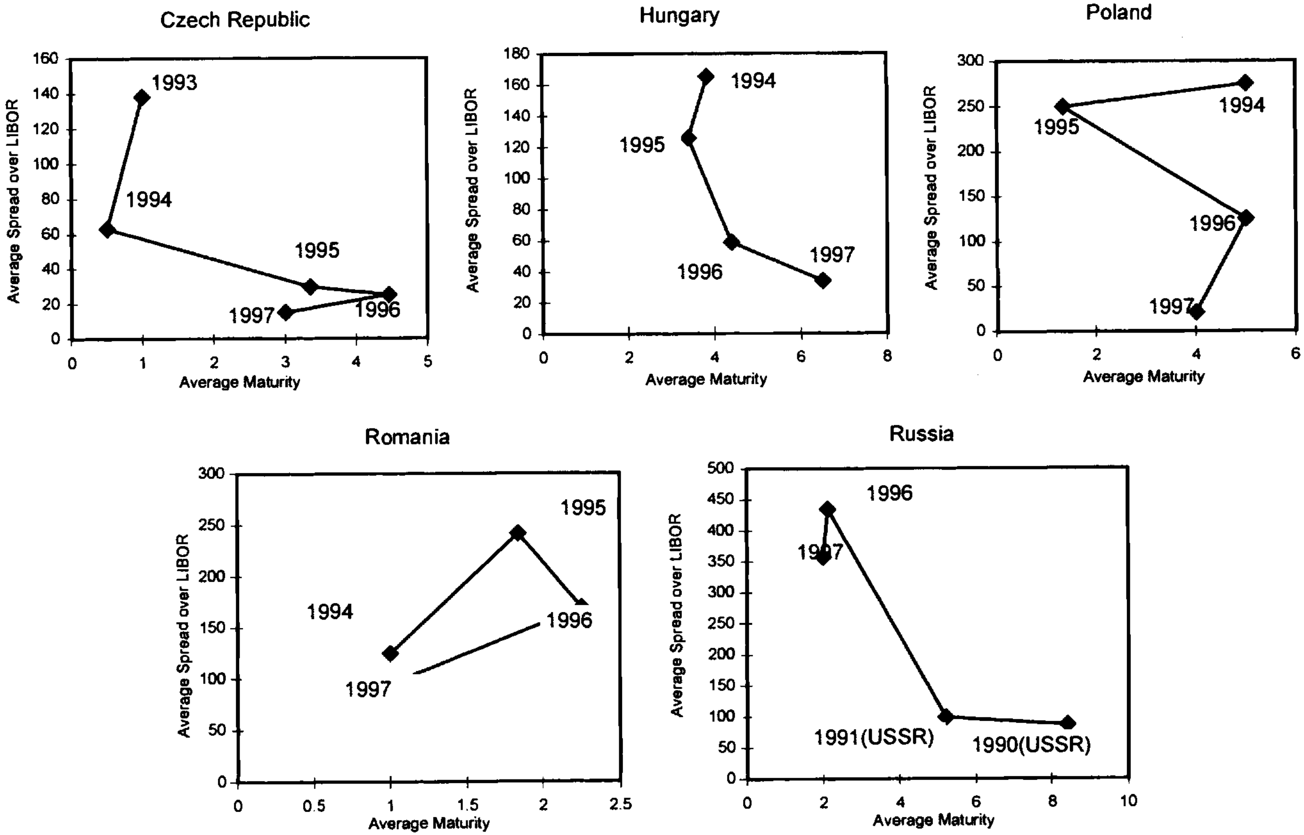


**Fig. 2.6 Average spreads and maturities of commercial bank loans: public sector borrowers**

*Source:* Euromoney Loanware.

*Note:* Spreads are in basis points, maturities in years.

**Table 2.4** **Equity Funds in Eastern Europe, the Baltics, and the Commonwealth of Independent States (millions of U.S. dollars)**

| Target | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 (9 months) | Cumulative Total since 1989 |
|---|---|---|---|---|---|---|---|---|---|---|
| Portfolio Funds (Listed Securities): Amount Invested as of 30 September 1997 | | | | | | | | | | |
| *Region* | | | | | | | | | | |
| Central and eastern Europe | | | | 12 | | 570 | 275 | 370 | 30 | 1,257 |
| Central Europe | | 135 | 28 | | | 1,200 | 280 | 760 | 15 | 2,418 |
| CIS | | 380 | | | 1,400 | 440 | 60 | 80 | 10 | 2,370 |
| Baltics | | | | 18 | | 82 | 5 | 45 | | 150 |
| Central Asia | | | | | | | | | 10 | 10 |
| *Country* | | | | | | | | | | |
| Albania | | | | | | | | | | 0 |
| Bulgaria | | | | | | | | 20 | | 20 |
| Czech and Slovak Republics | | | | 105 | 400 | 100 | 140 | 70 | 20 | 835 |
| Hungary | | 270 | | 10 | 5 | 9 | | | | 294 |
| Poland | | | 19 | 320 | | | | 190 | | 529 |
| Romania | | | | | | | | 15 | | 15 |
| Russia | | | | 140 | 180 | 550 | 520 | 1,300 | 350 | 3,040 |
| Ukraine | | | | | | | | | 60 | 60 |
| Total invested | | 785 | 47 | 605 | 1,985 | 2,951 | 1,280 | 2,850 | 495 | 10,998 |
| Total number of funds | | 8 | 3 | 6 | 7 | 42 | 14 | 56 | 34 | 170 |

Direct Equity Funds (Unlisted Securities): Amount Invested as of 30 September 1997

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *Region* | | | | | | | | | | |
| Central and eastern Europe | 50 | | | | | 40 | 40 | 100 | | 230 |
| Central Europe | | | 120 | | 40 | | 10 | 30 | | 200 |
| CIS | | | | | 40 | 120 | 30 | 20 | | 210 |
| Baltics | | | | | | 10 | 5 | | | 15 |
| Central Asia | | | | | | 30 | 10 | | | 40 |
| *Country* | | | | | | | | | | |
| Albania | | | | | | | 5 | | | 5 |
| Bulgaria | | | 50 | | | | | | | 50 |
| Czech and Slovak Republics | | | | | 50 | 20 | | | | 70 |
| Hungary | | 60 | 16 | | 8 | 12 | | | | 96 |
| Poland | 30 | 260 | | | | 70 | 95 | 40 | | 495 |
| Romania | | | | | | 25 | | | 20 | 45 |
| Russia | | | | | | 290 | 150 | 240 | 30 | 710 |
| Ukraine | | | | | | 40 | | 5 | | 45 |
| Total invested | 80 | 320 | 186 | 0 | 138 | 657 | 345 | 435 | 50 | 2,211 |
| Total number of funds | 2 | 3 | 5 | 0 | 5 | 21 | 13 | 11 | 4 | 64 |

*Source:* EBRD.

because of the lack of depth and liquidity of domestic equity markets. Some fifteen Russian corporates had launched ADR programs by the spring of 1997, and at least as many others were preparing such issues.

*Money Market Investments*

Inflows to local markets for short-term securities (a similarly recent phenomenon) have made an equally spectacular start and are again dominated by Russia. Inflows to the Russian T-bill (GKO and OFZ) market have been prompted by the gradual relaxation of restrictions on purchases by nonresidents since early 1996, which has been partly motivated by the authorities' desire to lower the cost of public debt.[19] Nonresidents purchased US$5.6 billion in T-bills through "S" accounts in 1996, and $5.4 billion in January–April 1997 alone. By April, they held approximately one-quarter of outstanding issues through these official channels, with additional stakes held as the result of "gray market" operations with Russian intermediaries. Since mid-1997, with yields on GKOs having declined significantly (from 89 percent annualized in early 1996 to 28 percent in April 1997), foreigners have been entering the more "exotic" Russian regional and municipal bond markets in search of higher yields (e.g., Orenburg[20] T-bills yielded 600 basis points over GKOs in August). Unhedged positions are now being taken in rubles.

The experience of Ukraine and Bulgaria demonstrates the impact that foreign inflows have had on market conditions (see figs. 2.7 and 2.8). In both countries, foreign investors were all but absent from the domestic securities markets until late 1996. Foreign hedge funds and proprietary traders of various investment banks began to enter the Ukrainian hryvna T-bill market in massive volumes in January 1997 and contributed to driving down yields by about 25 percentage points (annualized) within a matter of two weeks and by a further 10 percentage points by mid-July. In Bulgaria, annualized yields on four-week T-bills fell from 600 to 100 percent within the first three weeks of April after the government signed an IMF program. They declined further to less than 6 percent in July. Foreigners accounted for 20 percent (or US$98 million) of the outstanding stock of T-bills at the end of August, up from virtually nil in March. In addition, over the same period $225 million was invested in Bulgarian bank recapitalization bonds with a twenty-five-year maturity (indexed to the U.S. dollar but payable in leva), driving the market price up from around 40 to 75 percent of nominal value.

19. Since early 1996, nonresidents have been allowed to open so-called ruble "S" accounts at designated Russian banks to buy government paper, but profits have to be repatriated through contracts involving a cap on dollar yields. This requirement is gradually being phased out and markets are set to be fully liberalized by early 1998. "Gray market" purchases involving Russian intermediaries have played on the large arbitrage margins between resident and nonresident markets.

20. A Russian *oblast* (region).

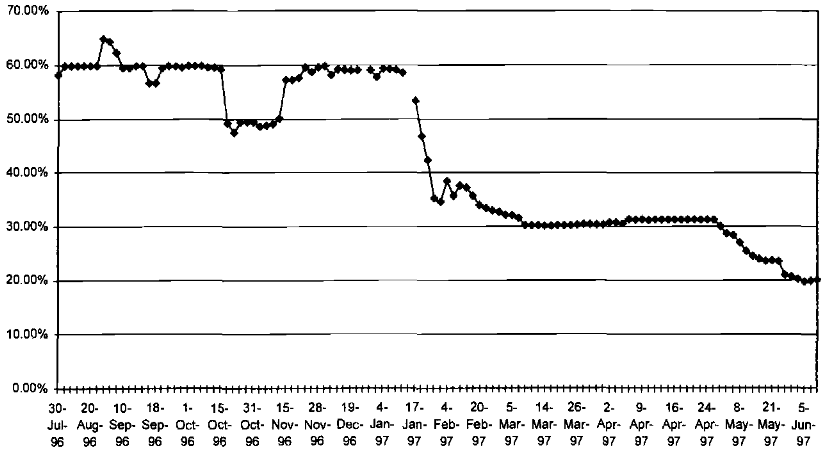


**Fig. 2.7 Ukraine: annualized yield on six-month treasury bills, July 1996 to June 1997**

*Source:* Salamon Brothers International.
*Note:* Gaps indicate no data, holiday, or halt in trading.

