



# IV

## Globalization and the Opportunities for Developing Countries

Since the mid-1980s, the pace of globalization in the world economy has quickened considerably. World trade has increased nearly twice as fast as world GDP, financial markets in many countries have been liberalized rapidly, and capital flows to many developing countries have accelerated. Clearly, some economies have benefited from globalization enormously. With this *World Economic Outlook*, Hong Kong, Korea, Singapore, and Taiwan Province of China (together with Israel) are moved from the developing country group to the new advanced economy group; they vividly demonstrate the great successes that can be achieved when policies take advantage of these forces. But what do the pressures of globalization mean for economic performance and policy orientations in developing countries more generally? Do larger trade flows and more liberal financial markets benefit all countries equally, or are some economies better positioned to reap the gains than others? What do closer trade and financial linkages suggest for the cross-country income convergence process? Are there successive groups of developing countries following in the footsteps of the Asian success cases or not? Are there particular policies that can help countries enjoy the benefits of globalization, enhance economic performance, and reduce the danger of becoming marginalized? These issues are the focus of this chapter.

The chapter begins with a review of the key changes that are taking place in developing countries as the world becomes more integrated—in trade, in financial markets, and in the movement of people. Patterns of growth performance are then highlighted to examine the degree to which per capita incomes have been converging on those in the advanced economies. Many developing economies have shown substantial gains in living standards, and real per capita incomes on average have roughly doubled over the past thirty years. This average gain, however, is no greater than that achieved by the advanced economies, so that on average there has been no convergence of per capita income levels between the two groups of countries; in fact, in absolute terms there has been a widening. Moreover, evidence to be presented below suggests that there has been an increasing polarization among the developing countries. Highly successful developing countries, such as Chile, Malaysia, and Thailand, have been converging toward advanced economy per capita income levels quite rapidly, but many poor

countries have been falling relatively farther behind. The reasons for this bipolar pattern and the factors that are associated with faster growth and convergence are then analyzed.

A key lesson seems to be that the pressures of globalization, especially in the past decade or so, have served to accentuate the benefits of good policies and the costs of bad policies. Countries that align themselves with the forces of globalization and embrace the reforms needed to do so, liberalizing markets and pursuing disciplined macroeconomic policies, are likely to put themselves on a path of convergence with the advanced economies, following the successful Asian newly industrialized economies (NIEs). These countries may expect to benefit from trade, gain global market share, and be increasingly rewarded with larger private capital flows. Countries that do not adopt such policies are likely to face declining shares of world trade and private capital flows, and to find themselves falling behind in relative terms.

The analysis then looks at what factors seem to be necessary and sufficient for faster per capita income growth. A main finding is that there are important policy complementarities. It is not just one type of policy that is needed, such as openness to trade, but rather a comprehensive set of policies and reforms that are mutually reinforcing. Finally the chapter looks at the problems of countries that seem in danger of being marginalized and suggests what policies might help put them on paths of higher growth and eventual convergence with more successful countries.

### Forces of Integration

#### Changing Trade Linkages

A striking feature of the growth in world trade and capital flows over the past decade has been the heightened involvement of developing countries. Developing countries not only increased their share of world trade from 23 percent in 1985 to 29 percent in 1995, but they also deepened and diversified their trade linkages. Interdeveloping country trade increased from 31 percent of total developing country trade in 1985 to 37 percent in 1995. Between 1985 and 1995, the share of manufactured products in these countries' exports increased from 47 percent to 83 per-

**Table 16. Advanced Economies Versus Developing Countries Including Newly Industrialized Economies: Diversification of Exports***(In percent of merchandise imports or exports)*

	Advanced Economies (Excluding Newly Industrialized Economies)						Developing Countries Plus Newly Industrialized Economies					
	Imports			Exports			Imports			Exports		
	1975	1985	1995	1975	1985	1995	1975	1985	1995	1975	1985	1995
Nonfuel primary products	10.2	6.8	5.2	7.1	5.6	4.2	5.7	6.1	5.0	10.1	7.4	5.7
Fuel	26.0	22.4	8.4	5.9	8.9	3.8	15.9	19.9	7.2	61.4	45.4	11.2
Manufacturers	63.8	70.8	86.4	87.0	85.5	92.0	78.4	74.0	87.8	28.2	47.2	83.0

cent, which reflects the industrialization process they have been undergoing (Table 16). Despite these overall encouraging developments, there have been wide disparities among the developing countries (Chart 33). Except for countries in Asia and some in Latin America, integration with the world economy has been rather slow. Africa's share of world trade has continuously declined since the late 1960s, while for the major oil producing countries the share has fallen dramatically since oil prices and revenues peaked in the early 1980s.

The expansion, diversification, and deepening of developing countries' trade linkages have to a large extent been the result of significant changes in trade and exchange regimes. Statist and inward-looking policies of protectionism and import-substitution increasingly have been abandoned in favor of more outward-looking and open policies; trade and exchange regimes have been liberalized, with tariff and nontariff barriers lowered significantly. On the basis of a fairly restrictive definition of openness adopted in one study, 33 developing countries switched from relatively closed to open trade regimes between 1985 and 1995.<sup>53</sup> Moreover, many developing countries have committed themselves to further reductions of tariffs and nontariff barriers in the multilateral context of the Uruguay Round. The participation by developing countries in regional trading arrangements, which may entail risks of trade diversion as well as benefits of trade creation, has also increased in the last decade or so.<sup>54</sup>

<sup>53</sup>See Jeffrey D. Sachs and Andrew M. Warner, "Economic Convergence and Economic Policies," NBER Working Paper No. 5039 (Cambridge, Massachusetts: National Bureau of Economic Research, February 1995). They deem a country's trade regime to be closed if it has any *one* of the following characteristics: (1) nontariff barriers covering 40 percent or more of total trade, (2) average tariff rates of 40 percent or more, (3) a black market exchange rate in which the domestic currency is depreciated 20 percent or more relative to the official exchange rate, (4) a socialist economic system, or (5) a state monopoly on major exports.

<sup>54</sup>See Richard Harmsen and Michael Leidy, "Regional Trading Arrangements," in *International Trade Policies: The Uruguay Round and Beyond*, Vol. II, *Background Papers*, by Naheed Kirmani and others (IMF, 1994).

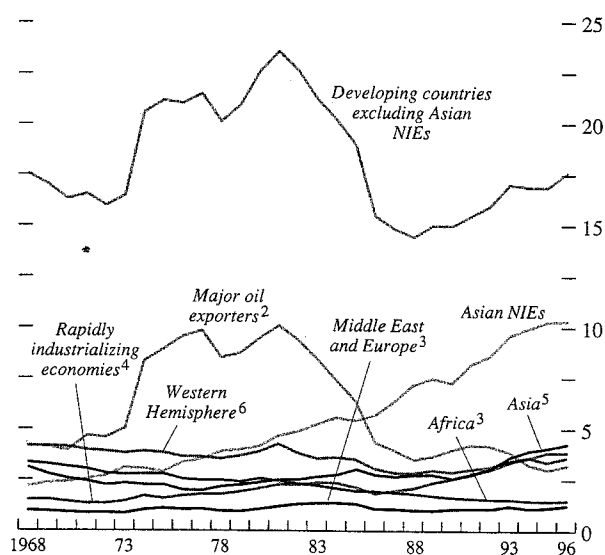
### More Interconnected Capital Markets

Developing countries are also becoming increasingly integrated with the global financial system. Net private capital flows to developing countries (excluding the Asian NIEs) averaged about \$150 billion a year over 1993–96 and almost hit \$200 billion in 1996—nearly a sixfold increase from the average annual inflow over 1983–89. In fact, capital flows to one country, China, were larger in 1996 than they were to all developing countries as recently as 1989. These capital inflows roughly doubled in relation to developing country GDP between 1985 and 1996. Unlike in the 1970s and early 1980s when most capital flows represented bank lending, the largest flows in recent years have been in equity and portfolio investments (Chart 34). Such private capital flows rose from a low of ½ of 1 percent of developing country GDP in 1983–89 to 2–4 percent of GDP in each of the years 1994–96. Foreign direct investment has posted the largest rise. This has flowed overwhelmingly toward the emerging market countries that have been experiencing relatively fast economic growth. Asian developing countries received almost twice the net private capital inflows as a percentage of their GDP that African countries received over 1990–96 (Chart 35). Liberalization of financial markets in both recipient and source countries has helped to spur this growing capital market integration. Successful developing countries increasingly have lifted controls on cross-border flows, especially on capital inflows, and removed restrictions on payments for current account transactions. The number of developing countries accepting the obligations to maintain current account convertibility of their currencies under the IMF's Article VIII has increased from 41 in 1985 to 99 today. With China's acceptance of Article VIII in late 1996, the proportion of developing country trade carried out under current account convertibility has increased from around 30 percent in 1985 to nearly 70 percent in 1997 (Chart 36). Impressive growth performance and an improved track record in terms of macroeconomic stability by many developing countries, and emerging market countries in particular, also have promoted capital market integration by

**Chart 33. Developing Countries and Asian Newly Industrialized Economies (NIEs): Trade<sup>1</sup>**

(In percent of total world trade)

While the shares of world exports of the Asian newly industrialized economies and the rapidly industrializing economies have increased in the past decade, the shares of most other developing country regions have been roughly flat or have declined.



<sup>1</sup>Excluding Cyprus and Malta.

<sup>2</sup>Excluding Iraq.

<sup>3</sup>Excluding major oil exporters.

<sup>4</sup>Consists of Chile, Indonesia, Malaysia, and Thailand.

<sup>5</sup>Excluding Asian newly industrialized economies, Indonesia, Malaysia, and Thailand.

<sup>6</sup>Excluding major oil exporters and Chile.

making these markets more attractive to investors from advanced economies wishing to diversify their portfolios.

### Changes in Employment and Relative Wages

As discussed in Chapter III, relative changes in employment and wages of skilled and unskilled labor in the advanced economies do not appear to have been closely related to increased trade or capital mobility. Instead, studies generally attribute the bulk of the decline in employment or relative wages of unskilled workers in advanced economies to a natural development progression as economies mature. Economic development has typically involved relative shifts of resources and output from agriculture to unskilled labor-intensive manufacturing, to high value-added manufacturing and services. Thus, the shift of employment away from manufacturing appears largely to reflect the forces of technological progress and capital deepening, rather than international trade pressures.<sup>55</sup> If advanced economies have flexible labor markets and good adjustment mechanisms, it can be viewed as natural and highly beneficial for them to shift their production to sectors with higher value added per unit of input than low value-added manufacturing.

Similar forces are at work in the developing countries themselves. Many of the developing countries that have integrated into the world economy have, for example, seen their highly skilled workers shift toward their tradable goods sectors, while their unskilled workers have shifted to nontradable sectors, such as construction and transportation.<sup>56</sup> This might imply temporary increases in unemployment as these economies adjust to the demands of closer integration into global markets. The rise in developing country incomes, in turn, helps to provide a growing market for some of the high-value-added output of the industrial countries. Increased North-South trade and integration may therefore be expected to lead to increasing prosperity in advanced and developing economies alike as both groups move up to the production of higher-value goods and services. Employment in the advanced economies can remain at high levels as the demand for services increases, provided labor markets are flexible, and employment in developing countries can increase as people shift out of the informal sector into the formal sector. However, the pressures of technology that tend to cause the relative incomes of certain groups of unskilled workers in both country groups to decline must be recognized and addressed by

<sup>55</sup>See, for example, Rowthorn and Ramaswamy, "Deindustrialization: Causes and Implications."