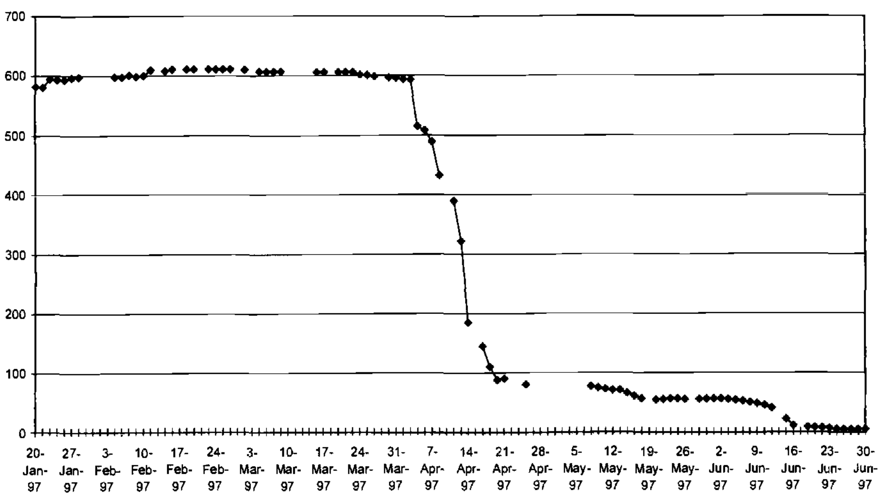


**Fig. 2.8 Bulgaria: annualized yield on four-week treasury bills, January to June 1997 (percent)**

*Source:* Salamon Brothers International.
*Note:* Gaps indicate no data, holiday, or halt in trading.

### 2.1.3 Capital Flows: Patterns and Determinants

Private capital flows to the transition economies have a short history. The recent surge in net inflows means that, by the end of this year under current projections, almost two-thirds of all private capital will have entered the region during 1996 and 1997. Combined with the paucity of detailed data, this makes a formal analysis of the determinants—let alone the consequences—of these inflows difficult. As mentioned, FDI has a slightly longer history in the transition economies than most other forms of capital flow, and we are able to draw on survey evidence and EBRD experience to discuss its motives and impact. As we shall see, FDI may also be a particularly important form of capital flow for the region because it goes well beyond the provision of finance in its ability to cement and promote the transition process. Our discussion of the patterns and determinants of portfolio flows will be shorter and will rely on more circumstantial evidence.

Our main result is that the level, location, and motive of FDI in the region are all closely associated with progress in transition. In other words, the basic human, natural resource, and geographical endowments are strong, implying that potential returns will be high if economic policies and institutions allow. While portfolio movements appear to be dominated by shorter run developments, these flows have essentially the same determinants and have recently "caught up" with reforms in the sense of investors' (rapidly) adjusting their perceptions of risks and returns. The markets have now recognized that gradual improvements in the structural and institutional fundamentals have gone a long way. Other factors, particularly macroeconomic stability, will have their role to play, but the progress in transition is and will be the driving force in integrating these economies into global markets.

#### Location of Foreign Direct Investment

As we have emphasized, Hungary and other eastern European destinations were the first to attract significant inflows of FDI. Russia and the oil economies of the CIS followed with some delay. Several countries of central Asia, the Caucasus, and southeastern Europe have so far failed to prove attractive to investors. The transition process first got under way in central Europe, and these economies continue to lead both in the depth of their reforms and in the volume of investment. It is tempting to compare measures of progress in transition with FDI per capita. Leaving out the three oil and gas economies of central Asia (Azerbaijan, Kazakhstan, and Turkmenistan), the rank correlation coefficient for twenty-two countries between the EBRD's average transition indicator in 1996 and cumulative FDI per capita over the period 1989–96 is .88 (it is .86 for FDI per capital in 1996 alone).[21] This association supports the conclusion that it is

21. See table 2.1 for the EBRD's transition indicator. The measure used here is the average of scores, on a scale from 1 to 4, along eight dimensions of transition, including large and small enterprise privatization, enterprise restructuring, price liberalization, trade and foreign exchange

**Table 2.5** **Obstacles to Doing Business: Survey Results**

| | CIS | World | Developing Countries | Developed Market Economies |
|---|---|---|---|---|
| High taxes or tax regulations | 80 | 59 | 62 | 50 |
| Policy instability | 52 | 32 | 36 | 12 |
| General uncertainty about costs of regulations | 44 | 29 | 30 | 17 |
| Crime and theft | 48 | 38 | 43 | 11 |
| Corruption | 84 | 47 | 54 | 18 |

*Source:* World Bank (1997b).
*Note:* Table reports percentage of respondents reporting a "strong obstacle."

the reform process that opens opportunities for profitable investment and that, through its impact on risk (as discussed in section 2.1.2), motivates investors to take advantage of them. It also suggests that direct equity investors have evaluated the economic environment and made informed choices.[22]

Continued reforms can therefore be expected to elicit additional growth in investment. These reforms have far to go, especially in the CIS. Both the practical experience of the EBRD and recent World Bank (1997b) survey evidence suggest that shortcomings in the implementation of reforms, and in particular in the way the business of government is conducted, remain a deterrent to private investor activity. The survey evidence relates to the CIS, but it is consistent—though the problems are less intense—with EBRD experience even in the more advanced economies in transition. Key messages from the survey include the following: taxes and tax administration are major problems (vague tax laws with little rationality across firms, and haphazard and sometimes corrupt implementation), laws and regulations are seen as burdensome and ever changing, there is continuing uncertainty about the institutional and regulatory regime, and there is little confidence in the ability of the administration to enforce property rights and contracts or to control crime and corruption.

The survey was conducted among enterprises worldwide and therefore allows comparisons of the severity of these investment deterrents with those for other regions. The results reproduced in table 2.5 confirm that the transition economies of the CIS still face significant challenges in improving their investment climate—for domestic investors but even more so if they are to compete successfully with other locations for FDI. The consequences that (largely transition specific) deficiencies in the administrative and regulatory environment

regime, competition policy, banking reform, and development of securities markets and nonbank financial institutions.

22. As we argue in section 2.1.4 below, the high degree of correlation between progress in transition and FDI may also partly result from causality running the opposite way, from FDI to progress in transition.

can have for investors are also demonstrated by the EBRD's experience, which is described with the help of examples in appendix A.

Additional factors that are hard to separate from our measure of transition are likely to have played a role in location decisions. They include in particular the proximity (both physical and cultural) of investment locations to Western markets and the prospects for market (and political) integration with the European Union. These factors, which are particularly relevant for cost-motivated investments (as opposed to those seeking new markets), are themselves closely associated with the achievements in market-oriented reform, partly because the prospect of accession to the European Union has served to stimulate the reform commitment, and partly because Association Agreements with the European Union have brought early benefits of market access and massive technical assistance. This close relationship between prospects for EU accession and the depth of reforms may also contribute to the motives for FDI, which we analyze in the following section.

### Motives for Foreign Direct Investment

The distinction between market and cost motives for foreign investment has been central to a variety of surveys of FDI in the economies in transition. One pattern that emerges very clearly is the predominance of market seeking as the prime investment motive. Factor cost considerations appear to be of less importance for the majority of investments. However, an EBRD survey (described in appendix B) shows that, while market seeking is indeed the dominant motive for a majority of the investments in the sample, the type of FDI varies significantly according to the host country's progress in economic transition.[23] FDI projects in countries that are more advanced in transition are more likely to be export oriented, more integrated into the foreign parent's multinational production process, and more likely to exploit the comparative advantage of the host economy.[24]

In examining the relationship between project function and host country characteristics (using a multinomial logit model), the host country transition indicator was found to be a significant determinant of the functional mix of projects operating in each country.[25] Results are reported in table 2.6, which

23. The following discussion draws on Lankes and Venables (1996), which describes the EBRD survey results in greater detail.

24. In light of our earlier discussion about the investment climate it is useful to note that a country's level of transition relates also to the likelihood of successful implementation. One point "up" in the transition indicator of a country is associated with an 80 percent fall in the chance of a project's being eventually abandoned or postponed.

"Export-oriented" investors stress the importance of production cost reduction in general and the availability of cheap *skilled* labor in particular—this is the single most important motivating factor in their investment decision. In the sample, salaries of skilled workers in export investments are at 16 percent of their Western (parent company) level, while productivity is reported to be, on average, 72 percent of the Western level. Since other, unspecified cost factors are less advantageous, overall unit costs of exporters represent 67 percent of those in western Europe.

25. The EBRD's 1995 transition indicators were used in these calculations for consistency with the timing of the survey (EBRD 1995).

Table 2.6 **Host Characteristics and Functional Type**

| | Local Supply/ Distribution | Export/ Distribution | Export/ Local Supply |
|---|---|---|---|
| Relative probability at mean | 3.0 | 1.8 | 0.61 |
| Percentage change in relative probability per unit change in transition indicator | 115 | 596 | 224 |
| | (1.2) | (2.5) | (1.9) |

*Note:* Number of observations is 140. Numbers in parentheses are *t*-statistics.

presents the changes in relative probabilities associated with a one-point increase in the transition indicator. Increasing the transition indicator increases the probability that the project is engaged in local supply relative to distribution. It also increases the probability that it is export oriented, relative to either local supply or distribution; the latter effect is particularly large and is statistically significant.[26] These results may be partly explained by the relation between costs and flexibility in production and the depth of reforms. Administrative discretion and trade barriers raise direct costs and can complicate logistics. The survey suggests that first-mover advantage is an important strategic motive among investors aiming at serving local markets. Efficiency-seeking export investors, on the other hand, focus more on costs and may therefore wait for the obstacles that raise costs (and risks) to recede.

A further result throwing some light on the process of integration into international production networks—especially if viewed in conjunction with the association between transition and export orientation—is that a project's position within the production chain of its multinational parent corporation differs by project function. An export investment is somewhat further "upstream" within the multinational's production chain and sells almost half its product within the corporation (i.e., to the parent company or other subsidiaries), while for a "market investment" the share is only 3 percent. In both cases, input supply is roughly one-third from within the corporation (imports). "Vertical FDI"—that is, the cross-border relocation of parts of the production chain—seems to be particularly prevalent among German investors, who, as mentioned in section 2.1.2, have concentrated almost exclusively on central European locations.

## Portfolio Investments and Commercial Bank Lending

As we have seen, bond purchases and commercial bank lending were the first to follow FDI into the region in significant amounts, with equity funds next in line and money market investments and direct offers of equity abroad much more recent phenomena. Again, the central European advanced reformers led the way, but the recent explosive growth in these markets is very much

26. Alternative specifications were investigated, allowing for the effect of measures of country size and controlling for industrial sector. These variables were not significant and did not change the signs or significance levels of results reported in table 2.6, which seem robust.

dominated by Russia. We shall argue that bank lending has built on relationships established over time with counterparts in the region and on the techniques of structured finance, while perceptions of short-term risk and return opportunities in the region's financial markets have played a greater role in portfolio flows. As mentioned, our discussion of the determinants of these flows in the following has to rely primarily on circumstantial evidence, much of it drawn from the lending experience of the EBRD.

Commercial banks were the main source of external funds for eastern Europe and the USSR during the 1980s. During that period, close working relationships were built with foreign trade banks. These relationships survived the uncertainty and debt defaults of the early transition years, though the volume and nature of lending changed. Commercial banks participated in export finance insured by export credit agencies and provided short-term trade finance collateralized with balances on correspondent accounts. By 1992–93, as trade flows between central and western Europe surged, terms on these transactions began to soften for central European obligor banks (see table 2.7 for confirmation fees on letters of credit). Collateral requirements were gradually replaced by uncovered forms of documentary credit and medium-term refinancing facilities. Between 1993 and 1994, for instance, Komercni Banka, a prominent Czech bank, was able to lengthen maturities on export refinance transactions from eighteen months to three years while spreads fell sharply. While Japanese banks made their first significant entry on that market in those years, contributing to greater competition, most of the lending operations were conducted with western European banks that had long-standing relationships with Komercni and other large Czech institutions. Project finance developed during that period in the context of FDI projects and syndications with international financial institutions such as the EBRD. This was assisted by improvements in the legal basis for secured lending.

Nonguaranteed bank-to-bank operations with the countries of the former Soviet Union took more time to develop, partly because of the more unsettled macroeconomic and regulatory environments and partly because—unlike in eastern Europe—new private banks quickly came to dominate the banking sectors in these countries and relationships took more time to rebuild.[27] Again, cash-collateralized trade finance was often the first step in this process. By 1996, on the basis of lengthening track records, Russian bank-to-bank lending and project finance had become well established, though other CIS countries, generally with weaker banking systems, were lagging behind.[28]

When commercial bank lending expanded rapidly in 1995–97, this was mostly on the basis of such previous relationships. As we noted in section

27. Except for Vneshekonombank, successor to the former Soviet trade bank, which continued to enjoy privileged access to funding from its established Western banking partners.

28. From 1996, demand for EBRD trade guarantee facilities, which insured counterparty risk for Western confirming banks by way of standby letters of credit, gradually declined from some of the larger new Russian banks.

**Table 2.7 Indications of Confirmation Fees on Letters of Credit for Transition Economies, 1995**

| Country | Indication of Confirmation Fees (CILC) | Availability |
|---|---|---|
| Albania | Case by case | Very difficult |
| Armenia | | Nothing available |
| Azerbaijan | | Nothing available |
| Belarus | Case by case | Very difficult |
| Bosnia-Herzegovina | | Nothing available |
| Bulgaria | 5% or more p.a. | Up to 360 days for two main banks |
| Croatia | Varies by bank | Up to 3 years possible for certain banks |
| Czech Republic | 1% p.a. | Up to 7 years available |
| Estonia | 5% or more p.a. | Up to 5 years possible |
| Georgia | | Nothing available |
| Hungary | 2% p.a. | Up to 5 years possible |
| Kazakhstan | | Nothing available |
| Kyrgyzstan | | Nothing available |
| Latvia | 5% or more p.a. | Up to 3 years, certain banks only |
| Lithuania | 5% or more p.a. | Up to 3 years, certain banks only |
| FYR Macedonia | Case by case | Up to 1 year possible |
| Poland | 1% p.a. | Up to 7 years |
| Moldova | | Nothing available |
| Romania | 5% p.a. | Up to 5 years |
| Russia | 5% p.a. | 360 days maximum, certain banks only |
| Slovak Republic | 1% p.a. | Up to 5 years |
| Slovenia | 1% p.a. | Up to 7 years |
| Tajikistan | | Nothing available |
| Turkmenistan | | Nothing available |
| Ukraine | | Nothing available |
| Uzbekistan | | Nothing available |
| Yugoslavia/Serbia | | Nothing available |

*Source:* Jardine Credit Insurance Ltd.

2.1.2, bank-to-bank lending appears to have dominated the surge. In addition, privatization in many countries moved into a new phase with infrastructure and large enterprises increasingly on offer. Privatization revenues for the region as a whole increased from US$3 to $4 billion in 1992–94 to $9 billion in 1995.[29] Together with FDI, this has vastly increased the opportunities for project finance. Infrastructure financing raised from foreign banks, for instance, grew from $960 million in 1994 to $3 billion in 1995 (World Bank 1997a, table 2.2). The improvement in terms that has accompanied this process over the past two years, especially in some countries of eastern Europe, would appear at times to have gone further than could be justified by the underlying risk. The sharp increase in competition from other sources of capital inflow has been the main driving force of the fall in spreads. This perception is shared by some of the

29. World Bank (1997a, table A.6.3). Regionwide data for 1996 are not available.

EBRD's Western banking partners, who nevertheless aim to maintain and develop long-term lending relationships and build market share in a promising market beyond what is viewed as a problematic but transitory phenomenon (implying low returns in relation to risk).

Apart perhaps from some of the equity funds that have long been operating in the region, supplies of portfolio flows and bond finance have, by their nature, relied less on direct relationships built over time and more on highly structured transactions. As in other markets they are motivated in part by the well-established benefits of portfolio diversification. However, three additional factors are likely to have played an even greater role in explaining recent rapid movements. The first factor is closely linked with the transition process itself. The rapid change associated with transition and the immaturity of local capital markets (both in terms of regulation and liquidity) has opened opportunities for short-term arbitrage and has generated lags and leads in the perception of underlying risk. The region does not have a history of credit ratings, and the first formal ratings came, for most countries outside central Europe, at a time when reforms had already progressed. This rating has put these countries "on the map" over the past two years. In 1996–97, the first credit assignments by Moody's and Standard & Poor's were given to Russia, Romania, Kazakhstan, Latvia, Lithuania, Moldova, Bulgaria, Croatia, and the cities of Moscow, St. Petersburg, and Nizhny Novgorod. Partly as a result, international fund managers "discovered" the region, and it is interesting to note how the most aggressive funds have moved from one security to the next successively in search of new arbitrage margins (such as from Russia to Ukraine and Bulgaria, or from Russian federal T-bills to regional ones).[30]

The second factor is the liquidity in global markets. Because yields in industrialized countries have remained low, and emerging market finance has recovered as memories of the Mexico crisis fade, liquidity has reinforced the greater interest in the opportunities offered by the region. A third important factor, finally, has been tensions within the macroeconomic policy mix of several countries, including Poland in 1995 and the Czech and Slovak Republics and Russia in 1996–97. Significant uncovered interest differentials emerged as the result of tight monetary policies, combined with loosening fiscal stances. These offered investors in money markets (particularly bank deposits) opportunities for short-term gain.

Referring to our discussion of the relation between risk and progress in transition, fundamentals on the side of demand for finance and of credit quality have moved far too gradually to be the explanation for the recent surge in short-term capital flows.[31] Of the factors reviewed above, information lags have, in

30. A Banque Nationale de Paris brochure (1997) refers explicitly to Russian GKOs as being "close to their sell-by date." It goes on to state that "by shopping around, you can equip yourself with the necessary breathing apparatus to keep climbing from here."

31. The softening of restrictions on foreign participants in the Russian T-bill market since early 1996 has clearly been an additional trigger, but there have been no such policy changes in countries

our view, been the most important in motivating the surge. International liquidity, macroeconomic policy, and, in Russia, remaining restrictions on security markets have reinforced this factor. This suggests that herding may have played a role and raises the prospect of macroeconomic instability associated with possible volatility in these flows, problems that are discussed in a little more detail in the next section.

### 2.1.4 Capital Flows: Consequences

Capital flows to the transition economies will be of great value in realizing the region's growth potential. The potential productivity (and profitability) of new capital is likely to be higher than in more settled market environments. The physical and human capital stock in transition economies is large by the standards of middle-income countries but inefficiently employed and partly obsolete. Investment for restructuring, combined with improved management and Western technology, offers opportunities for raising the yield of some of the existing capital at relatively low cost. At the same time, domestic financial systems are able to offer only limited support to investors, and savings are lower than under the earlier regime, especially during the recovery from the transition recession when future earnings expectations stimulate consumption. Capital flows have, as discussed in section 2.1.2, contributed significantly to lowering financing costs. Net capital inflows and associated current account deficits can therefore play a useful role in the region's development if channeled into quality investment. However, they also create obligations that will have to be serviced, and recent current account deteriorations and rising consumption have, in some countries, reached worrisome proportions.

In this section we argue that FDI, in particular, has the qualities most likely to stimulate transition and growth. Other forms of capital inflow can also contribute to the transition process, but they are likely to generate lasting benefits only if combined with cautious fiscal and monetary management.

Broadly speaking, the transition is about placing economic interactions on a market footing and promoting private and entrepreneurial initiative. Accordingly, one can identify three dimensions in the transition process: (1) the creation, expansion, and improvement of markets; (2) the establishment and strengthening of institutions, laws, and policies that support the market (including private ownership); and (3) the adoption of behavior patterns and skills that have a market perspective.

Apart from its role in capital accumulation, FDI tends to have a "package" of attributes that can make a significant contribution to transition along these dimensions through upstream and downstream linkages and demonstration effects. It can, for instance, force modern standards of product quality and supply

that have, on a smaller scale, attracted a similar surge in interest (Bulgaria, Croatia, Romania, and Ukraine).

reliability on local producers through its procurement management. This can both provide learning externalities from which other purchasers can benefit and promote market-oriented behavior. In monopolized markets, often a remnant of the command system, FDI may have the muscle to impose greater competition. Standards of behavior, including in relation to corporate governance, and technology can be transmitted via demonstration effects. And advanced marketing methods can have an impact on distribution systems and market logistics as well as competition. In the financial sector, FDI in banks (and equity funds) can have particularly broad effects by bringing credit skills and a strong element of financial discipline.

The EBRD assesses transition impact in the context of its investment projects. Traditional methods of project appraisal proved ill suited to the task. The spotlight in the analysis of transition falls precisely where cost-benefit analysis is weakest. Transition focuses on processes rather than outcomes. Of course, one looks to processes (here those of the market) that are thought likely to produce good outcomes, but the scope and depth of the changes make explicit modeling of outcomes intractable. We have developed an approach in which the type of impact of a project is assessed and checked against areas in a country or sector in which the transition challenge appears particularly great. A checklist of transition impact appears in appendix C. Figure 2.9 reviews the structure of transition impact of the EBRD's Russia portfolio and pipeline across the seven dimensions of transition impact identified in the checklist. Restructuring and competition are particularly relevant in private sector projects, while an emphasis on institution building and policies underpinning market efficiency represent key purposes of the EBRD's involvement in the state sector.