<sup>56</sup>See "Workers in an Integrated World," *World Development Report* (Washington: World Bank, 1995).

policies in such areas as social safety nets, and education and training.<sup>57</sup>

### Changes in the Movement of People

The flow of people across national borders has also increased as the world economy has become more interconnected, although the flow remains relatively small. In 1990, roughly 120 million people were living in countries in which they were not born, up from 75 million in 1965. The share of the world's labor force that is foreign born increased by roughly half between 1965 and 1990. Although the largest portion of labor migration is from developing country to developing country, flows from developing countries to industrial countries have accelerated the most over the past two decades. As incomes in poor countries increase and as the wage differential between an advanced economy receiving immigrants and a poor country experiencing net emigration drops to less than about four to one, migration from the latter to the former tends to diminish.<sup>58</sup>

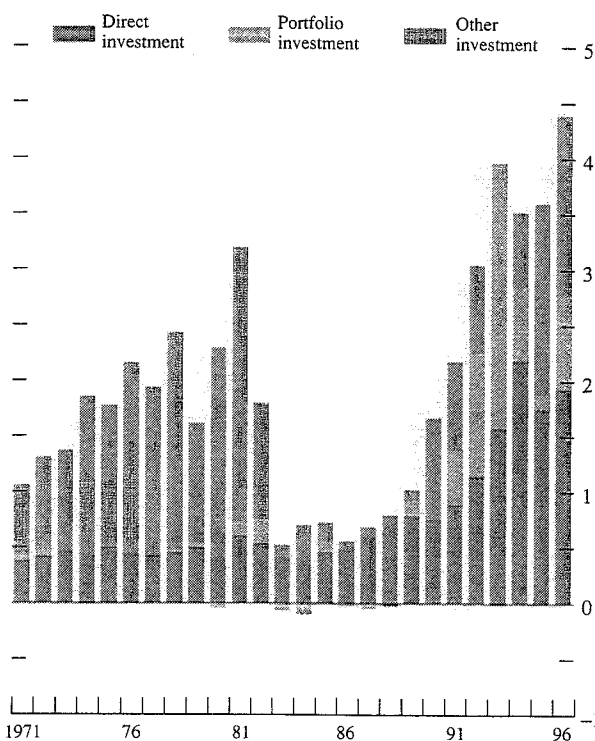
Labor flows almost certainly would have been greater without the surge in international trade already described. Some researchers have identified a hump-backed relationship between migration and trade, whereby trade helps to establish contacts, information networks, and channels that can lead to a temporary swelling of migration from poor countries to rich countries over the short and intermediate run.<sup>59</sup> Over the longer term, however, trade substitutes for the physical movement of capital and labor.

The free flow of factors, including labor, has many economic benefits—the main one being that it helps to maximize global output, promoting efficiency in both labor-supplying and labor-receiving countries. Countries receiving immigrant workers will find that certain production bottlenecks are opened up, which can reduce inflationary pressures, and that aggregate supply is boosted. Countries that receive foreign business managers or technical experts to help develop or manage enterprises are likely to find that the productivity in such facilities improves. Labor-exporting countries are likely to receive foreign resources in the form of worker remittances, which are estimated in one study to have totaled over \$70 billion globally in 1995, or other flows.<sup>60</sup> These flows have been particularly im-

**Chart 34. Developing Countries: Net Private Capital Flows<sup>1</sup>**

(In percent of GDP)

Overall, capital flows to developing countries have rebounded sharply in the 1990s from the depressed levels of the 1980s. Direct investment has led the way.



<sup>1</sup>Excludes major oil exporters. Because of data limitations, these data may include some official flows. Data for 1994 exclude Brazil.

<sup>57</sup>See Donald J. Robbins, "Evidence on Trade and Wages in the Developing World," OECD Development Centre Technical Paper No. 119 (December 1996). The author argues that contrary to the predictions of the factor price equalization theorem, the wages of unskilled workers in a number of developing countries have been falling in relative terms, probably because of the forces of technology.

<sup>58</sup>See Thomas Straubhaar, *On the Economics of International Labor Migration* (Bern; Stuttgart: Paul Haupt, 1988).

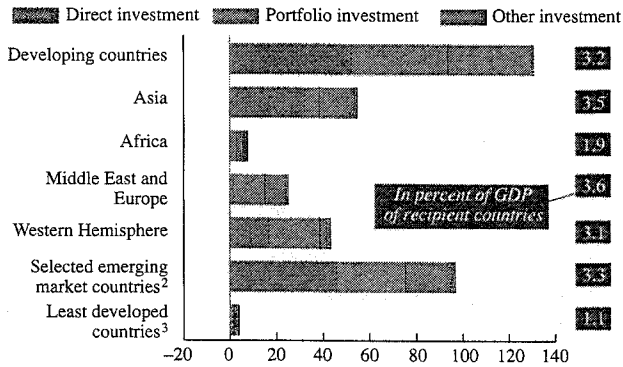
<sup>59</sup>See Phillip Martin, "Economic Aspects of International Migration" (unpublished: IMF, Research Department, December 1996).

<sup>60</sup>The estimate of worker remittances is from Martin, "Economic Aspects."

**Chart 35. Developing Countries: Net Private Capital Flows, 1990–96<sup>1</sup>**

(Annual average; in billions of U.S. dollars)

In proportion to GDP, capital flows to Asia have been running at twice the rate of flows to Africa.



<sup>1</sup>Excludes Brazil in 1994.

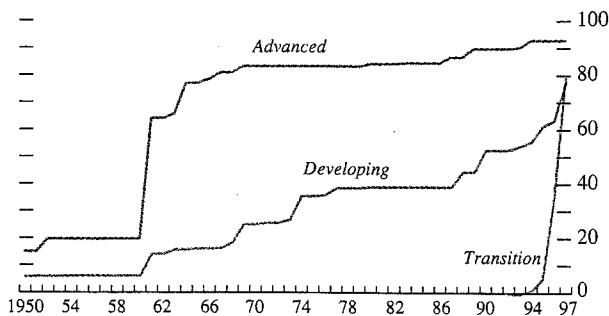
<sup>2</sup>Comprises Argentina, Brazil, Chile, China, Colombia, India, Indonesia, Malaysia, Mexico, Pakistan, Peru, the Philippines, South Africa, Thailand, Turkey, and Venezuela.

<sup>3</sup>Comprises Afghanistan, Bangladesh, Benin, Bhutan, Botswana, Burkina Faso, Burundi, Cambodia, Cape Verde, Central African Republic, Chad, Comoros, Djibouti, Equatorial Guinea, Ethiopia, the Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, São Tomé and Príncipe, Sierra Leone, Solomon Islands, Somalia, Sudan, Tanzania, Togo, Uganda, Vanuatu, Western Samoa, Republic of Yemen, Zaire, and Zambia.

**Chart 36. Advanced, Developing, and Transition Economies: Current Account Convertibility<sup>1</sup>**

(In percent)

The pace of liberalization of exchange regimes in developing economies has quickened in recent years.



<sup>1</sup>Percent of advanced, developing, and transition economies that have accepted Article VIII of the IMF's Articles of Agreement; economies are weighted by their 1990–95 share of aggregate exports of all advanced, all developing, or all transition economies. As of March 31, 1997, a total of 138 countries had accepted Article VIII.

portant for certain countries, including Bangladesh, Pakistan, and the Philippines. Such countries may also find that their overseas workers acquire valuable skills that benefit the domestic economy when the workers return home.

Both groups of countries, however, have concerns about migration. Labor-receiving countries are concerned, for example, that an influx of unskilled workers will reduce wages or employment opportunities, or both, for native unskilled workers. As indicated, however, the forces of technological change are likely to play a bigger role, through deindustrialization and changes in the structure of demand for labor. Meanwhile, labor-exporting countries are often concerned that the loss of human capital, especially skilled labor—including the “brain drain”—may not be compensated by the flow of remittances from workers abroad, with a substantial portion of foreign labor earnings not repatriated or invested in unproductive domestic assets, such as real estate.<sup>61</sup>

With regard to likely future trends in migration, the economic forces that influence the desire of people to move, including the growing per capita income gaps between successful and unsuccessful countries, might seem to point to the likelihood of a substantial increase in the potential supply of migrants. On the other hand, the downward pressure on low-skilled wages in the advanced economies and the trend toward tighter immigration policies in many countries may tend to limit both legal and clandestine labor flows.

### Implications for Relative Income Patterns and Convergence

How have these forces of integration affected cross-country growth and income patterns? In absolute terms, living standards as measured by real per capita incomes have risen substantially in most developing countries over the past thirty years. This is shown in Chart 37, where movements in absolute real per capita income are shown, measured in terms of average 1995 per capita GDP in the industrial countries. Even excluding the successful Asian NIEs, developing countries as a group more than doubled their real per capita income between 1965 and 1995, in line with the industrial countries. Most developing countries experienced substantial economic progress over the period. The gains have been nothing less than spectacular in some countries. Korea, for example, experienced almost a tenfold rise in per capita income

<sup>61</sup>For an analysis of the effects of human capital flight on growth, see Nadeem Ul Haque and Se-Jik Kim, “‘Human Capital Flight’: Impact of Migration on Income and Growth,” *Staff Papers*, IMF, Vol. 42 (September 1995), pp. 577–607.

between 1965 and 1995, while Thailand saw a five-fold increase, and Malaysia a fourfold rise. In the developing countries of the Western Hemisphere average per capita incomes doubled between 1965 and 1980 before stagnating over the next 15 years, a period much of which was dominated by the debt crisis and its aftermath.

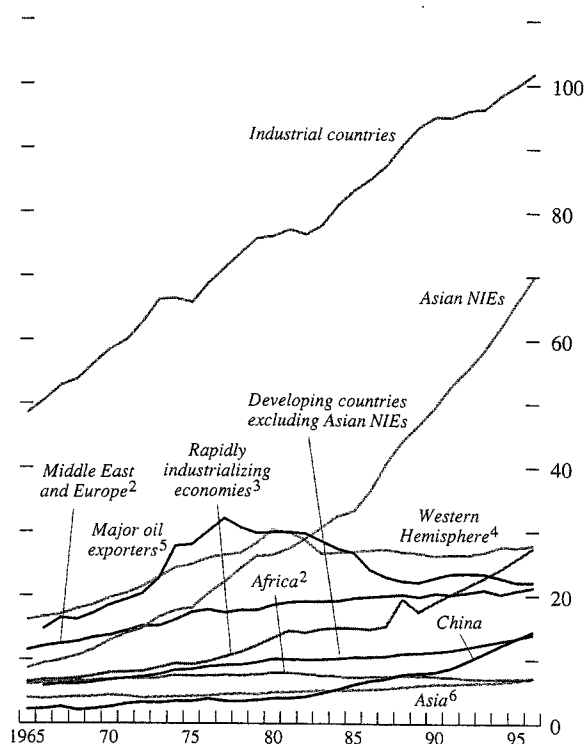
While the success stories illustrate that dramatic improvements in living standards are possible, many countries regrettably are not realizing their potential. In relative terms, most developing countries have failed to raise their per capita incomes toward those of the industrial countries (Chart 38). In fact, Asia is the only major region to have registered significant relative progress, in the sense of having achieved significant convergence toward industrial country living standards. The four Asian NIEs increased per capita incomes from 18 percent of the industrial country level in 1965 to 66 percent in 1995. For other Asian economies, the gap has also been reduced, with the fastest progress in the 1985–95 period. However, among the groups of countries in the Western Hemisphere, the Middle East and North Africa (MENA) region, and Africa, the gaps have widened since 1965 and especially since the mid-1970s. Western Hemisphere countries, for example, which had almost double the average NIE level of per capita income in 1965, saw the gap between their income level and that of the industrial countries gradually widen after the debt crisis of the 1980s. The average per capita income level of African countries fell in relative terms from 14 percent of the industrial country level in 1965 to just 7 percent in 1995. Africa and Asia roughly exchanged relative positions in this 30-year period. These regional developments in relative income performance seem to parallel the patterns of integration proxied, for example, by shares of world trade (Chart 33).

There has also been a sharp decline in upward mobility of developing countries within the international distribution of average per capita incomes and an increased tendency for countries to become polarized into high- and low-income clusters. Using the average per capita incomes of developing countries each year to define five income brackets—a lowest quintile for income levels from zero to 20 percent of the richest developing country level, a second quintile for income levels from 20 percent to 40 percent, and so forth—reveals an interesting profile. Of the 108 non-oil-producing developing countries for which data are available, 52 were in the lowest-income quintile in 1965, but the number had increased to 84 countries by 1995 (Table 17). Meanwhile, the number of developing countries in the middle-income categories fell rapidly. In 1965, 49 of these countries had incomes in the second and third income quintiles (between 20 percent and 60 percent of the richest developing country income level), but the number had dipped dramatically to just 21 countries by

**Chart 37. Developing Countries and Asian Newly Industrialized Economies (NIEs): Real Per Capita Income<sup>1</sup>**

(In percent of 1995 industrial country per capita GDP; purchasing power parity terms)

Per capita incomes in most developing country groups have increased since 1965, but progress has been far from uniform.



<sup>1</sup>Excluding Cyprus and Malta.

<sup>2</sup>Excluding major oil exporters.

<sup>3</sup>Consists of Chile, Indonesia, Malaysia, and Thailand.

<sup>4</sup>Excluding major oil exporters and Chile.