Bank lending, in the form of project finance, trade credit, and interbank lending, can contribute to the transition process through some of the same channels. In particular, it can transfer financial technologies and the learning effects associated with financial discipline. Similarly, equity flows and the issuing of corporate bonds can strengthen disclosure, shareholder rights, and other elements of corporate governance. A recent example is the legal battle over minority shareholder rights in Russia's Novolipetsk steel mill, which was won by foreign portfolio investors against management. The city of St. Petersburg overhauled its finances and took steps toward the commercialization of certain municipal services in the context of its international bond issue earlier this year.

Nevertheless, there are dangers associated with the rapid rise in capital flows. Combined with domestic demand-led growth, and partly fueling it, they have contributed to a significant deterioration in current account balances over the past two years (fig. 2.10). This raises the question of the vulnerability of balances of payments to sudden reversals in short-term flows if risk perceptions change. Two areas are of particular concern. First, the financial institutions and markets that intermediate part of these funds are still highly immature in many countries in transition. Greater liquidity, combined with weak regulation, can

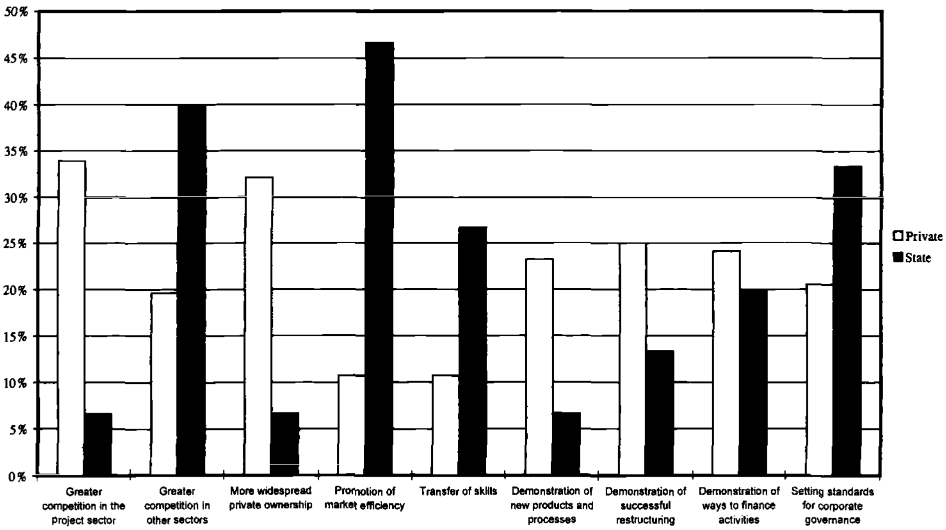


**Fig. 2.9 Russia: transition impact by class of borrower, stock of projects as of April 1997 (percentage of projects associated with each impact)**
*Source:* EBRD.

stimulate the accumulation of poor lending portfolios. Over recent months, we have seen banks even in the advanced transition countries rushing into transactions without due diligence. Simultaneously, the growing stability in the macroeconomic environment and the capital inflows themselves have reduced earlier sources of easy income for banks on the government securities and foreign exchange markets, and foreign funds compete with local banks by driving down margins on "blue chip" lending. This heightens the risk of bank failures and associated dangers of volatility in capital flows.

Second, the size of the current account imbalances could lead to volatility in expectations if the associated growth in the debt burden is judged to be unsustainable. Table 2.8 provides a grouping of countries into broad categories around some indicators of financial imbalance: the sizes of the current account and fiscal deficits and the ratios of external debt to exports and GDP. In such a broad-brush categorization, the cutoff points for "low," "medium," and "high" are necessarily somewhat arbitrary. Also, the fiscal deficit criteria should ideally be expanded to cover "quasi-fiscal deficits" resulting from the state's influence over the activity of banks and enterprises. The accounts of Belarus and Turkmenistan, for instance, would then look far worse. Nevertheless, table 2.8 offers some useful insights. With very few exceptions, the external debt burden is not high by international standards. For instance, the Latin American average ratio of gross debt to exports (including goods and nonfactor services in the denominator) was 203 percent in 1996 (World Bank 1997a), a level surpassed

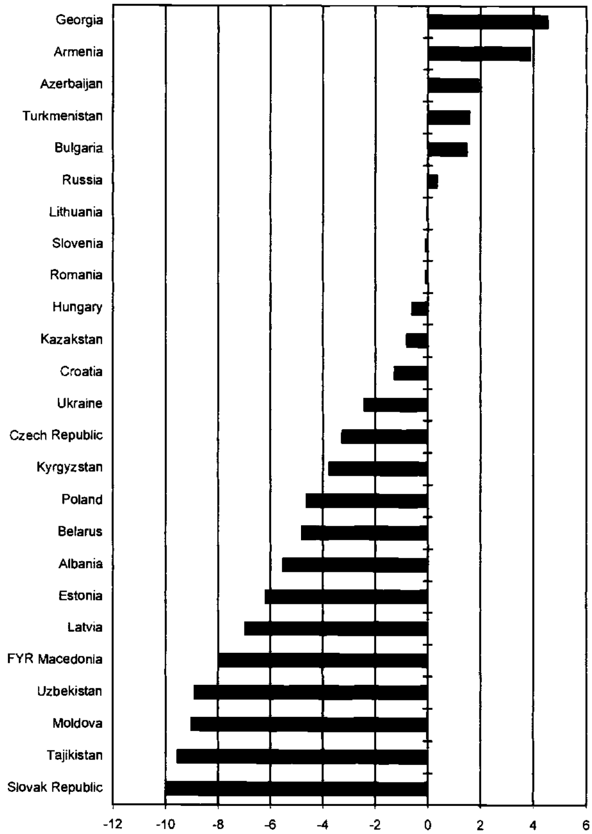


**Fig. 2.10 Deterioration in trade balances, 1996 (percentage of GDP)**
*Sources:* IMF, national authorities, and EBRD estimates.

among transition economies only by Armenia, Bulgaria, and Georgia. The average for all developing countries was 146 percent, compared with 121 percent for the transition economies.[32]

However, while external debt is not (yet) high, it has been growing very rapidly, and current account deficits have been associated with significant budgetary imbalances in several CIS countries. Together with evidence of low public investment activity (Kapur and van der Mensbrugghe 1997), this suggests that a large proportion of foreign funding may serve to meet current outlays that do not improve those countries' future repayment capacity. Foreign borrowing was in some cases explicitly earmarked to reduce budgetary pensions and wage arrears (e.g., a recent Russian bond issue and a planned Kazakh

32. Weighted averages. The ratio was almost the same in eastern Europe and the Baltics (123 percent) and in the CIS (118 percent).

**Table 2.8** **Indicators of Debt and Deficits, 1996**

| Current Account Balance[a] (% of GDP) | Fiscal Balance[b] (% of GDP) | Gross External Debt/ Current Account Revenues[c] | Net External Debt/ GDP[d] |
|---|---|---|---|
| | Low | | |
| Russia (2.2) | Belarus (−1.6) | Albania (82.1) | Albania (20) |
| Bulgaria (1.3) | Croatia (−0.5) | Azerbaijan (66.4) | Armenia (28) |
| Poland (−1) | Czech Republic (−0.7) | Belarus (16.3) | Azerbaijan (10) |
| Slovenia (0.3) | Estonia (−1.5) | Croatia (58.9) | Belarus (4) |
| Turkmenistan (−0.7) | FYR Macedonia (−0.4) | Czech Republic (67.3) | Croatia (13) |
| | Latvia (−1.4) | Estonia (11.8) | Czech Republic (15) |
| | Slovak Republic (−1.2) | Kazakhstan (69.3) | Estonia (−7) |
| | Slovenia (0.3) | Latvia (29.4) | FYR Macedonia (25) |
| | Turkmenistan (−0.2) | Lithuania (34.8) | Georgia (27) |
| | | Slovak Republic (70.2) | Kazakstan (9) |
| | | Slovenia (36.9) | Latvia (−4) |
| | | Turkmenistan (36.0) | Lithuania (4) |
| | | Ukraine (45.5) | Moldova (27) |
| | | Uzbekistan (61.7) | Poland (17) |
| | | | Romania (16) |
| | | | Russia (26) |
| | | | Slovak Republic (24) |
| | | | Slovenia (9) |
| | | | Turkmenistan (−19) |
| | | | Ukraine (17) |
| | | | Uzbekistan (1) |

*(continued)*

**Table 2.8** (continued)

| Current Account Balance[a] (% of GDP) | Fiscal Balance[b] (% of GDP) | Gross External Debt/ Current Account Revenues[c] | Net External Debt/ GDP[d] |
|---|---|---|---|
| | Medium | | |
| Albania (−4.7) | Azerbaijan (−2.6) | FYR Macedonia (128.9) | Hungary (40) |
| Belarus (−6.7) | Georgia (−4.4) | Hungary (143.7) | Kyrgyzstan (35) |
| Georgia (−4.9) | Hungary (−3.5) | Kyrgyzstan (141.0) | |
| Hungary (−3.8) | Kazakhstan (−3.1) | Moldova (100.2) | |
| Kazakhstan (−3.8) | Lithuania (−3.6) | Poland (145.3) | |
| Lithuania (−4.4) | Poland (−3.1) | Romania (110.5) | |
| Romania (−5.9) | Romania (−3.9) | Russia (125.9) | |
| Ukraine (−2.7) | Ukraine (−3.2) | Tajikistan (186.0) | |
| | High | | |
| Armenia (−26.6) | Albania (−12.0) | Armenia (211.4) | Bulgaria (105) |
| Azerbaijan (−23.6) | Armenia (−9.3) | Bulgaria (204.0) | Tajikistan (90) |
| Croatia (−7.6) | Bulgaria (−13.4) | Georgia (331.0) | |
| Czech Republic (−8.1) | Kyrgyzstan (−6.4) | | |
| Estonia (−10.3) | Moldova (−6.7) | | |
| FYR Macedonia (−7.8) | Russia (−8.3) | | |
| Kyrgyzstan (−23.7) | Tajikistan (−5.3) | | |
| Latvia (−7.2) | Uzbekistan (−7.3) | | |
| Moldova (−13.1) | | | |
| Slovak Republic (−10.2) | | | |
| Tajikistan (−10.9) | | | |
| Uzbekistan (−7.9) | | | |

*Sources:* IMF, national authorities, and EBRD estimates.

[a]Categories are "low," current account deficit is less than −2 percent; "medium," between −2 percent and −7 percent; and "high," greater than −7 percent.

[b]The fiscal deficit refers to the general government. Categories are "low," fiscal deficit less than −2 percent; "medium," between −2 and −5 percent; and "high," greater than −5 percent.

[c]Categories are "low," ratio of gross external debt to current account revenues smaller or equal to 100; "medium," between 100 and 200; and "high," greater than 200. Current account revenues include merchandise exports and exports of nonfactor services. In the case of Armenia, Azerbaijan, Belarus, Bulgaria, FYR Macedonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Romania, Tajikistan, Uzbekistan, the gross external debt is divided only by merchandise exports.

[d]Net external debt equals gross external debt net of gross reserves of the monetary authorities. Categories are "low," ratio of net external debt over GDP smaller or equal to 30 percent; "medium," between 30 and 50 percent; and "high," greater than 50 percent.

issue).[33] The association between budgetary and external imbalances is particularly worrying if viewed against the background of weak fiscal revenue performance across much of the CIS. The vast majority of CIS debt is owed by sovereign or sovereign-backed borrowers. Problems of fiscal sustainability are perhaps the most likely source of external instability in the future.

### 2.1.5 Prospects and Policies

A discussion of prospects for capital flows to the region takes us very quickly to a discussion of the prospects for transition and to economic policies. We have seen that flows have been predominantly to countries at more advanced stages of transition and to countries with better records on macroeconomic stability. Thus the underlying advantages of the region are strong in terms of market potential, low cost, and proximity to European markets. It is rapid transition and sound economic policies that unlock this potential.

Over the past two years or so the markets have realized the opportunities that are available. There has been a rapid adjustment in perceptions and a major acceleration in flows. Thus FDI has more or less tripled between 1994 and 1997, with an even more dramatic rise in other flows. FDI in the region is now running at around US$40 to $50 per capita, or 2 to 3 percent of GDP. In some countries it is more than $200 per capita. It is natural to ask whether this acceleration of flows will continue. In our judgment it is likely that over the next few years FDI in the region will grow further. Growth of output is now positive in nearly all economies of the region and is returning in Russia. The rise in real exchange rates that has brought a 50 percent increase in the region's GDP in the past three years (notwithstanding zero or negative real output growth) is likely to continue, albeit at a slower rate. Thus the next few years will see strong market growth. The presence of significant human capital, together with the scrapping of much obsolete capital stock, makes the potential return on investment high. As we have emphasized throughout, the crucial additional ingredients are continued transition and sound policy.

The prospects for other capital flows are more difficult to judge. The rapid acceleration of the past two years is, however, unlikely to be maintained since it is, as we have suggested, in some part due to a one-off adjustment in perceptions. It should also be kept in mind that the transition has far to go, and in some respects, for example financial institutions, it is fragile. There is little doubt that political commitment has been remarkably strong through difficult times and changing governments, but one must expect setbacks and crises on the way. The very high balance-of-payments deficits that have emerged in the past year or two (together with capital inflows) are likely to cause problems before too long and may result in sharp reactions from the markets. The future

33. And, in fact, certain state-owned enterprises are said to have borrowed abroad to meet their tax liabilities. This is a reflection of the liquidity crisis in the enterprise sector of the CIS.

of very large capital outflows, particularly from Russia, is also hard to predict. It is to be hoped that those Russians seeking returns outside Russia will also have greater confidence in the high returns to be obtained from domestic investment.

Subject to continued advance in the transition, and greater security of their assets through the legal and administrative systems, investors will be looking particularly closely at fiscal policies. It has been monetary policies that have led the way in restoring macroeconomic stability with, at times, extraordinarily high real rates of interest. If the macroeconomic position is to be secured, the fiscal position must be put on a sound long-term basis. In many countries there are still difficult adjustments to make on both the revenue and expenditure sides. As a broad generalization we can say that in the western part of the region the challenges will be particularly severe in controlling expenditure, and in the east in raising revenue. As on most dimensions of the transition, improving policy on the fiscal front requires careful attention not only to building institutions but also to promoting and enforcing responsible behavior both inside and outside government. While the first phase of the transition can be seen in terms of liberalization and privatization, the next phase involves the building and deepening of these institutions and behavior. These processes will take time, but in most countries of the region the next phase of transition is under way.

# Appendix A
## *Obstacles to Investment: The EBRD's Experience*

Each year, the EBRD invests about US$3 billion in over 100 projects. Including the investments made by sponsors of these projects and other financial investors, the total investment in Bank-supported projects amounts to about $10 billion per year. This figure corresponds to roughly 5 percent of total fixed investment in the Bank's countries of operations. Since the Bank is active in all its countries of operations, this participation in investment throughout the region generates a considerable body of experience that underpins its analysis and understanding of the obstacles to growth that are associated with failures in the investment climate.

Perhaps the most fundamental lesson from the Bank's experience for private investment is its severely limited scope in the absence of macroeconomic stabilization and of basic structural reforms (such as price and trade liberalization, privatization of small-scale enterprises, and elimination of directed credits and interest rate controls in credit markets). In such a climate for investment, financially viable private investment projects tend to be restricted to those that operate as enclaves within the local economy. Such projects are often capital-intensive projects in the natural resource sector, where the capital inputs are sourced from abroad and the output is exported. The main locally provided inputs are labor and transportation services. This type of private investment, while it can be of real value, has only limited linkages to the local economy and is unlikely to generate the types of commercial interactions that yield significant spillovers on the productivity of the local private sector.

With progress in macroeconomic stabilization and basic structural reforms, however, the EBRD has been able to expand significantly its support for private investment projects, particularly in the local private sector. Nevertheless, the Bank often encounters a number of obstacles related to government policies and practices. The examples that follow serve to illustrate our experiences. While they have been expressed in general terms to avoid reference to specific projects, they are based on concrete and sometimes painful experiences.

### Corporate Taxation

A pervasive problem in private investment projects throughout the region is the lack of predictability of tax rules (a problem that can be exacerbated by the retroactive implementation of some measures) and the arbitrary and discriminatory enforcement of taxation (e.g., many domestic enterprises accumulate tax arrears and enjoy exemptions while compliance by enterprises that are not so favored, including foreign companies, is strictly enforced). The level of taxes for the honest taxpayer who is not privileged with exemptions can be punitive, and many potentially viable projects do not come to fruition for this reason.

A second set of problems related to corporate taxation is the inability to deduct certain legitimate business expenses (e.g., part of interest payments, training, and travel) and the distortions that arise from the structure of depreciation allowances. The Bank is involved in a number of projects in the region (which are viable over the medium term) that are currently running at a loss according to International Accounting Standards but that are nevertheless paying substantial profit taxes because of the peculiarities of the accounting and tax systems. In one case, these taxes amount to close to US$100 million.

### Product Markets

Barter transactions among enterprises are prevalent in some countries and sectors. It appears that barter transactions serve to conceal profits and to stifle competition. The use of barter can be exacerbated by sometimes severe liquidity problems and prevents the financial viability of otherwise viable projects.

### Enterprises (Including Infrastructure and the Environment)

Excessive licensing and regulation of businesses often contribute to bureaucratic obstacles to business formation and investment. For example, one

EBRD-supported project required seventy signatures from officials to clear all applicable licensing and regulatory hurdles. Such government policies and practices fuel corruption and inhibit investment.

EBRD support for the privatization of some enterprises has placed it in the position of minority shareholder with the government retaining an influential role in corporate control. In some investments, governments have used their residual ownership stakes to pursue noncommercial objectives, including political patronage. This has involved privileged sales of shares at special prices to enterprise managers after outsiders have been sold shares at higher prices and the manipulation of share registers. Such actions cut against the objective of instilling a strong commercial orientation in enterprises through privatization. Also, they obviously discourage outside investors from buying shares, thereby eliminating an important source of finance and corporate governance.

Many dominant infrastructure enterprises remain largely unreformed, despite the potential for de-monopolization and for increasing competition in the provision of services. In addition, the structure of infrastructure tariffs continues to place a heavy burden on business customers, with the structure of tariffs often inverted (i.e., with businesses paying tariffs that are five and six times those paid by households, despite the higher costs of delivering services to households; see, e.g., EBRD 1996).

The region has relatively little experience with regulatory institutions and practices, and only a handful of countries in the region have established independent regulatory agencies. Several EBRD-supported and other commercial infrastructure projects have been adversely affected by arbitrary regulatory actions and by adverse court rulings, contributing to investor caution. These actions have included the withdrawal of previously agreed licenses, the failure to implement agreed tariff increases, and the imposition of misguided restrictions on competition.

The tolerance of payments arrears in the energy sector (primarily by large state-owned industries and local governments) severely curtails the financial viability of projects, as does the extensive use of barter. It is also limited by the failure to implement tariffs that reflect the incremental costs of production and the financial constraints of government (although the EBRD recognizes that there are social constraints to the instantaneous introduction of such tariffs). Taken together these problems have inhibited the flow of private investment into power generation and distribution. As a result, EBRD activity in this sector has also been held back.

### Financial Markets and Institutions

In some countries, governments have sought in effect to nationalize financially viable private banks with which the EBRD was associated through directed mergers with state-owned banks. Such actions are in conflict with the transition objective of achieving a strong commercial orientation through private ownership of commercial banks, and the possibility of such actions inhibits investment in the sector.

Connected lending by commercial banks remains a pervasive practice in the region and has been a principal cause of several bank failures.

Accounting standards remain inadequate from the perspectives both of internal financial control of banks and of prudential regulation. Rapid movement to International Accounting Standards remains a priority.

Failure of government to implement effectively the prudential regulation of banks and other financial institutions has contributed to financial instability that has adversely affected the performance of otherwise sound banks with which the EBRD is involved.

**Legal Institutions**

In contrast to the countries in eastern Europe and the Baltic region, those in the CIS have no prewar experience with commercial and civil codes. While such codes have now been established in much of the region, this lack of commercial traditions has meant that there is relatively little understanding of the functioning of these codes. This in turn may contribute to a lack of respect for the laws, weak judicial enforcement, and reliance on private enforcement of agreements. Some EBRD projects have experienced a range of arbitrary interventions by local government—for example, attempting to expropriate the project company's output and to prevent its export.

# Appendix B
## *EBRD Investor Survey*

In January 1995, the EBRD conducted an investor survey.[34] They contacted 11,000 firms worldwide. Of the 1,435 firms that responded, 628 indicated that they were willing to be interviewed at the senior executive level. Executives from 117 of these firms with 145 investments in eastern Europe and the former Soviet Union were interviewed between June and November 1995. To qualify for the survey, a company needed to have an operational, planned, postponed, or abandoned project in the mining or manufacturing sector of an EBRD country of operation; in addition, its headquarters had to be in western Europe. The 145 surveyed investments cover sixteen economies in transition, employ 39,000 workers, and have a total foreign equity contribution of US$2.8 billion. A summary description of investment projects in the survey is presented in table 2B.1.