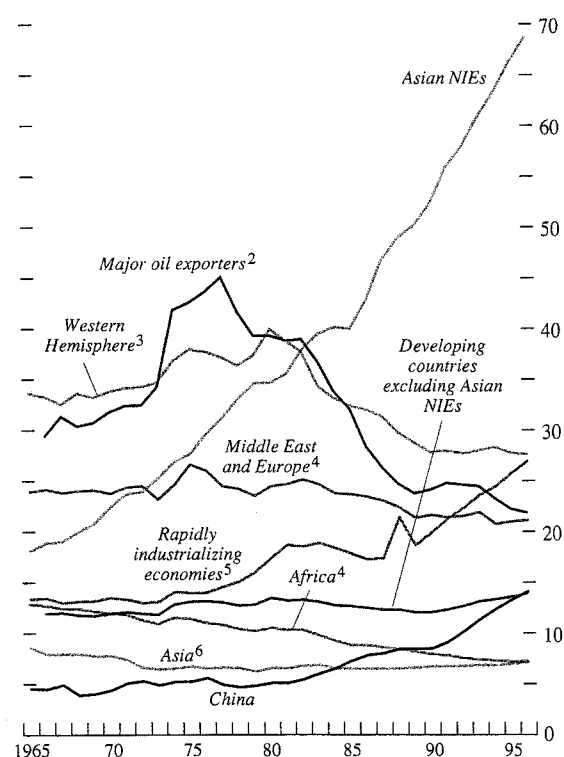
<sup>5</sup>Excluding Iraq.

<sup>6</sup>Excluding Asian newly industrialized economies, China, Indonesia, Malaysia, and Thailand.

### Chart 38. Developing Countries and Asian Newly Industrialized Economies (NIEs): Relative Economic Performance<sup>1</sup>

(In percent of current industrial country per capita GDP; purchasing power parity terms)

With the exception of the Asian newly industrialized economies, China, and a group of four industrializing economies, most country groups have not experienced convergence toward per capita incomes in the industrial countries.



<sup>1</sup>Excluding Cyprus and Malta.

<sup>2</sup>Excluding Iraq.

<sup>3</sup>Excluding major oil exporters and Chile.

<sup>4</sup>Excluding major oil exporters.

<sup>5</sup>Consists of Chile, Indonesia, Malaysia, and Thailand.

<sup>6</sup>Excluding Asian newly industrialized economies, China, Indonesia, Malaysia, and Thailand.

1995.<sup>62</sup> Simply put, over the past thirty years the vast majority of developing countries—84 out of 108—have either stayed in the lowest-income quintile or fallen into that quintile from a relatively higher position. Moreover, there are now fewer middle-income developing countries, and upward mobility of countries seems to have fallen over time. While there was some tendency for countries to move to higher brackets and to progress relative to the advanced economies over the 1965–75 period, the forces of polarization seem to have become stronger since the early 1980s.

Income convergence requires that poor countries have faster per capita income growth than rich countries. Given the trends just discussed, it should not be surprising that there is little evidence of such income convergence between developing countries and advanced economies over recent decades. Chart 39 shows a scatter diagram of average per capita income growth rates over the period 1965–95 plotted against initial (1965) per capita income levels for both advanced and developing countries. If incomes in these countries were tending to converge toward some global average, there would be few data points in the northeast and southwest quadrants—the richest countries would not be growing faster than average, and the poorest countries would not be growing more slowly than average. However, as the diagram makes clear, there has been no such convergence trend. Even excluding the advanced economies from the diagram, to test whether there has been convergence just among the developing countries and newly industrialized economies themselves, suggests no such tendency (Chart 40).

This lack of cross-country income convergence may be surprising because there are many reasons to expect a converging pattern, especially in a more open and integrated world economy. First, there are wide technology gaps between advanced economies and developing countries, giving the latter great potential for technological catch-up. With open trade and liberal financial markets, poorer countries should be able to benefit from technology spillovers, such as through the stock of knowledge embedded in imported capital goods. Second, capital-to-labor ratios in developing countries are lower than in advanced economies, and other things equal this relative scarcity of capital might be expected to make the return from investment in the former higher than in the latter. In a world in which capital is free to flow in search of highest returns, there are therefore grounds for expecting that it might increasingly flow to developing countries where

<sup>62</sup>This thinning of the middle range of the developing country income distribution leads to a global income distribution that appears to be characterized by two large clusters at each end, which has been termed the “twin peaks” phenomenon. For example, see Danny T. Quah, “Twin Peaks: Growth and Convergence in Models of Distribution Dynamics,” *Economic Journal*, Vol. 106 (July 1996), pp. 1045–55.

**Table 17. Developing Countries and Asian Newly Industrialized Economies:  
Increased Polarization and Reduced Mobility in Cross-Country Relative Income<sup>1</sup>**

(Per capita income in purchasing power parity terms; income distribution is in quintiles)

Countries that started out in the lowest income quintile have generally remained in the lowest quintile.

		1965-75					Number of Countries
		Final position in 1975 income distribution <sup>2</sup>					
		First	Second	Third	Fourth	Fifth	
Initial relative position in 1965 income distribution	First	46	6				52
	Second	4	23	7			34
	Third			7	6	2	15
	Fourth					2	2
	Fifth				1	4	5
Number of countries		50	29	14	7	8	108

		1975-85					Number of Countries
		Final position in 1985 income distribution <sup>2</sup>					
		First	Second	Third	Fourth	Fifth	
Initial relative position in 1975 income distribution	First	50					50
	Second	20	9				29
	Third	1	11	2			14
	Fourth		5	2			7
	Fifth			6		2	8
Number of countries		71	25	10	0	2	108

		1985-95					Number of Countries
		Final position in 1995 income distribution <sup>2</sup>					
		First	Second	Third	Fourth	Fifth	
Initial relative position in 1985 income distribution	First	71					71
	Second	13	11	1			25
	Third		6	3	1		10
	Fourth						0
	Fifth					2	2
Number of countries		84	17	4	1	2	108

		1965-95					Number of Countries
		Final position in 1995 income distribution <sup>2</sup>					
		First	Second	Third	Fourth	Fifth	
Initial relative position in 1965 income distribution	First	50	1	1			52
	Second	27	6		1		34
	Third	7	6	1		1	15
	Fourth		1			1	2
	Fifth		3	2			5
Number of countries		84	17	4	1	2	108

<sup>1</sup>Excluding major oil exporters, Malta, and Cyprus.

<sup>2</sup>The figure in each cell is the number of countries whose relative position in the initial and terminal year was in the income brackets corresponding to the row and column of that cell. For example, for the period 1965-95, the first row of numbers show that out of 52 countries that were in the bottom one-fifth of the income distribution in 1965, 50 remained in the bottom one-fifth, 1 country moved to the second quintile and 1 country to the third quintile in 1995. Similarly, the numbers in the first column show that out of the 84 countries in the bottom one-fifth of the income distribution in 1995, 50 were in the first quintile, and that 27 and 7 moved down from the second and third quintiles, respectively, of the 1965 income distribution. For a similar analysis, see V. V. Chari, Patrick J. Kehoe, and Ellen R. McGratten, *The Poverty of Nations: A Quantitative Exploration*, Staff Report No. 204, Federal Reserve Bank of Minneapolis (January 1996).

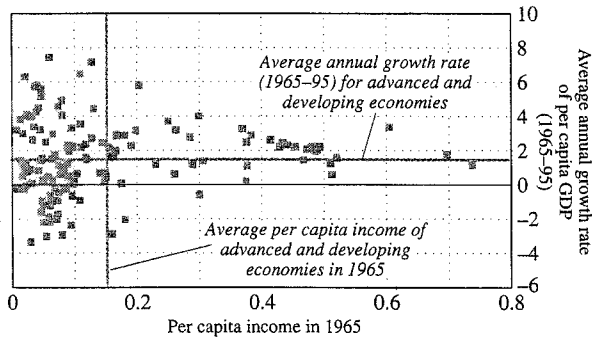
it can help boost income growth. These forces should work to promote productivity and income growth in developing countries and should therefore increase the likelihood of convergence.

So, given the empirical evidence, what remains of income convergence? The data appear to show that there is a tendency for countries to converge to long-term per capita income levels that are determined by



**Chart 39. Advanced and Developing Economies: Convergence in Per Capita Income, 1965–95<sup>1</sup>**  
(In purchasing power parity terms)

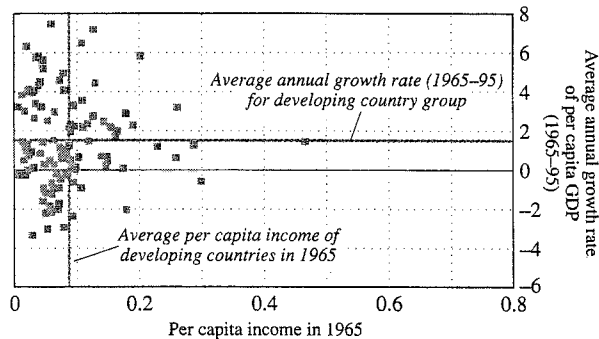
The fact that many economies are in the southwest quadrant—lower than average per capita income in 1965 and slower than average growth over 1965–95—suggests a lack of convergence.



<sup>1</sup>Excluding Iraq, Kuwait, Lebanon, and Qatar; as a percent of industrial country per capita income in 1995. A necessary condition for convergence is that economies be concentrated in the upper left and lower right-hand quadrants.

**Chart 40. Developing Countries and Asian Newly Industrialized Economies: Convergence in Absolute Income, 1965–95<sup>1</sup>**  
(In purchasing power parity terms)

Even among just the developing countries and the newly industrialized economies there is no evidence of convergence over 1965–95.



<sup>1</sup>Excluding Cyprus, Lebanon, Malta, and the oil exporting countries; as a percent of industrial country per capita income in 1995. A necessary condition for convergence is that countries are concentrated in the upper left and lower right-hand quadrants.

their own policies and resources. In cross-country analyses of growth, factors that have been found to be important in contributing positively to long-run potential per capita income include the skill level of the workforce, the absence of distortions affecting investment decisions, the degree of openness of the economy, macroeconomic stability, and freedom from political and civil unrest. A country's rate of convergence then depends upon these factors and the gap between its initial and potential income levels. The larger the gap, the faster the rate of growth, but the longer the time taken to converge.<sup>63</sup> China, for example, would take about 16 years to cut in half its current income gap with the advanced economies if it maintained its 10 percent a year real per capita growth rate of recent years (Table 18). Chile, even though it has been growing at less than half the rate of China, would halve its gap with the advanced economies in only ten years if it maintained its recent growth rate, because it has a higher current level of income. These two cases illustrate the point that although most developing countries are not converging toward advanced economy levels of income, there are some cases where growth conditions and policies are highly favorable, and where progress toward convergence can be achieved in a relatively short period of time.

### Policies to Boost Growth and Promote Convergence

In the light of growth patterns that show many developing countries diverging away from advanced economy per capita income levels over recent decades, the question of how developing countries' growth performance could be improved gains urgency. What are the sources of economic growth and what policies could make a difference in whether a country converges toward high income levels? In simplest terms, economic growth springs from the accumulation of physical and human capital, labor, and advances in production technology (total factor productivity). Although views differ on the relative importance of these factors (see Box 9), for most developing countries conventional growth-accounting studies show that the accumulation of factors, especially physical capital, has accounted for the greater part of output growth. Recent estimates suggest that in the period 1960–92 roughly 60 to 70 percent of growth in per capita incomes was due to increases in physical capital per worker, while education con-

<sup>63</sup>After correcting for different long-run potential income levels resulting from differences in policies and resources, initially poorer countries do tend to grow faster than relatively richer countries. This tendency has been termed "conditional convergence" to signify the dependence on policies. For further details, see the box "Economic Convergence," in the October 1994 *World Economic Outlook*, pp. 94–95.

**Table 18. Developing Countries: Convergence and Growth in Selected Countries<sup>1</sup>**  
(In percent)

	Relative Per Capita Income		Average Growth Rate of Relative Per Capita Income, 1985-95	Average Rate of Convergence, 1985-95 <sup>2</sup>	Average Growth Rate of Relative Per Capita Income, 1990-95	Average Rate of Convergence, 1990-95 <sup>2</sup>	Years to Close Half the Gap in 1995 at 1990-95 Growth Rate	Implied Rate of Convergence <sup>2</sup>	Implied Relative Per Capita Income After Halving of 1995 Gap
	1985	1995							
Chile	33.6	46.7	3.3	1.3	4.5	1.8	10	2.6	73.3
Indonesia	13.7	18.8	3.2	0.5	5.0	0.8	23	1.7	59.4
Malaysia	39.9	48.0	1.9	0.8	5.2	2.2	8	3.1	74.0
Thailand	20.5	36.1	5.8	1.6	6.0	1.8	11	3.0	68.0
Argentina	33.5	31.4	-0.6	-0.2	2.8	0.8	26	1.3	65.7
China	7.3	13.3	6.2	0.6	9.5	1.0	16	2.7	56.6
India <sup>3</sup>	5.8	6.9	1.7	0.1	1.9	0.1	112	0.4	53.4
Sri Lanka	14.5	15.8	0.9	0.1	2.8	0.4	46	0.9	57.9
Uganda	3.5	6.9	7.2	0.3	4.0	0.2	52	0.9	53.5
Uruguay	32.8	39.3	1.8	0.6	2.0	0.7	29	1.0	69.6
Bangladesh	6.6	6.9	0.4	0.03	1.5	0.1	141	0.3	53.4
Vietnam	0.7	0.9	2.7	0.02	4.8	0.04	87	0.6	50.4
<i>Memorandum</i>									
Asian newly industrialized economies <sup>4</sup>	56.4	86.7	4.7	2.9	4.6	3.4			

<sup>1</sup>All growth rates, rates of convergence, and relative per capita income levels are in relation to the average of advanced economies (excluding the newly industrialized economies). For example, the relative per capita income for any country (shown in the first two columns) is the ratio (in percent) of its per capita income to the average per capita income of advanced economies (excluding the newly industrialized economies). Income refers to GDP in U.S. dollars, based on purchasing power parity exchange rates. The simulations, summarized in the last three columns, assume that the industrial countries as a group maintain their current average rate of growth.