34. A fuller presentation of the survey is contained in Lankes and Venables (1996).

**Table 2B.1** **Summary Description of Investment Projects in EBRD Survey**

| Country (Group) | | Status | | Function | | Control Mode | |
|---|---|---|---|---|---|---|---|
| Czech Republic and Hungary (Group I) | 44 | Planned | 38 | Distribution and services | 24 | License or subcontract | 16 |
| Poland, Baltics, and other eastern Europe (Group II) | 57 | Operating | 91 | Supply of regional or local markets | 72 | Joint venture | 72 |
| Russia and other CIS (Group III) | 44 | Postponed or abandoned | 16 | Exports from the region | 44 | Wholly owned by foreign parent | 53 |
| Total | 145 | | 145 | | 140 | | 141 |

# Appendix C
## *Qualitative Aspects of Transition Impact of Projects: A Checklist*

The following checklist covers only those potential effects of a project on the host country that relate to the conversion from a command economy to an economy driven by well-functioning markets. It does not cover direct income and resource effects of a project, and it covers environmental impact only indirectly to the extent that it is a consequence of the broadening and deepening of markets. Applications of the checklist should therefore be viewed in conjunction with an analysis of the financial and economic rate of return and of the wider environmental impact of a project. The checklist is "generic" in the sense that, in principle, its categories fit all project types (e.g., small and medium-sized infrastructure projects and technical assistance).

### Project Contributions to the Structure and Extent of Markets

1. *Greater competition in the project sector:* A project can promote greater competition in its sector of activity. Increased competitive pressure is likely to improve the efficiency with which resources are utilized, demand is satisfied, and innovation is stimulated. However, in some circumstances a project might lead to a slackening of competitive pressure on market participants, including the project company itself.

2. *Expansion of competitive or market interactions in other sectors:* A project can help to set business relationships in other markets on a more competitive footing. The benefits for the transition process would be similar to those described under point 1 above. There are two important ways in which markets can be extended and their functioning improved by projects: (i) through interactions of the project entity with suppliers and clients and (ii) through project contributions to the integration of economic activities into the national or international economy, in particular by lowering the cost of transactions.

To have a structural effect, these contributions should not be one-off but should enhance competitive market interactions on a sustained basis. This would generally be achieved either through the formation of actors, methods of work, policies, and institutions that last, or through interactions that have a strong demonstration effect.

### Project Contributions to the Institutions and Policies That Support Markets

3. *More widespread private ownership:* A project may result in increased private ownership through privatization, or new private provision of goods and services. This can generally be expected to strengthen market-oriented behavior, innovation, the pool of entrepreneurship, and, more generally, commitment to the transition. Private ownership is also in itself part of the transition objec-

tive. With the right kind of business standards, regulation, and legal environment, private ownership is complementary to, and often a condition for, the expansion and improvement of markets.

4. *Institutions, laws, and policies that promote market functioning and efficiency:* A project may help to create or reform governmental or private institutions, policies, and practices whose function is to enhance entrepreneurship and the efficiency of resource allocation. This is particularly relevant where not only the project entity itself but also other economic activities benefit. Four types of contribution are of particular importance here: (i) the creation and strengthening of public and private institutions that support the efficiency of markets; (ii) improvements to the functioning of regulatory entities and practices; (iii) project contributions to government policy formation and commitment, promoting competition, predictability, and transparency; and (iv) contributions to laws that strengthen the private sector and the open economy.

## Project Contributions to Market-Based Conduct, Skills, and Innovation

5. *Transfer and dispersion of skills:* Projects can directly contribute to providing and improving the skills required for well-functioning market economies. This may include management, procurement, marketing, financial, and banking skills. Such a transfer represents a relevant transition impact only when the skills are likely to be spread so as to benefit nonproject entities (otherwise they are simply costs like any others). Skill transfers are often complementary to other transition-related project impacts such as institution building, market expansion, and demonstration effects.

6. *Demonstration of new replicable behavior and activities:* A project may lead the way by showing other economic actors what is feasible and profitable and thereby inviting replication. Three types of demonstration effect are of particular importance here: (i) demonstration of products and processes that are new to the economy, (ii) demonstration of ways of successfully restructuring companies and institutions, and (iii) demonstration to both domestic and foreign financiers of ways and instruments to finance activities.

7. *Setting standards for corporate governance and business conduct:* By implementing high standards of corporate governance and business conduct in entities supported by the EBRD, projects may contribute to the spreading of behavior and attitudes that enhance the legitimacy and functioning of the market economy. This is a form of demonstration effect that functions by establishing reference points for other firms and individuals concerning businesses that they wish to invest in or interact with. Where role models for business conduct and corporate governance are rare, such pressures are less likely to materialize. A difference with institutional change, as discussed under point 4, is that such behavior may not be codified in a formal way.

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# 2. *W. Michael Blumenthal*

When our chairman used his seductive methods and superior persuasive powers to talk me into coming here and I accepted in a fit of absentmindedness, I wondered what it was that I could contribute. Since he asked me to tell war stories, that is what I now propose to do; so you're going to hear something that is very much at the microlevel, not at all macro as all the presentations so far have been.

Gil Diaz touched on country-specific factors that are sui generis and have to do with elements we don't immediately think about, such as the quality of human resources, the people we work with. He referred to that in connection with what is happening in banks and mentioned historical factors in the way that people relate to each other and how they work together. I agree that when you talk about the functioning of capital flows, it eventually comes down to what happens with very small groups of actors in the economy and their interactions.

I shall only talk about one country, Russia. First of all, I want to stress that when you consider capital flows to Eastern Europe and the former Soviet Union, you are often lumping together countries that are really quite different. Second, even within Russia, it is extremely difficult to generalize. I noticed

Martin Feldstein wrote an op-ed piece called "Russia's Rebirth." If he's responsible for this title, I warn him: Just because you wander around the streets of Moscow you can't conclude anything definitive about what is happening in, for example, the places where we operate in the Pacific part of Russia—Khabarovsk or Sakhalin Island. That's a different world altogether, and you need to look at these places as well, to get some sense of what is happening in the country as a whole. Moscow and St. Petersburg are not like the rest. The Far East is not like European Russia; Siberia's smaller towns are very, very different, both in the way in which they are run and in the way in which business is conducted.

The third point I want to make with regard to Russia is that it is a country of enormous contrasts. You can find anything you want there. One reads a lot about crime in Russia, and there certainly is a tremendous amount of that. Yet there are also instances of sublime honesty in Russia, and a lot of things you can do that could only be accomplished with hardworking, honest people. It is easy to lose lots of money on Russian investments. But there are also huge opportunities to make lots of money (I will give you a couple of examples to illustrate both experiences). More and more people are better off, and one notices this, particularly among younger people. But there are as many or more Russian citizens who are still substantially worse off than they used to be, particularly the older ones.

Let me tell you something about the environment in which the U.S. Russia Investment Fund (TUSRIF) operates. I shall then say a few words about TUSRIF itself and cite a few examples of both successes and failures we have experienced in our operations.

First of all, the positives. We find much in Russia today that is a lot better than when we started up three years ago. In 1992 inflation was 2,500 percent; in April of this year it was 15 percent. They're talking about a budget—and I should say, numbers in Russia are very, very iffy; statistics are orders of magnitude—that projects only about 5 percent inflation. Well, if it's 12 or 15 percent, it's still pretty good from where we've come, and it's clearly gone in the right direction. The budget deficit has been reduced. There was huge negative growth a few years ago. Now it's level, or maybe it's up a percent or two, and that's tremendous progress. One hundred and twenty thousand enterprises have been privatized in Russia in a very short period of time, and many, many more (we don't know how many) start-ups were launched. If you walk around any of the cities you see the kiosks and the new stores. All of that has to be counted in. Much of it did not exist before. We estimate that one-third of the population lived below the subsistence level three or four years ago. The number is still large, but it's much less now, maybe 20 percent. There are other indications of progress. Unfortunately, perhaps, car registrations are one index; those have doubled in two years. Russia now expects to be registering 1.5 million new cars each year over the next couple of years. A lot of capital is also suddenly flowing in. Russia has become exciting and fashionable for speculators and general investors. The stock market is booming; it tripled in eighteen months. There is more direct investment of the kind we're making. Clearly, things have moved faster than anyone would have expected two to three years ago.

But there are still huge long-term problems. They will be slow to resolve. The result is that the risk-reward ratio works with a vengeance, unlike anyplace else in the world I've ever seen. The tax system is a mess. Taxes are high, and jurisdictions overlap. There is total uncertainty about what will hit you. Tax administration is arbitrary; official promises and commitments are broken. Local authorities don't pay attention to the center and vice versa, and direct investment under those circumstances requires a strong stomach. There is large-scale evasion of taxes, which makes it very difficult for an outside honest investor because you compete with others who do not pay their taxes. On the other hand, for a non-Russian investor to make the right investments and to engage in the same kind of evasion that Russians do would carry particular risks, which certainly we and our fund cannot accept. That is something any private investor has to consider very carefully.

Moreover, the judiciary is often corrupt and generally underpaid. Laws and regulations are a morass, arbitrarily enforced or not enforced at all. Sometimes they are illegally enforced. It is very difficult to enforce your rights once you've signed a contract. For example, you can find your equity interest suddenly heavily diluted, contrary to a prior agreement, with your partners selling stock without telling you. Also, there are no dependable financial data. Audited statements are hard to come by. Bureaucratic inertia and late payment of debts is common.

Some of you may have read a long article about a place named Leninsk Kusninsky, which is reputed to be run by gangsters. It is a rather large city, where the most important man is a fellow with the interesting Russian title of "Killer." He uses this English word to describe what he does to keep things in line. That's an extreme example, of course. Petty crime is much more common. We tried to invest in a string of sandwich shops in the subways of Moscow, for example. In the end we didn't because we found that those places have to pay for protection and we didn't feel we could be a part of that. There are, of course, also plenty of instances of crime or corruption at a very high level, where assets were picked up for practically nothing as they were privatized.

Why then, would anybody invest in Russia under those circumstances? The reason simply is that the potential is great, for those who are greedy and willing to take risks. Arminio Fraga asked, Why would anybody stick around? The answer is greed—the potential for very large returns.

Turning now to TUSRIF. What is it? It is an acronym for the U.S. Russia Investment Fund. It grew out of 1993 U.S. commitments made in the course of G-7 meetings in Vancouver and Tokyo to help in the restructuring of Russia. TUSRIF is one of the U.S. enterprise funds that were originally organized for Poland and Hungary back in the Bush administration. The Clinton administration had the good sense to pick up these programs and to continue them. The fund is organized and funded by the U.S. government but operates like a private investment fund, with a private board of directors. The chairman is appointed by the president, as are the directors. The fund reports to the government—our contact point is the Agency for International Development—but operates independently with minimal or no interference. We report, of course, both to the Congress and to the executive. We presently have an authorized capitalization of $440 million, of which less than half has as yet been funded. Our offices are in Moscow, St. Petersburg, Yekaterinberg, Rostov on the Don, Khabarovsk, Vladivostok, and Sakhalin.

To date we have invested about $100 million in 22 large and medium-sized businesses, $10 to $15 million in 135 small businesses, $5 million in a microlending program, and about $1 million in technical assistance money connected with our various projects. Total employment in the various enterprises is about 20,000 people, and the projects cover many industries, from communications to publishing, beverages, textiles, wood manufacturing, retailing, food processing, and consumer services.

Let me now cite three examples to illustrate how these kinds of investments in Russia can work, both those that did well and the ones that went sour.

An investment of the first type is a bottled water company. We invested $2 million in equity. (Incidentally, we can make equity or debt investments, or a combination of the two.) The company's revenue in 1995 was $3 million, in 1996 $10 million, and in the first six months of this year $11 million. We think it'll be about $25 million for the year as a whole. So we've gone in two years from $3 million to $25 million. Profits were $200,000 in 1995 and will be about $2 million this year, and we hope to double them again next year. Our partner is the Russian Orthodox Church, and it makes sure that nobody holds us up. The Church, thus, is a good partner. Bottled water is a consumer product much in demand in Russia. We think we could already sell our stake for a multiple of the $2 million we invested. So that has been a very good and successful story for us.

A second good story concerns a pharmaceutical distributor. Same kind of situation: the first year saw $37 million in revenue, second year $60 million, and this year $100 million; quadrupling of profit and lots of opportunity to make more money in the future.

The third success story concerns a string of breweries. Net sales in 1994 were $43 million, in 1995 $108 million, in 1996 $180 million, and in the first six months of this year $150 million, so we'll do over $300 million. Profits: we had a loss in 1994, $370,000 in 1995, $3.7 million in 1996, and we estimate higher numbers this year. These are obviously very attractive results.

But perhaps you are more interested in our failures, which illustrate some of the problems you can run into in Russia.

We invested in a supermarket chain in the Far East, a joint venture among the former Ministry of Fisheries, a Russian chain of small stores, the free economic zone of Nachotka, a Russian bank, and a U.S. supermarket chain. We committed $8 million and began with a bridge loan of $3 million to the enterprise, which we have since written off. What happened? We found that the management lacked the skills to run such an activity. We found that they withheld the truth from us, hid their problems, and sent us inaccurate numbers. Cash disappeared or was wasted. Wrong equipment was bought.

Then the partners disagreed with each other. The U.S. partner wouldn't deliver. And there was large-scale pilfering in the region where they were operating. As the company was going down, the Russian bank, which is one of the smallest creditors, filed suit. Our office is in Moscow, and our lawyers are in Moscow, but the bank is right there in Vladivostok and knows the judiciary. The court grabbed the assets to which the bank had a substantially subordinated claim, even though the bank had made an agreement with us acknowledging that we had a superseding claim, which it did not tell the judge about. The judge, when he heard about the agreement, said it was not relevant. We appealed in Moscow, because in theory the Moscow courts have jurisdiction. Moscow agreed with us but has so far been unable to get the relevant parties in Vladivostok to answer the telephone. We have written off the $3 million.

The second example of a problem case is a $2.5 million investment in a very nice plywood manufacturing activity in a place called Kostroma. Based on technical expertise from a British plywood manufacturer, we financed the equipment. Everything was going along swimmingly—we were exporting the product and making a profit. The local tax authorities, I guess, needed money and decided that they would pay the value-added tax rebate on exports, no longer on the basis of documentary evidence that the product has been exported, but only after the product has been received in the foreign country, which, moving by ship, takes quite a while. To get the actual documentation back and *then* to encounter a delay of roughly four to six months costs the company $2 to $3 million in cash flow. It's a small company; it doesn't have $2 to $3 million, so unless its investors have deep pockets and are willing to come in and finance that, the company will go bankrupt. There is no appeal for this kind of thing. We don't have the Russian Orthodox Church, in this instance, to come and help us, and we now face a very difficult problem of what to do. We are looking for a solution.

Finally, you run into tax avoidance schemes and questions all the time. It is customary in Russia to pay off the import and customs authorities so that they will allow you to bring in equipment without paying full duty. It's done all the time, but we don't do it. It's also common to use short-term dummy corporations, which are later abandoned, in order to avoid taxes, or to set up an offshore purchasing company to buy the raw material, sell it to the manufacturing company, and accumulate most of the profit offshore, which is then never reported, or to use a short-term dummy corporation to avoid paying the value-added tax. We looked at a manufacturing company that showed $10 to $15 million in revenue, was able to generate $4.5 million in cash, but never really paid any taxes. The problem for an honest foreign investor is how to compete with that.

I would end by saying that a country as large as Russia, with no historical memory of operating a free enterprise system, with seventy years' experience with a bureaucratically run socialist system, but with many wonderful human and natural resources, will have a substantial impact on international capital flows. That is beginning with the stock market, but it can move very quickly in either direction. As you assess the opportunities and the impact on the global system, it is important to look behind the global numbers at the reality of the problems that have to be faced within a country, in order to judge which direction things are likely to move.

# 3. Jiří Weigl

I have to point out at the beginning that the paper by Lankes and Stern includes an excellent amount of information regarding the capital flows to my region, and I appreciated reading it, not only from the point of view of personal interest, but as background for my work at the prime minister's office. I think it is a very good analysis. It allows a better understanding of what is going on, so the EBRD is doing a very good job.

Surprisingly, I am going to cover the same topic that was discussed here for an hour and a half. It is the exchange rate issue and the introduction of convertibility in the transforming economies of central and eastern Europe. I would like to concentrate on the Czech case, which I know best. I think it represents a case study of successful and far-reaching transformation, but on the other hand, this year it became popular for a different reason. It hosted the first example of a currency shake-up coming from international capital markets, quite a new phenomenon in the transforming economies in central and eastern Europe.

Before I start, I would like to stress that my remarks and conclusions do not necessarily reflect the official positions of my government.

Back to the exchange rate problem. A radical opening of the economy through the liberalization of current account transactions was considered one of the cornerstones of our transformation, and the selection of an appropriate exchange rate regime was a precondition for the success of this initial phase of the transformation. At that time—the beginning of the 1990s—the prevailing economic advice we received propounded the advantages of anchoring the economy to one fixed point: the exchange rate. This would be the firm point according to which all the volatile variables would settle down and somehow stabilize, and it would enable us to weather the turbulent initial phase after the collapse of communism. We had some misgivings about that arrangement, but eventually we accepted it in cooperation with the people from the IMF. The system functioned, remained stable for seventy-six months (until recently), and worked surprisingly well. The empirical evidence shows that fixing the exchange rate has brought about rapid disinflation and stabilization of the economy, which was crucial to the success of the transition process as a whole.

Another key factor in our economic development was the rapid broadening of Czech koruna convertibility. It started as so-called internal convertibility for commercial transactions, which restricted capital accounts, and then in 1995 expanded to full current account convertibility, under IMF Article VIII, together with significant liberalization of capital account transactions. So in terms of the degree of convertibility, the Czech Republic has become a front-runner among the central and eastern European transforming economies, and this policy, together with the general results of the transformation, has had a significant impact on capital flows to the country. The economy within the past several years, after the transformation shakeout and the accompanying decline in production, has started to grow quite rapidly, at a rate reaching 5 percent in 1995–96. The inflation rate has achieved single digits. The unemployment rate, about 3 percent, is among the lowest in Europe, and the budget has been kept balanced every year. Extensive mass privatization has been successfully accomplished. Furthermore, the country has enjoyed remarkable political stability, and up to now has been governed by a reform-minded, conservative government, with strong popular support and a good international reputation. These factors, together with low external debt, were reflected in the country's strong credit ratings from rating agencies. Moreover, the Czech Republic was the first of the central and eastern European countries to be admitted to the OECD. International financial markets appreciate these developments, and the country has enjoyed easy access to foreign capital. By the end of last year foreign direct investment exceeded $7 billion, foreign portfolio investments are about $5 billion, and enterprise debt has multiplied several times in the past several years.

So generally speaking, for a long time the Czech economy has produced confidence and optimistic expectations. Nevertheless, it was my country that this year was the first central European transitional economy to become a victim of a wave of currency speculation, similar to that occurring in Asian emerging markets. Thus we have to ask ourselves how it could happen. I would return to the exchange rate question. I think the fixed exchange rate regime was one of the factors at work. Its effects were quite controversial. On the one hand, I have already mentioned its stabilizing role, and I can add its function as an efficiency tool, putting pressure on exporters to improve efficiency and competitiveness because of the inflation differential between the Czech economy and its main trading partners. But on the other hand, long-lasting fixed exchange rates practically eliminate exchange rate risk and create very attractive conditions for foreign capital, especially speculative flows. Starting with the rapid economic recovery in 1993, capital flows were pulled by very strong investment demand, as a result of both the necessary restructuring after the privatization of the enterprise sector and, on the government side, the launching of many environmental and infrastructural projects that were required by international treaties or were simply a precondition for economic recovery, like telephones and so forth.

The extraordinarily high level of gross capital formation became more and more dependent on foreign capital inflow, which peaked in 1995 at 17.4 percent of GDP, when the share of national saving in GDP started to decline. This resulted in money supply growth of about 20 percent per year and inflationary pressure. Soon the symptoms of overheating in the economy became apparent. The situation posed a serious dilemma for economic policymakers. The first option was naturally an exchange rate adjustment, but as Moeen Qureshi has mentioned, we were confronted with unwanted appreciation pressures, so this option was not seen as a realistic solution because it would have exhausted the exchange rate cushion necessary for enterprises to survive this difficult restructuring. Maintaining the stabilizing role of the exchange rate fix was still seen as the number one priority.

The fiscal option was even less realistic, because the budget was balanced every year, and for political reasons it was practically impossible to achieve a fiscal surplus large enough to sterilize the extensive capital inflow. We did not want to introduce excessive capital controls, so the central bank was in quite a difficult position: what to do? Passive sterilization and high interest rate policy only worsened the problem and led to a vicious circle with no solution. High interest rates under a regime of extensive capital account convertibility gave banks and companies easy access to foreign debt instruments, and in this environment the effect of domestic interest rate policy was weakened, and competition from cheap foreign debt instruments created serious problems for local banks fighting with a growing burden of bad loans. So to escape this policy deadlock, the central bank widened the fluctuation band of the koruna, in order to increase exchange rate risk for speculators, and followed by greatly liberalizing capital account transactions, enabling capital outflow from the country. These actions temporarily terminated the speculative short-term inflows, but another, more important challenge started to emerge.

Since 1995, the current account deficit had grown progressively, driven especially by the rapid growth in investment I have already mentioned. The investment ratio in 1996 reached the extreme of 33 percent. The growth in investment had the shape of a massive wave, starting from a relatively low initial rate, and it was necessary to expect a relatively long time lag between the demand-generating and capacity-generating effects of the investment. Also, the specifics of privatization played an important role in this development. In the Czech Republic, where the voucher method of privatization had been extensively used, a turbulent process of ownership concentration was launched and became a relatively long-lasting phenomenon. These conditions affected the emerging domestic stock market, which has not functioned predominantly as a tool for capital mobilization, but instead has served mainly to redistribute existing stock holdings. This has made the Czech stock market a nonstandard place for foreign investors, damaging the credibility of the country.