<sup>2</sup>The rate of convergence is defined as the percentage of the gap below the average per capita income of advanced economies (excluding the newly industrialized economies) that is reduced per year.

<sup>3</sup>For India, real per capita GDP growth in 1995 and 1996 has been significantly higher than the average for 1990-95. The average growth rate of relative per capita income in 1995-96 was 3 percent. If India maintains this growth rate then the number of years required to close half its gap with the advanced economies (excluding the newly industrialized economies) will be lowered to 69 years from 112 years as shown in the table.

<sup>4</sup>In 1995, Hong Kong's relative income was 114.6 percent, Korea's 54.6 percent, Singapore's 105.6 percent, and Taiwan Province of China's 72.1 percent of the average per capita GDP of advanced economies (excluding the newly industrialized economies).

tributed about 15 to 20 percent, and total factor productivity accounted for the remainder.<sup>64</sup> A comparison of fast- and slow-growing developing countries over the periods 1965-85 and 1985-95 shows that the shares of both investment and saving in GDP have been significantly higher for the first group (Table 19). It appears therefore that policies that raise the rates of investment and saving can play a crucial role in raising growth, if the investment is productive.<sup>65</sup> This section considers what role policies can play in boosting capital accumulation and total factor productivity.

<sup>64</sup>See Barry Bosworth, Susan M. Collins, and Yu-chin Chen, "Accounting for Differences in Economic Growth," *Brookings Institution Discussion Paper*, No. 115 (Washington: Brookings Institution, December 1995).

<sup>65</sup>Since the growth rate of output is necessarily equal to the investment-output ratio divided by the incremental capital-output ratio (ICOR), higher investment-output ratios will be associated with faster output growth unless the ICOR is at least commensurately higher (marginal productivity of capital lower). This relationship indicates also that raising the investment ratio may not boost growth if the capital stock added has a low productivity.

Ross Levine and David Renelt, "A Sensitivity Analysis of Cross-Country Growth Regressions," *American Economic Review*, Vol. 82

## Macroeconomic Stability

By reducing uncertainty, macroeconomic stability allows investment and saving decisions to be made in a manner consistent with underlying economic fundamentals, thereby promoting an efficient allocation of resources. Macroeconomic stability also boosts confidence, which can encourage domestic investment and the inflow of foreign capital. Over 1985-95, median inflation was about 8 percent a year and fiscal deficits about 2 percent of GDP among the fastest-growing developing countries, while in the slowest-growing economies median inflation was about 14 percent a year and budget deficits averaged about 6 percent of GDP (Table 19). Empirical studies using large samples of country experiences suggest that the effect of inflation on growth becomes increasingly negative as inflation rises through some range, which some researchers put in the neighborhood of 8 percent a year,

(September 1992), pp. 942-63, find that among a variety of economic policy, political, and national indicators, only the share of investment in GDP turns out to have a positive and robust correlation with growth.

### Box 9. Measuring Productivity Gains in East Asian Economies

In recent years, many economists have attempted to identify how much of the rapid economic growth in the East Asian region has been due to productivity growth and how much to the growth of factor inputs. These growth-accounting exercises have aimed to unearth the process underlying the impressive success stories of such economies as Hong Kong, Korea, Singapore, and Taiwan Province of China since the 1970s and Indonesia, Malaysia, and Thailand more recently. Identifying the growth process is important not only in evaluating the role played by policies but also in assessing the growth prospects of these economies and the lessons for others. However, largely as a result of the wide variety of accounting methodologies and empirical techniques, which are subject to a high degree of arbitrariness, little consensus has emerged regarding the relative importance of productivity growth vis-à-vis resource accumulation in accounting for the growth rates. While some studies find that almost all the growth in these countries can be attributed to unusually high rates of resource mobilization, leaving little to be explained by gains in productivity, others conclude that increases in productivity have been as high as 4 percent a year, thus accounting for a large proportion of output growth (*see table*).

To those who find little evidence of significant growth in factor productivity, the sustained high rates of output growth in the East Asian region are explained by the large increases in the use of inputs during the period.<sup>1</sup> They are more pessimistic about the prospects for continued growth in these countries at the high rates witnessed in the last two decades, since that would require continued high rates of resource mobilization, including the maintenance of domestic saving at over 30 percent of GDP and the availability of increasingly skilled labor. Others, however, are more optimistic about the future economic performance of these countries, given the evidence of productivity growth that they find, since if this continues, relatively high rates of output growth can be sustained even with lower rates of factor accumulation.

In general, a growth-accounting exercise deducts from output growth measured, for example, as the annual change in real GDP, a weighted average of the changes in aggregate physical and human capital and labor inputs and then interprets the residual as the growth of total factor productivity (TFP). There are two sets of problems associated with this approach that are at the root of the large variations in the estimates of productivity growth found in the various studies. Measures of the stock of aggregate physical capital are not only difficult to obtain but are also unreliable; they are generally constructed from his-

torical investment data, using simplifying and to some extent arbitrary assumptions about the quality and depreciation of capital. Proxies for human capital, such as the average number of years of schooling of the labor force, the proportion of the labor force with higher education, and so on, are not only largely arbitrary measures but they also fail fully to reflect cross-country differences in the quality of education. Similar data-related issues arise in measuring employment. Moreover, there is little uniformity in the classification and collection of such data across countries.

The second type of problem arises in determining the appropriate weight to attach to the growth of a factor in assessing its contribution to overall output growth. In principle, the weight should be the elasticity of output with respect to the factor concerned—that is, the proportionate increase in output when an additional unit of the particular factor is used in production. But this cannot be measured directly, and estimating it is not straightforward. For example, estimation using regression techniques generally suffers from the assumption that the weights are constant over the estimation period. In fact, however, the relative importance of different factors may well change over time, especially when an economy undergoes rapid transformation, as has been the case in the East Asian region. An alternative and more frequently used approach has been to approximate the output elasticity of a factor by its share in national income. This approximation is valid if factors are paid their marginal products; but this requires that there are no increasing returns to scale or externalities in the use of any factor, that technological progress is not embodied in factor inputs, and that all input and product markets are perfectly competitive. In fact, however, many industries are characterized by increasing returns, and factors such as human capital generate strong externalities. Furthermore, technological progress is often embodied in new inputs of capital and labor,<sup>2</sup> while the large profit markups<sup>3</sup> observed in some product markets do not support the assumption of perfect competition. In the presence of such markups in product markets, productivity growth, computed as the residual component of growth after the contributions of the different factors have been

<sup>2</sup>See Paul M. Romer, "Crazy Explanations for the Productivity Slowdown," *NBER Macroeconomics Annual*, 1987, ed. by Stanley Fischer (Cambridge, Massachusetts: MIT Press, 1987), pp. 163–203.

<sup>3</sup>There have been few studies that estimate markups for industries in the East Asian region. In industrial countries, which generally have a more competitive environment, in almost all industries markups are positive and large, for example, see Joaquim O. Martins, Stefano Scarpetta, and Dirk Pilat, "Mark-Up Ratios in Manufacturing Industries: Estimates for 14 OECD Countries," OECD Working Paper No. 162 (Paris: OECD, 1996).

<sup>1</sup>See Paul Krugman, "The Myth of Asia's Miracle," *Foreign Affairs*, Vol. 73 (November–December 1994), pp. 62–78.

### Selected Developing Countries and Newly Industrialized Economies in Asia: Estimates of Total Factor Productivity Growth

(In percent a year)

	Young (1995) 1966–90	Bosworth and Collins (1996) 1960–94	Bosworth and Collins (1996) 1984–94	Sarel (1995) 1975–90	Sarel (1996) 1979–96
Hong Kong	2.3	...	...	3.8	...
Korea	1.7	1.5	2.1	3.1	...
Singapore	0.2	1.5	3.1	1.9	2.5
Taiwan Province of China	2.6	2.0	2.8	3.5	...
Indonesia	...	0.8	0.9	...	0.9
Malaysia	...	0.9	1.4	...	2.0
Philippines	...	0.4	-0.9	...	-0.9
Thailand	...	1.8	3.3	...	2.0

Sources: Alwyn Young, "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *Quarterly Journal of Economics*, Vol. 110 (August 1995), pp. 641–80; Barry Bosworth and Susan M. Collins, "Economic Growth in East Asia: Accumulation Versus Assimilation," *Brookings Papers on Economic Activity*: 2 (1996), pp. 135–203; Michael Sarel, "Growth in East Asia: What We Can and What We Cannot Infer From It," IMF Working Paper 95/98 (September 1995); and Michael Sarel, "Growth and Productivity in ASEAN Economies," paper presented at the Conference on "Macroeconomic Issues Facing ASEAN Countries," held in Jakarta, Indonesia on November 6–8, 1996.

accounted for, can be overestimated. Moreover, empirical evidence indicates that the residual component of growth is also correlated with demand-side variables, such as monetary and fiscal policies,<sup>4</sup> so that interpreting the residual as purely productivity growth may be misleading. Also crucial is the time period for which the analysis is conducted. During periods of rapid growth, the average rate of TFP increase has been disproportionately higher than during low growth periods.<sup>5</sup> In sum, given the large degree of arbitrariness in measuring inputs and their effect on output and given the differences in the time periods for which the accounting exercises have been performed, it is not surprising that estimates of TFP growth for countries in East Asia vary enormously (*see table*).

The low rates of TFP growth in the fast-growing East Asian economies found in some studies contrast with the finding that it has been the main contributor to the output growth of the industrial countries in recent decades.<sup>6</sup> However, it may not be surprising if the relative importance of the different sources of growth changes in the

process of economic development. Economic growth in the nineteenth century in the United States appears to have been largely due to increases in inputs rather than productivity growth<sup>7</sup> as was the growth of the Japanese economy between the Meiji Restoration and World War I. The experiences of the more advanced economies suggest that the accumulation of physical capital is an important source of growth in the early stages of economic development, but that once a relatively high level of capital intensity (capital-to-labor ratio) is reached, technological progress takes over as the principal source of growth.<sup>8</sup> Capital intensities in the economies of the East Asian region, including even the newly industrialized economies, are still significantly lower than they were in the industrial countries in the early 1960s. Given these relatively low capital-to-labor ratios, there is still plenty of room for input-based growth among fast-growing countries in the region. Consequently, even if productivity gains may not have contributed as much to growth as some studies suggest, the future growth prospects of the East Asian economies remain bright, and both their rapid rates of accumulation of capital and the high levels of efficiency with which it has been allocated remain impressive accomplishments.

<sup>4</sup>See, for example, Charles L. Evans, "Productivity Shocks and Real Business Cycles," *Journal of Monetary Economics*, Vol. 29 (April 1992), pp. 191–208.

<sup>5</sup>See Arnold C. Harberger, "Reflections on Economic Growth in Asia and the Pacific," *Journal of Asian Economics*, Vol. 7, No. 3 (1996), pp. 365–92.

<sup>6</sup>See Barry Bosworth, Susan M. Collins, and Yu-Chin Chen, "Accounting for Differences in Economic Growth," *Brookings Discussion Papers on International Economics*, No. 115 (October 1995), pp. 1–630.

<sup>7</sup>Moses Abramovitz and Paul A. David, "Reinterpreting Economic Growth: Parables and Realities," *American Economic Review*, Vol. 63 (1973), pp. 428–39.

<sup>8</sup>See Lawrence J. Lau, "The Sources of East Asian Economic Growth," Stanford University Working Paper (Palo Alto, California: Stanford University: November 1996).

**Table 19. Developing Countries and Asian Newly Industrialized Economies: Policies and Economic Performance<sup>1</sup>**

	Low Growth <sup>2</sup>		Medium Growth		High Growth	
	1970-84	1985-95	1970-84	1985-95	1970-84	1985-95
<b>Initial conditions</b>						
GDP per capita in initial year <sup>3</sup>	1,697	2,185	2,266	2,188	1,776	2,734
Human capital <sup>4</sup>	2.2	3.3	3.2	3.8	3.5	5.4
<b>Macro conditions</b>						
Saving <sup>5</sup>	17.8	16.5	18.5	19.2	26.0	31.4
Investment <sup>5</sup>	19.0	19.4	22.1	21.1	27.4	31.9
Inflation rate per year (median)	11.0	14.1	10.9	11.1	11.3	7.8
<b>Fiscal conditions</b>						
Fiscal balances <sup>5</sup>	-5.7	-5.6	-4.2	-3.3	-2.0	-2.4
Government expenditure <sup>5</sup>	19.9	25.0	19.6	20.0	19.5	18.9
Government revenue <sup>5</sup>	14.2	19.4	15.4	16.7	17.6	16.5
<b>Monetary conditions</b>						
Money + quasi-money <sup>5</sup>	33.0	38.4	28.7	36.4	25.6	64.9
Quasi-money <sup>5</sup>	16.5	24.3	13.8	22.9	10.0	36.6
Bank credit to the private sector <sup>5</sup>	20.4	25.4	18.5	31.0	21.0	63.1
<b>International</b>						
Net private capital flows <sup>6</sup>	20.2	11.8	12.9	19.9	66.9	68.3
Balance on current account <sup>5</sup>	-1.0	-2.6	-3.7	-1.4	-1.9	0.3
Exports <sup>5</sup>	11.3	17.2	14.9	17.2	18.2	33.0
Imports <sup>5</sup>	12.2	17.7	17.4	18.1	19.5	32.4

<sup>1</sup>Excludes major oil exporting countries, Cyprus, and Malta.

<sup>2</sup>Low growth is defined as per capita real income growth of less than one-half of 1 percent a year, which is roughly the mean growth rate minus one-half of the standard deviation of growth in the sample for the specified period. Correspondingly, high growth refers to rates above the mean plus one-half of the standard deviation (2.9 percent).

<sup>3</sup>Group average in U.S. dollar terms, using purchasing power parity weights.

<sup>4</sup>Average schooling years in population aged 15 and over. See Robert J. Barro and Jong-Wha Lee, "International Measures of Schooling Years and Schooling Quality," *American Economic Review, Papers and Proceedings*, Vol. 86 (May 1996), pp. 218-23.

<sup>5</sup>In percent of GDP.

<sup>6</sup>In percent of total private capital flow to developing countries. Excludes Asian newly industrialized economies.

and that the relationship may be nonlinear.<sup>66</sup> During episodes of low-to-moderate inflation, the effect of marginally higher or lower inflation on growth may be small, but high rates of inflation tend to have significant, negative growth effects. Large and persistent budget deficits also may slow growth, because they tend to reduce the supply of loanable funds for the private sector and crowd out private investment. Among many examples, an extreme case is Argentina, where growth rebounded from -6 percent in 1989 to nearly 9 percent in 1993 during a period when annual inflation was reduced from a rate close to 5,000 percent to 18 percent. Although it is difficult to establish from the data a close relationship between large fiscal deficits and low growth, many countries that have ex-

perienced low growth have also had large fiscal deficits. Countries such as Chile and Uganda, where strong fiscal adjustments were undertaken during the 1980s to promote macroeconomic stability, saw output shift to markedly steeper paths.<sup>67</sup>

### Openness

Policies toward foreign trade are among the more important factors promoting economic growth and convergence in developing countries.<sup>68</sup> With open

<sup>67</sup>See May and October 1996 issues of the *World Economic Outlook* for a fuller discussion of the consequences of fiscal imbalances and inflation, respectively.

<sup>68</sup>Sachs and Warner, using their own openness indicator, claim that openness is the single most important factor in bringing about convergence. Dan Ben-David and Atiqur Rahman in "Technological Convergence and International Trade," Centre for Economic Policy Research Discussion Paper No. 1359 (London: CEPR, March 1996), find that among the richest 25 countries in the world there is significant evidence of absolute convergence within each country's main trading partners' group.

<sup>66</sup>See, for example, the October 1996 *World Economic Outlook*, pp. 120-22, and Michael Sarel, "Nonlinear Effects of Inflation on Economic Growth," *Staff Papers*, IMF, Vol. 43 (March 1996), pp. 199-215. Also see Michael Bruno and William Easterly, "Inflation Crises and Long-Run Growth," World Bank Working Paper No. 1517 (Washington: World Bank, September 1995).

trade, domestic prices reflect world prices, thereby promoting the efficient allocation of resources. Open trade and capital account policies not only allow a country to exploit its comparative advantages in production, but they also promote the importation of low-cost products, often with embedded advanced technology. Trade also allows a country to employ a larger variety of intermediate goods and capital equipment that enhance the productivity of its own resources. Such spillovers of advanced technology into developing countries provide a key mechanism for productivity catch-up with advanced economies.<sup>69</sup> The strong correlation between policies fostering trade openness and fast economic growth is evident in Table 19. Over the period 1985–95, the developing countries that achieved the fastest economic growth were the countries that as a group had the highest ratios of imports and exports to GDP. Medium- and low-growth countries had import and export ratios that were roughly half as large as the fast-growing countries. Chart 41 shows that the group of countries that substantially liberalized their trade over the period 1988–92 experienced a sharp pickup in both exports and imports, and a noticeable increase in their absolute income levels.

### Role of State-Owned Enterprises

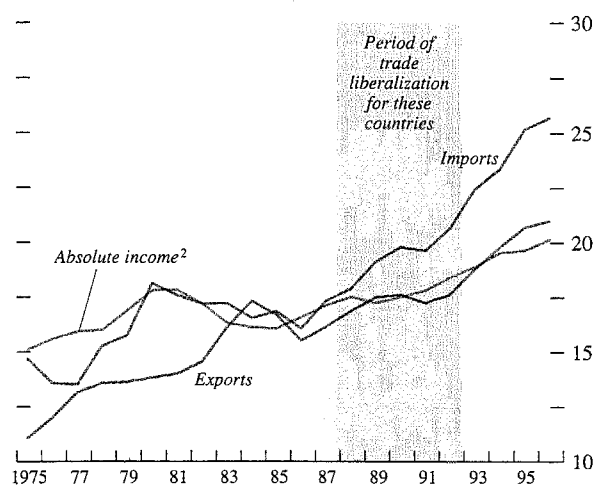
Excessive state intervention in the economy limits the role of the private sector in economic activity, and administrative controls in product and financial markets distort resource allocation. The result is often low investment and growth, and poor investment quality. Among many developing countries, the direct involvement of the state in economic activity is large and widespread, with state-owned enterprises (SOEs) having monopoly rights in a large number of sectors, including manufacturing and the financial sector (see Box 10). While SOEs in developing countries generated 11 percent of GDP on average in the period 1978–91, in industrial countries their involvement was limited to about 5 percent. In countries such as Ethiopia, Somalia, Sri Lanka, and Tanzania, the SOE share of manufacturing has been in excess of 30 percent.

While the public sector's share of the economy has been large in many of the poorer developing countries, many of the more successful developing countries also have had large shares of manufacturing under state control. However, there has been a significant reduction in the involvement of state-owned enterprises over the years in the more successful cases. For example, in Taiwan Province of China, the share of such enterprises in manufacturing output fell from 56 percent in 1952 to about 21 percent in 1970, and by 1990 was

**Chart 41. Selected Economies: Exports, Imports, and Per Capita Real Income<sup>1</sup>**

(Simple group averages; in percent of GDP, unless otherwise noted)

A group of countries that liberalized trade over the period 1988–92 has experienced a sharp pickup in both exports and imports and an increase in per capita income levels.



<sup>1</sup>Comprises Argentina, Brazil, China, India, Indonesia, Kenya, Mexico, the Philippines, Sri Lanka, Turkey, Uganda, and Uruguay. Among the countries that undertook major trade reforms in the period 1988–92, these were the 12 largest in terms of GDP.

<sup>2</sup>Percent of 1995 industrial country per capita GDP (in purchasing power parity terms).

<sup>69</sup>See David T. Coe, Elhanan Helpman, and Alexander W. Hoffmaister, "North-South R&D Spillovers," *Economic Journal*, Vol. 107 (January 1997), pp. 134–49.

**Box 10. Stabilization and Reform of Formerly Centrally Planned Developing Economies in East Asia**

Several countries in East Asia, including Cambodia, China, the Lao People's Democratic Republic, and Vietnam, while undergoing development, are also in the process of moving from central planning toward economic systems based largely on market principles.<sup>1</sup> The experience of these countries differs substantially from that of the group of transition countries considered in Chapter V, reflecting both differences in the structures of their economies and in the nature of the process of transformation being undertaken.<sup>2</sup>

Though these countries differ greatly in size of population, they share many similarities in terms of economic structure, notably a population that remains largely rural and predominantly employed in agriculture. In Cambodia, the Lao People's Democratic Republic, and Vietnam, although the share of industry is increasing, the economies remain dominated by a family-based, rather than collectivized, agricultural sector (*see table*). The private sector remained active throughout the period of central planning in these three countries, and state-owned industries generally accounted for a relatively small part of the economy. This contrasts with the transition countries of eastern Europe and the former Soviet Union, where urban-based industries typically employed the majority of workers and accounted for the largest part of output, and where state-owned enterprises constituted a dominant share of the economy before the transition. This is true even for Mongolia, which as a result of tight economic alignment with the former Soviet Union is characterized by an urbanized population and an industrial structure more similar to the transition countries than to other newly emerging market economies in Asia. In China, although the economy until recently remained largely rural and the workforce concentrated in agriculture, central planning was more deeply embedded than in the other East Asian countries, with virtually no private enterprise before the initiation of reforms.

The particular structural characteristics of the East Asian economies have led to substantial differences in the evolution of their economies as compared with the countries in transition. Most striking has been the absence of sharp output drops of the kind suffered by the transition countries, although growth did slow at the start

of reforms in each country and briefly turned negative in the Lao People's Democratic Republic. Output is now growing at annual rates of 7–10 percent in all four countries. The absence of large output drops reflects, to some extent, the low initial level of output in the East Asian countries, partly as a result of war and civil conflict. But it is also attributable partly to the less pervasive nature of the initial economic distortions and hence of the transformation. In the East Asian economies, the transformation has consisted primarily of relatively narrowly focused economic reforms without accompanying political and social changes, and partly as a result there has been much less uncertainty and short-term instability than in many of the transition countries. The smaller share of industry, particularly in terms of the labor force, and the relative absence of a capital-intensive manufacturing base further meant that the East Asian countries did not face the challenge of replacing a massive amount of capital suddenly made obsolete by the end of central planning. Instead, the transformation has involved the establishment of conditions that would permit a shift from agriculture to industry.

These countries were also less closely integrated into the trading arrangements of the former Council for Mutual Economic Assistance (CMEA), and thus did not suffer to the same degree as the other members from its collapse, although Cambodia, the Lao People's Democratic Republic, and Vietnam all experienced both losses of financial assistance from the former Soviet bloc and declines in their terms of trade as prices of imports from the transition countries, such as energy and raw materials, adjusted upward to market levels. This limited degree of integration into the trading system of the other former centrally planned economies is another factor setting the East Asian countries apart from the transition economies of central Asia, which were far more severely disrupted by the breakdown of intraregional flows of raw materials with the collapse of central planning. The East Asian countries also benefited to some degree from their geographical proximity to the newly industrialized and other fast-growing economies of the region, which has led to investment in joint ventures and wholly owned subsidiaries formed to take advantage of expanding markets and low wages.

The process of reform began in China in 1978, in the Lao People's Democratic Republic in 1979 with comprehensive reforms starting in 1986, in Vietnam in 1985 with comprehensive reform starting in 1989, and in Cambodia in the early 1990s. At the start of their reforms, Cambodia, Vietnam, and the Lao People's Democratic Republic had only recently emerged from isolation or war. Initial reforms in the East Asian countries broadly followed the Chinese model in being principally aimed at boosting productivity, particularly in agriculture where reforms such as the undoing of collectivization proceeded most rapidly. At the same time, non-state enterprises were allowed to expand by absorbing surplus labor from agriculture, while other reforms including the liberalization of regulations on joint ventures and foreign direct investment have been introduced more

<sup>1</sup>Myanmar has also taken some steps to reverse central planning; however, these reforms have so far been partial and have failed to achieve a fundamental transformation in the economic system.

<sup>2</sup>See John R. Dodsworth, Ajai Chopra, Chi D. Pham, and Hisanobu Shishido, "Macroeconomic Experiences of the Transition Economies in Indochina," IMF Working Paper 96/112 (October 1996) for an in-depth review of stabilizations in Vietnam, Cambodia, and the Lao People's Democratic Republic.; Eduardo Borensztein and Jonathan D. Ostry, "Accounting for China's Growth Performance," *American Economic Review*, Vol. 86 (May 1996), pp. 224–28 for a discussion of the effects of reforms on China; and Richard W.T. Pomfret, *Asian Economies in Transition: Reforming Centrally Planned Economies* (Cheltenham: Edward Elgar, 1996) for a broad overview of reforms across Asian countries.