An attempt to address the problem of increasing external imbalance using monetary tools produced a rapid fall in the rate of growth, as a result of a severe increase in reserve requirements by the central bank last year; and the decline in output had serious budget consequences, while the current account deficit kept worsening, reaching 8.6 percent of GDP in 1996. High interest rates prompted a resumption of the inflow of speculative capital and pushed the exchange rate up to the appreciation limit, thus further hurting current account development. These events, together with the more delicate political balance in the wake of the 1996 elections, eroded the confidence of international financial markets at a time when the Thai bhat crisis was approaching.

In the spring of this year, the longtime prevailing exchange rate appreciation was reversed, and in mid-May the level was pushed to record lows by speculative short selling, despite central bank interventions and dramatic highs in interest rates. Eventually, the fixed exchange rate regime was abandoned and replaced by a floating rate, and the koruna depreciated by some 12 percent on average. The currency shock led to a government reshuffle and an economic policy revision, based on drastic fiscal tightening and a public sector wage freeze, along with a set of systemic measures such as stock market reform, energy and rent control liberalization, and a speeding-up of privatization.

Five months later the situation has more or less stabilized, despite the devastating floods that hit parts of the Czech Republic in July. Also growth is estimated to slow down to about 1.5 to 2 percent. Inflation is still about 10 percent, 2 percent higher than last year, but the current account deficit will definitely end up visibly better this year than in 1996. The speculation against the koruna stopped almost immediately after the currency regime was changed.

My question is about the substance of these developments. Were they a manifestation of real economic crisis, or mere turbulence, or only a temporary loss of confidence by international financial markets? Some analysts describe the Czech case as an eastern European Mexico. I think this is an exaggerated parallel. We could hardly match Mexico's full-blown economic crisis generated by all-around weak fundamentals: Foreign debt, estimated at about 39 percent of GDP, remains moderate by the region's standards, and the debt-servicing ratio remains around 10 percent. About 70 percent of liabilities consist of long-term debt incurred chiefly by the private sector. Foreign reserves stood at comfortable levels before the crisis, with an import cover of four months. Unlike Mexico, the Czech Republic is facing its most serious difficulties financing the current account deficit, and moreover—and this is unique—the fiscal deficit is not a problem.

So when searching for the reasons why the recent shock happened, I think we are justified in asking whether the exchange rate fix was not kept too long, and whether the degree of currency convertibility adopted in the Czech Republic was not too high, whether it was not introduced too early, and whether it was adequate to the depth of changes produced by the transformation process in the economy. The enhanced liberalization of capital accounts was not able to compensate for the negative effects of the fixed exchange rate regime, which disarmed monetary policy. On the contrary, the extensive liberalization of capital accounts in circumstances of increased international uncertainty made the domestic currency particularly vulnerable to speculative attack.

One phenomenon illustrates the degree of convertibility of the Czech currency, which exceeds regional standards: The Czech koruna has become the only Eurocurrency within the region, and starting in 1995, about fifty-five Eurobond issues were placed in the market. On the one hand, this can be interpreted as a sign of confidence in the Czech economy; on the other hand, I think it increases the volatility of the currency and weakens the control of the central bank over the money supply.

The Czech experience shows that a credible exchange rate fix offers important advantages in the *early* stages of transition, but in my opinion, the fix should disappear in the medium term. The Czech Republic made this necessary shift late, and under pressure from speculation, which increased the cost. The introduction of currency convertibility was correct in terms of sequence, but too fast in terms of timing. The combination of a fixed exchange rate and extensive currency convertibility proved to be, in my opinion, a very risky arrangement at a time when the degree of current account imbalance, and the concern of international markets about the sustainability of the situation and the government's ability to react, was high. The coincidence of this development with the changing view in international markets of some, especially Asian, emerging markets provoked speculators to test the Czech currency. The shock was strong but short, and after a visible policy shift, the situation has returned to normal. The confidence of the international markets has not been substantially shaken, which is proved by the exceptionally favorable conditions of credit that our central bank was able to mobilize to replenish its international reserves, depleted during its hopeless attempt to intervene in the market during the attack.

Judging from these facts, I would call the developments in my country this year a terrible short-term crisis, serious turbulence that could be repeated if things go wrong. The koruna was attacked not because problems in the Czech economy were much worse than in other postcommunist economies. The attack was, in my opinion, partly a side effect of the strong speculative wave that hit other emerging market currencies and was made possible by the degree of convertibility of the Czech currency and because preventive exchange rate policy action was not taken in time.

There are arguments that such turbulence has some positive effects. I agree: it effectively disciplines economic policy and mercilessly forces changes in unsustainable trends. From this perspective, the far-reaching opening of the Czech economy, which allowed this automatic disciplining mechanism to function and, through international markets, to punish economic policy mistakes, can be seen as a fundamental vehicle for successful transformation. These arguments have strong potential, but we should also ask about the costs of this volatile adjustment mechanism, and especially whether and when the transforming economies can afford it.

The problems the Czech economy faced this year are not unique within the region. Trade deficits are becoming a general problem among the transitional economies in Europe, and the importance of foreign capital inflows is increasing. The process of liberalizing and broadening the convertibility of currencies is on track and is closely linked to the obligations of new central European OECD members. It creates a lot of space for the inflow of private capital but also makes these relatively weak economies more vulnerable to speculation and the risk of capital flight. The scope and speed with which the former communist countries have opened their economies and adopted currency convertibility has been much greater than similar processes after World War II in western Europe. Generally, this is regarded as an important sign of progress, and in my opinion, it undoubtedly is. But far-reaching openness also means great vulnerability to volatile capital movements and high risk for the still relatively weak transforming economies. So I would argue that the degree of convertibility and the pace at which it is introduced in these countries should correspond to progress in transformation, and the governments and central banks should fine-tune the process very carefully, together with a responsible exchange rate policy. Otherwise, the price that the small open industrial, ex-communist economies will pay for premature capital account liberalization could be quite high.

The enterprise restructuring question is very important.[1] Institutional bottlenecks still exist within the Czech system: the functioning of the court system, bankruptcy procedures, limited protection of creditors, and things like that, which simply prolong the lives of companies that should have gone bankrupt a long time ago. Sometimes people exaggerate the role of state ownership of the banks. In our case, the state is a very passive owner. The problem within the banking sector is not that the state somehow intervenes and pushes banks to extend loans but that corporate governance as such is lacking; the state is not able to exert its power, either for good or for bad. That is why privatization of the banks is one of the priorities of my government these days, but it is of course very controversial. I think there is no secret that our friends from Nomura Securities are bidding for the third largest bank in our country, and I wish them good luck. The government has already approved it. We are waiting for audits only. It is one component of the package that was adopted after the currency crisis, to accomplish systematic reform and to accomplish the privatization of such key institutions as the banks.

The capital market is another weak point, especially in the Czech Republic. It has been the subject of criticism for many years, and I was one of those pushing for rapid standardization. I think some defects arose naturally because

1. The remainder of this comment addresses points raised during the discussion.

of the voucher scheme. An artificial market was created to enable petty shareholders to trade their shares. It was a very nonstandard place and regulation was poor, so fraud and illegal practices and insider trading became not the exception but the norm. Methods that are unmentionable in developed markets have been used quite often, and of course it has become a political problem. The government recognizes it and is making it one of the priorities for the beginning of next year. An independent commission will be established to exert control over transactions, and there will be strong reporting requirements, as well as legal changes that will divide the mutual funds and banks that came into existence during the voucher privatization and created nontransparent structures wherein enterprises have natural links with banks. The banks own companies and extend them credit at the same time, and on the other hand, the companies own banks. It's a very nontransparent system, and it has to be changed and standardized.

# Discussion Summary

*Nicholas Stern* noted that Michael Blumenthal's observations regarding Russia mirror the experiences of the EBRD. Stern said that the pace of change in the region has been remarkable but that there are reasons for caution. Previously, the EBRD encouraged investors to partner with them in order to convince them that "it's not really as risky as you think." Now, the rationale for partnering with the EBRD is that "it's rather more risky than you think." In particular, Stern drew a distinction between the fundamentals underlying much of the foreign direct investment to the region and the enormous drop in spreads accompanying portfolio flows. Moreover, the region is now characterized by high current account deficits and real exchange rate appreciation. The appropriate management of these conditions represents a substantial challenge to policymakers in the region.

Moving from the macroeconomic perspective to the day-to-day realities of business, Stern noted that organized crime is pervasive and extremely efficient in Russia today. The mafia visits companies immediately after registration and carefully monitors them to ensure that steady payments are extracted. Nonetheless, Stern emphasized that private investing in the region, while risky, can be extremely lucrative.

*Sebastian Edwards* disagreed with the emphasis on portfolio flows in precipitating crises and suggested that the combination of governance and the quality of the financial system are determining factors. In fact, if the IMF characterization of the Mexican crisis is correct, he noted, domestic investors took out as much money as foreigners did.

*Arminio Fraga* commented that banks, and particularly state banks, are central to the understanding of these situations. In particular, he noted that while private banks are difficult to monitor, public banks are impossible to monitor given the interests of bureaucrats and politicians. Consequently, public banks should be carefully monitored and supervised or, better yet, closed.

*Jiří Weigl* responded that state ownership of banks is problematic in the Czech Republic because of the passive role of the state as an owner and not because of excessive intervention. As a consequence, there exists no effective governance in state-owned banks. He noted that the privatization of banks remains central to the future of systemic reform in the Czech Republic.

Comparing the Czech and Mexican situations, *Francisco Gil Diaz* noted that the outcome in Mexico may have been more violent as the result of the combination of a tenuous reserve position and the overhang created by the issuance of the Tesobono bonds.

*Bernard Wasow* drew attention to the fact that a number of unviable Czech enterprises are still being supported by the state and that this policy of sustaining employment in the Czech Republic has not been addressed fully.

*Weigl* replied that a number of bottlenecks exist in the restructuring of state-owned enterprises. Notably, the legal system and the intransigence of creditors are prolonging the lives of companies that are no longer sustainable. He also noted that the voucher privatization system has hindered the growth of capital markets because it has created an artificial environment in which nonstandard behavior is the norm. Therefore, better oversight and standardization of procedures within capital markets are also important parts of the reform agenda.

*Robert Feenstra* noted that for foreign direct investment to flow into the region, foreign investors must perceive a viable exit opportunity through the existence of robust domestic capital markets. Accordingly, the creation and supervision of such capital markets should be foremost on the agenda for attracting foreign investment.

*Blumenthal* downplayed the importance of capital markets for attracting greater foreign direct investment. Instead, he noted that the most important determinant of future FDI flows would be a legal framework that provides predictability and stability. Such a framework is growing in the region, and companies are responding by investing more. In turn, Blumenthal suggested, capital markets will grow to accommodate the needs of the expanding firms.