### Comparison Between Developing Countries in East Asia Moving Away from Central Planning and Selected Transition Countries in Eastern Europe and the Former Soviet Union

	1993		1990		1994
	Share of GDP in		Share of Labor Force in		Percent Urban
	Agriculture	Industry	Agriculture	Industry	Population
<b>Developing countries moving away from central planning</b>					
Cambodia	51	...	74	7	20
China	20	48	72	15	29
Lao People's Democratic Republic	51	18	78	6	21
Vietnam	29	28	71	14	21
<b>Selected transition countries</b>					
Albania	40	13	55	23	37
Czech Republic	6	35	7	35	65
Moldova	35	48	33	30	51
Mongolia	21	46	32	22	60
Russia	9	51	14	42	73
Ukraine	35	47	20	40	70

Sources: World Bank, *World Development Report, 1996* and *Social Indicators of Development*.

gradually. Although productivity rose in agriculture as a result of the reforms, the striking difference between the share of the labor force in agriculture and the share of GDP produced by agriculture highlights the very low productivity levels in that sector, and thus the scope for continued industrialization. This remains particularly evident for China despite its head start in implementing reforms, possibly because its economy had been the most centralized, with the most distorted structure of production and prices.

A two-track system of prices has emerged in these countries, with controls on a narrow range of essential items, but prices of most goods (accounting for 80 to upward of 90 percent of prices at the retail level) now determined by market forces. In some countries, even before price liberalization, extensive informal markets fed by remittances from expatriates abroad and diverted export proceeds acted to reduce the price distortions of central planning.

In China, growth has risen significantly since the start of the reform progress, as increased productivity in agriculture and the employment of surplus rural labor in the nonstate manufacturing sector made possible fairly large increases in output. Reforms in agriculture that allowed farmers to benefit from harvests above specified levels met with an immediate supply response, though less progress has been made in boosting output in largely industrial state-owned enterprises, for which soft budget constraints and complex tax regulations continue to stifle incentives to raise productivity. Instead, the nonstate sector grew rapidly, particularly in coastal regions that benefited from foreign direct investment, which began in 1984 and surged in the early 1990s. Subsequent reforms have included trade liberalization, financial market reform including the establishment of offices by foreign banks, and exchange system liberalizations that culminated in convertibility for current account transactions in December 1996.

In Cambodia, the Lao People's Democratic Republic, and Vietnam, reforms were undertaken during periods in which monetization of large fiscal deficits led to sharp spikes in inflation, accompanied by extensive dollarization and widening gaps between official and informal exchange rates. Initial stabilization policies in all three countries comprised a mix of flexible exchange rates, trade liberalization, high interest rates, and reductions in government expenditures, particularly through cuts in subsidies to consumers and restrictions on soft credits to state-owned enterprises. Stabilizations from high inflation were largely money based, with steep expenditure cuts allowing reduced monetary expansion. Given the lack of resources, maintaining a stable exchange rate was not feasible at the start of the reforms; instead, official exchange rates were adjusted with increased frequency to track rates determined in parallel markets. Despite cuts in government expenditures, the boost in productivity that resulted from the reforms, particularly in the agricultural sector, served to maintain positive growth both before and throughout the macroeconomic stabilizations, while employment in the private industrial and service sectors rose rapidly during the early transition period and helped absorb workers released from the public sector.

Further market-oriented reforms are required to ensure continued growth that matches the potential of these countries. Following the success of their initial stabilizations, the newly emerging market economies of East Asia have each had to deal with the overheating problems that often accompany strong growth, including those associated with substantial inflows of foreign capital. Particularly important challenges for these countries are enhancing their infrastructure and developing modern banking systems, both of which will promote increased investment. Closer integration into the global economic and financial system will also promote further growth, including through increased trade.



down to 11 percent.<sup>70</sup> The SOE share of manufacturing output in China also has been dropping rapidly. However, the SOE share of financial resources remains large in China and could complicate macroeconomic policy and impede growth unless it is reduced quickly. Often state-owned enterprises are operated inefficiently, and despite their monopoly status they tend either to make low profits or to run persistent and large losses that burden government budgets. In India during 1989–94, for example, after-tax profits as a percent of total sales were roughly four times higher among private sector companies than in state-owned enterprises in comparable sectors.<sup>71</sup> Market-oriented structural reforms that limit state intervention to areas of genuine market failure (such as health, education, and infrastructure) and improve the efficiency of government may be expected to boost growth by reducing distortions and encouraging greater private sector participation.

### Financial Liberalization

The mobilization of savings and their efficient allocation among competing investment projects require stable financial markets with well-designed instruments. Studies using long-run data have found a stable and positive correlation between growth and indicators of financial development, and also between the initial level of financial sector maturity and subsequent growth.<sup>72</sup> Countries that suffer from low growth have typically been characterized by a significantly lower level of financial development, as indicated by the ratio of broad money to GDP, than high-growth economies (Table 19). Although the positive relationship between financial development and economic growth is likely to be the result of two-way causation, and while there have been cases where countries have experienced rapid development with only modest degrees of financial openness, limited development of financial markets and institutions is likely to be a severe obstacle to overall economic development.<sup>73</sup> Also, it is becoming increasingly clear that financial liberalization needs to be accompanied by strengthened regulation and supervision of finan-

cial institutions for an economy to derive the greatest benefits.

### Governance

How effective an economic reform package is in delivering higher growth and long-run prosperity often depends on the quality of governance in an economy. Definition of the concept of governance is far from straightforward, and judgments about its quality are subjective, but there are several facets on which there is some agreement. In many developing countries, a lack of transparency and accountability in public policymaking and excessive government intervention and regulation of economic activities have invited widespread rent-seeking behavior and corruption. Not only do weak governance and corruption tend to lower government tax revenue<sup>74</sup> and thereby both contribute to fiscal imbalances and reduce critical public investment in areas such as health and education, but they also deter both domestic and foreign direct investment. Inadequate protection of private property rights and a weak rule of law also have long been held to be critical obstacles to growth.<sup>75</sup> Reduced state intervention in economic affairs and greater transparency in regulatory policies can limit rent seeking and corruption and allow governments to focus on their essential tasks—of maintaining order and justice, of allocating public resources to priority uses, including investment in health and education, of helping to maintain macroeconomic stability, and of providing cost-effective and well-targeted social safety nets. While it is difficult to quantify the efficiency of governance and the extent of corruption, some studies based on rudimentary and somewhat subjective indicators suggest that weakness in these areas can have significant and lasting negative effects on growth.<sup>76</sup> Other studies using different proxies for the effectiveness of government, such as the quality of the bureaucracy (including its degree of autonomy from political pressure), expropriation risk, and so forth, have found little effect on growth.<sup>77</sup>

### Human Resource Policies: Education and Population Growth

Investment in education and human capital leads to the acquisition of skills that raise efficiency and make

<sup>70</sup>See James A. Schmitz Jr., “The Role Played by Public Enterprises: How Much Does It Differ Across Countries?” *Quarterly Review*, Federal Reserve Bank of Minneapolis, Vol. 20 (Spring 1996), pp. 2–15.

<sup>71</sup>See Omkar Goswami, “Whither Corporate Sector Reforms in India?” paper presented at the seminar on “Putting India on a High-Growth Path: The Macroeconomic Strategy and Key Structural Reform” organized by the IMF, and held in Washington on March 6, 1996.

<sup>72</sup>See Ross Levine, “Financial Development and Economic Growth: Views and Agenda,” World Bank Working Paper No. 1678 (Washington: World Bank, October 1996).

<sup>73</sup>Recent issues of the *World Economic Outlook*, especially the October 1996 *World Economic Outlook*, have discussed in detail the importance of financial development to the growth process.

<sup>74</sup>See Nadeem Ul Haque and Ratna Sahay, “Do Government Wage Cuts Close Budget Deficits? A Conceptual Framework for Developing Countries and Transition Economies,” IMF Working Paper 96/19 (February 1996).

<sup>75</sup>This argument was made in 1776 by Adam Smith in *The Wealth of Nations* (New York: The Modern Library, 1937), p. 862, and was recently stressed by Sachs and Warner, “Economic Convergence.”

<sup>76</sup>See Paolo Mauro, “The Effects of Corruption on Growth, Investment, and Government Expenditure,” IMF Working Paper 96/98 (September 1996).

<sup>77</sup>For further details, see Robert J. Barro and Xavier Sala-i-Martin, *Economic Growth* (New York: McGraw Hill 1995), pp. 439–40.

more widespread the use of existing technology, and also promotes new technological development. Reflecting such investment, the level of initial human capital in high-growth countries has been significantly higher than in less-successful countries (Table 19). More formal analysis also finds that the initial level of education, especially at the primary level, is an important determinant of subsequent growth.<sup>78</sup> However, few studies have found evidence of a strong positive impact of changes in the level of education on growth.<sup>79</sup> Higher education has been found to have a relatively strong positive impact on growth, and public spending on education as a share of GDP has been found to be strongly and positively related to growth. These findings suggest that the quality of education is important. Also, social factors, such as the nature of institutions in society, affect the pace of economic development in a country. The initial level of social development, of which the level of human capital is an important component, is also significantly related to subsequent growth in per capita income and productivity.<sup>80</sup>

Among many of the poorer countries, high growth rates of population have undermined efforts to increase the average levels of education and health. Although rapid population growth increases the labor force and raises the output capacity of an economy, cross-country analyses of long-run data have shown that population growth has a negative effect on the growth of per capita income.<sup>81</sup> In many countries, despite attempts to contain the growth of population, which have varied according to national culture and values, progress has been slow. In these cases, long-run economic and social development and the alleviation of poverty hinge critically on greater success in slowing the rate of population growth.

### Economic Convergence and the Importance of Policy Complementarities

While policies in all the areas discussed above can help promote the accumulation of physical and human capital and the development of technology, and thus help determine the growth performance of a country, a

few key policy areas seem particularly important. To study the effects of some of these policies on growth outcomes, a data set for 110 developing countries was compiled for the period 1985–95—a time period when the global integration process described earlier was in full swing. Data were collected on trade openness; the degree of macroeconomic stability, proxied by the standard deviation of the rate of inflation; and the degree of government intervention in the economy, proxied by the share of government spending in GDP, which although not the best measure of government intervention suffers less than others from data-related problems. Countries were scored as “high,” “medium,” or “low” in each of these categories with cutoff points determined by statistical criteria, though necessarily with some degree of arbitrariness.<sup>82</sup> Developing countries with average 1985–95 real per capita GDP growth rates of 2.9 percent or higher were classified as high-growth countries (e.g., Chile, Thailand, Uganda), those with growth rates between 0.5 percent and 2.9 percent a year were classified as medium-growth countries (e.g., Colombia, Morocco, Pakistan), and those with growth rates lower than 0.5 percent a year were classified as low-growth countries (e.g., Cameroon, Ecuador, Zambia) (Table 20). Altogether 28 percent of all developing countries were classified as high-growth countries, while 44 percent fell into the low-growth category.

Three general policy combination clusters emerged. Approximately one-fifth of all developing countries in the data set had closed economies, poor macroeconomic stability, and a large government—all the presumed least favorable policies. Another fifth of the countries were moderately open, with moderate macroeconomic stability and a medium-sized government. Another fifth of the countries can be described as highly open with moderate to high macroeconomic stability and a small to medium-sized government—the presumed best policies. As expected, there was found to be a strong overall correlation between policies and income growth performance: countries with open trade positions, a stable macroeconomy, and a relatively small government tended to show better growth outcomes than countries that were less open, less stable, and had larger governments.

Perhaps the most interesting finding is that not one of these desirable policies by itself seems to have been sufficient to ensure that a country had high growth. That is, good performance in one category, but mediocre or poor performance in the other two categories, appears to have been a recipe for low growth. For example, among countries with the most open trade stances, but with only low or medium macro stability and large or medium-sized governments, only

<sup>78</sup>Barro and Sala-i-Martin, *Economic Growth*, pp. 436.

<sup>79</sup>See, for example, Lant Pritchett, “Where Has All the Education Gone?” World Bank Policy Research Working Paper No. 1581 (Washington: World Bank, March 1996).

<sup>80</sup>See Jonathan Temple and Paul Johnson, “Social Capability and Economic Development,” Nuffield College Working Paper (Oxford, England: Nuffield College, July 1996). They use the Adelman-Morris index, which includes measures of the size of the agricultural sector, the extent of urbanization, social mobility, literacy, and mass communication to proxy the level of social development.

<sup>81</sup>For example, Levine and Renelt, “Sensitivity Analysis” report that a 1 percentage point increase in the growth rate of population reduces per capita GDP growth by roughly ½ of 1 percentage point. However, population growth and fertility may themselves be responsive to the rate of output growth.

<sup>82</sup>For all variables, the high category was defined as the mean value plus one-half of the standard deviation, or higher; the low category was the mean minus one-half of the standard deviation or lower; and the medium category included all values in between.

**Table 20. Developing Countries Including Asian Newly Industrialized Economies: Relationship Between Policies and Growth, 1985–95, and Conditional Probabilities of Success<sup>1</sup>**

(In percentage points)

	High Growth	Medium Growth	Low Growth	Number of Countries in Sample
	Percentage Distribution			
<b>Percentage of countries</b>	<b>28</b>	<b>28</b>	<b>44</b>	<b>110</b>
<b>Conditioning policies</b>				
High openness <sup>2</sup>	41	19	41	37
High macroeconomic stability <sup>3</sup>	41	32	27	41
Small government <sup>4</sup>	30	33	37	43
High openness with <i>at least</i> one other category being low and <i>at most</i> one other being medium	25	25	50	8
High macroeconomic stability with <i>at least</i> one other category being low and <i>at most</i> one other being medium	—	60	40	5
Small government with <i>at least</i> one other category being low and <i>at most</i> one other being medium	21	33	46	24
Low openness with <i>at least</i> one other category being high <sup>2</sup> and the other <i>at least</i> medium	19	43	38	21
Low macroeconomic stability with <i>at least</i> one other category being high and the other <i>at least</i> medium	—	—	100	1
Large government with <i>at least</i> one other category being high and the other <i>at least</i> medium	25	17	58	12
Policy combination with <i>at least</i> two categories being high <sup>2</sup> and the other medium	57	19	24	21

Source: Jahangir Aziz and Robert Wescott, "The Washington Consensus and Policy Complementarities in Developing Countries," IMF Working Paper (forthcoming).

<sup>1</sup>High-growth countries were the ones with average per capita real growth rates of 2.9 percent or higher over the period 1985–95, while the low-growth countries were the ones with average growth rates below ½ of 1 percent. For all variables, the high and low cutoff points were determined as mean plus one-half standard deviation and mean minus one-half standard deviation of the respective distributions.

<sup>2</sup>Openness is measured by the ratio of total foreign trade to GDP. A high degree of openness is defined as the case where the average of exports and imports as a percent of GDP is higher than 45 percent, while in the case of low openness it is lower than 27 percent.

<sup>3</sup>Macroeconomic stability is measured by the standard deviation of the rate of inflation in the period. Low macroeconomic stability was defined as having a standard deviation of inflation higher than 19 while high stability required a standard deviation of less than 5.

<sup>4</sup>Size of government is measured by the ratio of government expenditure to GDP. A large government is categorized as one with public expenditure of the central government above 38 percent of GDP, and a small government is one with less than 23 percent of GDP.

about one-fourth experienced high growth and about one-half low growth. Likewise, of the 24 countries that had the smallest size of government, but low or medium openness and stability, only about one-fifth achieved high growth, and about one-half posted low growth. Along a single policy dimension, the probability of failure in the case of high openness was just as high as in the case of a small government (Table 20).

The analysis also suggests that poor performance in one policy area can hold an economy back, even if other policies are favorable. To illustrate this necessity of comprehensively good policies, consider the countries that had medium or high macro stability and small or medium-sized governments, but low openness: only one in five had fast growth, and twice that

fraction—two in five—had slow growth. Or, of countries with medium or high openness and stability, but an undesirably large government, fewer than one-third experienced fast growth, while nearly two out of three experienced low growth.

The key lesson that emerges is that no policy by itself is sufficient for fast growth, and that at least a moderate degree of policy success is necessary in several areas to support fast growth.<sup>83</sup> That is, good poli-

<sup>83</sup>This conclusion differs from that drawn by Sachs and Warner, "Economic Convergence." These authors test for the effectiveness of various policies in promoting higher-than-average economic growth and conclude that an open trade stance and protection of private property rights together are sufficient for fast growth.

cies tend to be mutually reinforcing and policy complementarities are important. For example, in a relatively open economy, financial markets may punish bad macroeconomic policies and reward good policies more vigorously than they would in a closed economy. To illustrate the importance of these complementarities, the developing countries with either medium or high degrees of success in all three policy areas had a three in five chance of achieving fast growth over 1985–95, and a better than three in four probability of either medium or fast growth (17 out of 21 such countries in the sample). Fewer than one out of four of these countries had low growth.

This simple analysis does not suggest an ironclad relationship between good policies and good growth outcomes, and certainly there are exceptions to the rule reflecting the influence of many other factors (social and institutional factors, resource endowments, and so forth) that also exert a strong influence on growth. Uruguay, for example, had low trade openness and only moderate macroeconomic stability over 1985–95, and yet experienced relatively fast economic growth. Other countries, such as Botswana, have experienced relatively fast growth despite having a large government sector. Rather this analysis suggests that for most of the 110 developing countries in the data set over 1985–95, the goal of fast income growth was most likely to be achieved by pursuing market-oriented policies (trade openness and small to medium-sized governments) in an environment of macroeconomic stability.

### Reaping Gains from Globalization and Avoiding Marginalization

For countries with relatively strong fundamentals and the types of policies that the above analysis suggests are conducive to growth, openness has helped to speed up the convergence process. Malaysia and Thailand are examples of countries with these characteristics. The policy challenge for these countries is to safeguard their gains by maintaining a market-oriented policy stance, maintaining macroeconomic stability, and improving infrastructure and the supply of skilled labor so as to ease supply constraints in the economy. Overheating pressures often have been a consequence of strong capital inflows, and experience shows that although capital inflows can supplement domestic saving and contribute to strong economic performance, without appropriate policies or in the presence of large exogenous shocks such flows can raise a country's vulnerability to external and domestic financial disturbances. This was seen in the Mexican crisis, and it underscores again the importance of maintaining macroeconomic and financial stability, with a sustainable balance of payments. In addition, a scarcity of skilled labor can boost wage growth, erode external competi-

tiveness, and fuel inflationary pressures. This suggests that labor market reforms may also be necessary to ease such capacity constraints.

Countries should also aim to let domestic investors diversify their portfolios internationally, to reduce their risks and also to help prevent price bubbles in real estate and other domestic asset markets. In this respect, a gradual and cautious removal of capital controls within the framework of policies to promote a sound domestic banking system, along with an exchange rate policy that permits an appropriate degree of flexibility, will lessen the burden on fiscal adjustment and provide a better balance among policy instruments through a more developed financial sector. Additionally, many countries, such as China, Thailand, and Malaysia, are experiencing rapidly growing demands for transportation and other public facilities. Private sector participation in these areas, as employed in Malaysia (port facilities), the Philippines (power supply), and Chile (public utilities), can supplement government efforts to alleviate supply bottlenecks without burdening public finances excessively.

### Policies for Avoiding Marginalization

Many of the countries near the bottom of the world's distribution of per capita incomes face difficult conditions, such as low stocks of human capital, poor resource bases, and political instability—including civil wars and regional conflicts that have acted to deter investment and growth. Many of these countries also suffer from high levels of public debt, including external debt, that was accumulated over years of poor fiscal management, commodity price shocks, macroeconomic instability, and poor governance. Still, a number of developing countries have overcome such obstacles, and there has been a resurgence of GDP growth in many countries where macroeconomic and structural reforms have been undertaken since the early 1990s. Between 1990 and 1995, the number of countries in sub-Saharan Africa with rates of real GDP growth greater than 4 percent increased steadily from 14 to 25, just as the number of countries with negative growth declined from 18 to 9. Uganda, which has implemented far-reaching reforms since the late 1980s, has been closing the gap with advanced economy income levels in the 1990s, and India has experienced average growth of 7 percent in 1995 and 1996, reflecting the effects of the liberalization program that started in 1992. Vietnam had an average real per capita income in 1990 of less than 1 percent of advanced economy levels but has been growing at more than 7 percent a year in real per capita terms aided by continued macroeconomic and structural reforms. Still, given the low levels of per capita income in such developing countries, relatively high growth rates will need to be sustained for many

years to close the gap with the advanced economies (see Table 18).

As the above analysis of policy complementarities suggests, a successful strategy for growth requires openness toward international trade, macroeconomic stability, and limited government intervention in the economy.<sup>84</sup> Protectionist trade policies, such as high tariffs and widespread nontariff barriers, clearly have obstructed the integration of many countries into the world economy. In sub-Saharan African countries, for example, tariffs average about 27 percent compared with 15 percent among the East Asian countries, and the average nontariff barrier coverage ratio is many times higher than in the world's fastest-growing developing country group. At least partly because of such policies, the sub-Saharan African share of world trade fell from roughly 3 percent in the mid-1950s to just over 1 percent in 1995. And in recent years, this region has been attracting only about 3 percent of the total foreign direct investment in developing countries. With the phased reductions in nontariff barriers under the Uruguay Round agreements, many of the low-income countries will also need to improve the competitiveness of their exports, which have enjoyed preferential treatment in the past.

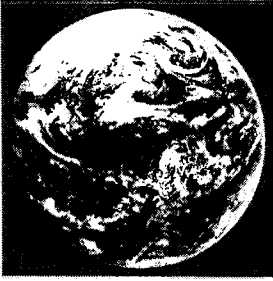
In addition to becoming more open, poor countries also need to reform government operations. These countries have great needs in the areas of health, education, and infrastructure, but government spending has been channeled too heavily into defense (at least until recently), into subsidies for loss-making and in-

efficient state enterprises, and into inefficient public administration. Spending needs to be rechanneled into more socially beneficial uses, and especially where international aid is available, project implementation needs to be improved. Governments in these countries also need to reform their revenue systems. In many countries, practices of arbitrary exemptions and weak enforcement have, in effect, led to the imposition of high tax rates on narrow tax bases. The result is that sectors that are subject to taxes have a strong incentive to evade them. To finance large fiscal deficits, many of these governments have resorted to financial repression, which has thwarted the development of financial markets, and to direct monetization, which has fueled inflation; and many have borrowed heavily in their small domestic capital markets, crowding out private investment and increasing public debt. These policies have fueled inflation and increased macroeconomic instability.

Many poor countries have accumulated large stocks of external debt, including debt owed to multilateral agencies. To address the debt problems of the heavily indebted poor countries, a joint initiative has been launched by the IMF and the World Bank that will provide special assistance to the countries that have followed sound policies but for whom traditional debt-relief mechanisms have failed to secure a sustainable external position (see Chapter II).<sup>85</sup> As many poor and formerly poor developing countries have demonstrated, the mutually reinforcing benefits of a return to external viability, greater international openness, domestic macroeconomic stability, and good governance with priority-based government spending can generate higher growth rates and rapid convergence.

<sup>84</sup>William Easterly and Ross Levine, "Africa's Growth Tragedy: A Retrospective, 1960-89," World Bank Working Paper No. 1503 (Washington: World Bank, August 1995), however, find that in addition to government intervention, political instability and spillovers between neighboring countries' economic performances are significant in explaining low growth.

<sup>85</sup>For further details on the Highly Indebted Poor Countries (HIPC) Initiative and the debt burden of these countries, see the October 1996 *World Economic Outlook*, pp. 74-76.



# V

## Integration of the Transition Countries into the Global Economy

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

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

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

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

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

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

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

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

Sources: European Bank for Reconstruction and Development (EBRD); and IMF staff estimates.

<sup>1</sup>Simple average of the EBRD *Transition Report's* nine indicators of progress in transition.

<sup>2</sup>Formal acceptance of the obligations of Article VIII of the IMF's Articles of Agreement generally represents the culmination of a process of liberalization of payments for current account transactions. Liberalization therefore usually preceded to a substantial extent the dates shown.

<sup>3</sup>Ratio of the average of exports and imports to GDP in 1996.

<sup>4</sup>IG denotes investment grade, SIG sub-investment grade; see Table 25.

<sup>5</sup>Cumulative 1991-96 per capita inflows in U.S. dollars; see Table 26.

<sup>6</sup>The allocation of transition countries to these two groups is an imperfect simplification, since the degrees of progress by different countries are closer to a continuum.

<sup>7</sup>The authorities in Estonia have deliberately not sought a credit rating.

<sup>8</sup>There are no transition indicators available for Mongolia.

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

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

## Liberalization of Trade and Payments

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

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

### Currency and Payments Arrangements

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

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

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

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

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

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

### Trade Liberalization

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



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

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

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

## Revival and Reorientation of Trade

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

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

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

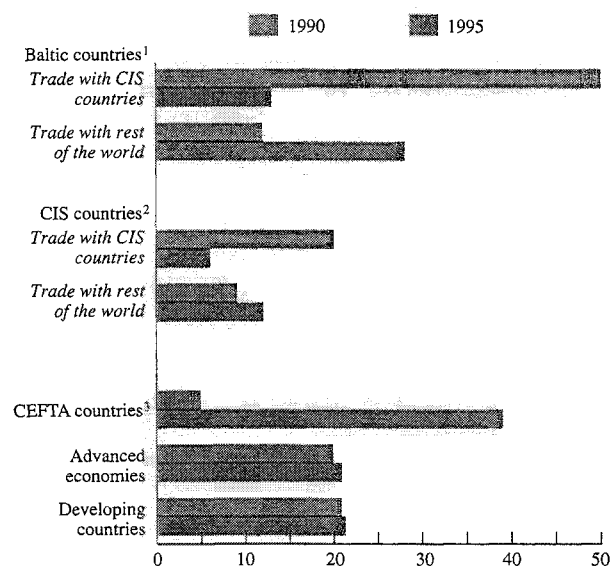
The Baltic countries rapidly liberalized trade, except for agriculture, which remains protected in Latvia and Lithuania, and have both removed state involvement and substantially reoriented trade toward the industrial countries. Although Russia remains the first or second largest trading partner for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

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

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

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

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



<sup>1</sup>Estonia, Latvia, and Lithuania.

<sup>2</sup>The Commonwealth of Independent States comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

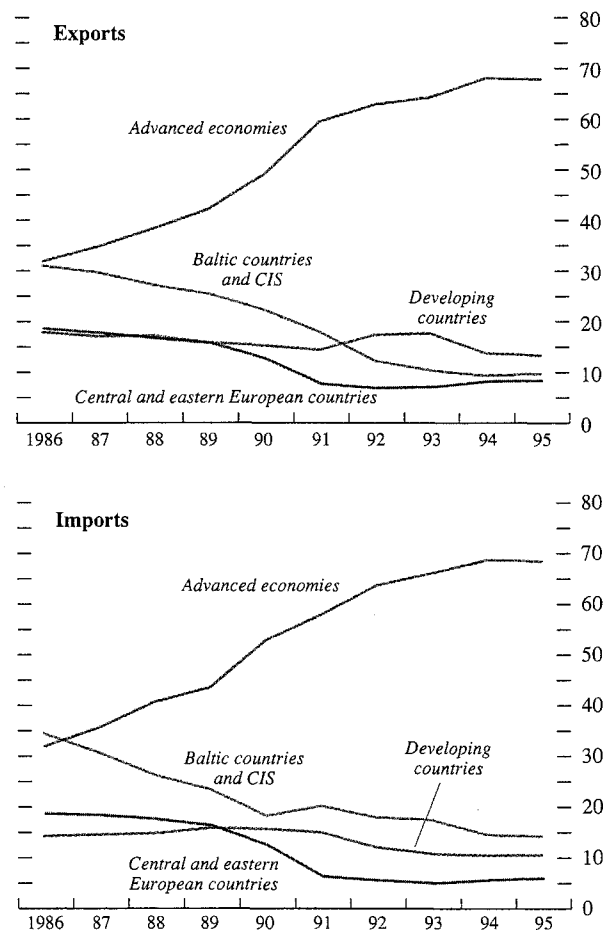
<sup>3</sup>The central European free trade area comprises Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.

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

**Chart 43. Central and Eastern European Countries:  
Composition of Trade by Partner**

(In percent of total trade)

The transition countries have reoriented trade to the advanced economies.



Note: CIS denotes Commonwealth of Independent States.

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

### Expansion of Trade: Prerequisites and Consequences

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

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

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

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

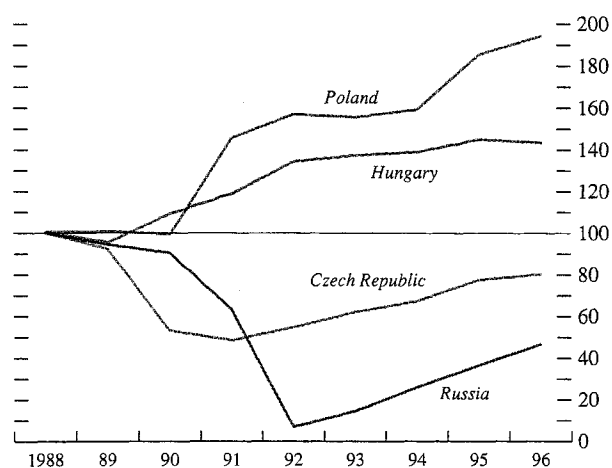
### Wages and Competitiveness

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

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

**Chart 44. Selected Countries in Transition: Real Exchange Rates vis-à-vis U.S. Dollar<sup>1</sup>**  
(1988 = 100)

Most transition countries have experienced real appreciations following macroeconomic stabilization.



<sup>1</sup>In terms of relative consumer prices.

<sup>90</sup>Coe, Helpman, and Hoffmaister, "North-South R&D Spillovers."

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

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

Source: OECD, *Short-Term Economic Indicators: Transition Countries*.<sup>1</sup>Based on data for the first half of 1996.

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

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

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

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

### Progress with Financial Integration

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

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

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

more than 35 percent and more than 43 percent, respectively, in interstate trade between 1990 and 1994.<sup>94</sup>

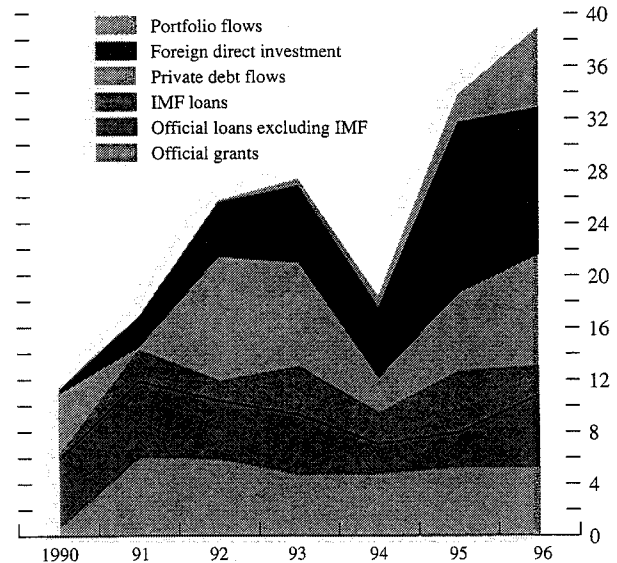
From the outset of the transformation process, it was recognized that the financing needs of the transition economies could not be met solely by private financial markets. The IMF and the World Bank Group assumed central roles in organizing the efforts to mobilize official financial support, including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

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

**Chart 45. Countries in Transition: Medium- to Long-Term Net Financial Flows**

(In billions of U.S. dollars)

The share of private financing is increasing.



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

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

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

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

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

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

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

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

### The Increasing Role of Private Financing

Many transition economies have gained substantial access to private financing. As macroeconomic stabilization has typically involved a combination of high domestic interest rates and broadly stable nominal

exchange rates, private financing initially took mainly the form of short-term flows, including repatriated flight capital. Such inflows were often substantial compared with the size of the economy, posing considerable challenges for monetary policy.<sup>98</sup> The

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

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

### International Lending and Bond Markets

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

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

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

The agreements with the London and Paris Clubs and other creditors, together with growth in export revenues, have put most transition economies in a po-

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

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

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

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



### Box 11. Normalizing the Transition Countries' Creditor Relations

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

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

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

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

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

an agreement on the rescheduling of uninsured commercial debt owed by the former Soviet Union.<sup>2</sup>

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

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

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

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

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

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

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

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

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

### Role of Foreign Direct Investment

Foreign direct investment (FDI) can potentially play a vital role in the transformation process. The countries in transition need substantial fixed investment, as they inherited an obsolete fixed capital stock and an inadequate infrastructure. From a macroeconomic point of view, foreign direct investment complements domestic saving and contributes to total investment in the economy without adding to the external debt burden. Moreover, it has the advantage of usually bringing with it advanced technology, management, and

marketing skills, as well as access to export markets.<sup>101</sup> However, uncertainties regarding property rights and the legal and fiscal environment in which businesses can operate naturally tend to deter foreign direct investment. Reflecting such uncertainties, FDI flows into many transition economies have remained relatively small and often directed at local markets. As the economic transition progresses, foreign direct investment may be expected to gain in prominence and to become more diversified and export oriented.

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

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

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

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

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

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

<sup>1</sup>January–March 1997.

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

<sup>3</sup>The country risk rankings are based upon weighted scores of analytical, credit, and market access indicators in nine categories.

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

The geographical and sectoral distribution of foreign direct investment in the early years of the transformation has been uneven. In terms of destination, the central and eastern European and Baltic countries attracted more than 70 percent of the cumulative foreign direct investment inflows into the transition economies during the 1991–96 period, with Hungary and the Czech Republic alone accounting for close to 50 percent of total inflows. On average, per capita FDI received by the CIS countries was less than 15 percent of the inflows into the central and eastern European and Baltic countries (Table 26). In terms of countries of origin, Austria, Germany, and the United States have been the main investors, accounting for more

than two-thirds of the investment into the transition economies in 1994 and for almost two-thirds of the cumulative investment inflow in 1988–94. Austria and Germany are also the advanced economies with the highest shares of foreign direct investment in transition countries relative to other destinations. In terms of sectoral composition, finally, data through 1994 indicate that a large share of foreign direct investment in the early years of the transition was placed in sectors mainly oriented toward supplying the domestic market, such as the trade and distribution sectors, and, within manufacturing, the food-, beverage-, and tobacco-processing industries.<sup>103</sup>

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

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

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

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

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

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

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

<sup>1</sup>Cumulative 1991–96 per capita inflows in U.S. dollars.

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

#### Foreign Investment in Domestic Securities and Equity Placements

Foreign investment in domestic securities and international equity placements in the form of depository

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

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

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

### Box 12. Foreign Direct Investment Strategies in Hungary and Kazakhstan

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

Hungary's leading position among transition countries in attracting FDI is rooted in the early start and strong outward orientation of its transformation process. The country liberalized prices, foreign trade, and foreign participation in companies ahead of other transition economies and created a stable and transparent legal framework for FDI early in the transition, following the adoption of a new investment law in 1988. Having already developed strong business relationships with western companies and enhanced its creditworthiness by meeting its debt-service obligations, Hungary adopted a general policy of promoting greater foreign participation in the domestic economy. The 1989 privatization program, which involved selling medium- and large-sized state enterprises to foreign investors, was a central element of this outward-looking policy and acted as a major stimulus for FDI inflows, which surged from \$300 million in 1990 to \$2.3 billion in 1993.<sup>1</sup> Following a slowdown of privatization and FDI inflows in 1994, a revised privatization program was adopted in May 1995 aimed at selling large enterprises in the energy, financial, and infrastructure sectors to foreign investors; as a result, about 95 percent of 1995 privatization revenues were

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

in foreign currency, and FDI peaked at more than \$4 billion compared with little more than \$1 billion in the previous year. Companies with foreign participation have begun to play a role in the Hungarian economy similar to that in smaller western European countries. Such enterprises now form a very dynamic part of the economy in terms of investment and output performance and account for well over half of the country's exports. According to the Hungarian Privatization Research Institute, at the end of 1996 more than two-thirds of the country's 200 largest companies had foreign participation; foreign investors hold majority stakes in the utilities and banking sectors.

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

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

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

ment has announced a further liberalization of foreign access.

Foreign investment in equities, which remained modest until 1995, surged in a number of countries in 1996. Nonresident investors now account for substantial shares of stock market holdings and turnover in the Czech Republic, Hungary, Poland, and Russia and have contributed to very sharp increases in stock market prices in 1996; stock market indices, computed in U.S. dollar terms, rose by almost 100 percent in

Budapest, by more than 70 percent in Warsaw, and by more than 150 percent in Moscow. The Hungarian and Polish markets have been included in the International Finance Corporation's investable country indices for emerging markets since 1993, the Czech market since 1995, and the Russian and Slovak markets since February 1997. By the end of 1996, eight more transition economies had functioning stock markets; most of them, however, are still small and fairly illiquid and have not yet attracted strong foreign interest.

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

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

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

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

around 40 percent of FDI was absorbed by enterprises managed by foreign companies, and the share of these enterprises in total exports may have been similar to that in Hungary.

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

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

In light of the practical problems and risks involved in investing directly in the stock markets of the transition countries, corporations in these economies have started to organize international equity placements in the form of American or global depository receipts.<sup>107</sup>

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

Corporations from four transition economies made depository receipt placements of around \$300 million in 1994, with Hungarian companies accounting for the bulk of this activity. This amount was doubled in 1995, and the issuer base was broadened to three more countries. Mainly because of activity by Russian companies, which were authorized to place American depository receipts in September 1995, placements again doubled in 1996, including issues by major Russian energy producers Gazprom and Lukoil.

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

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

### Regional Integration Initiatives

While making efforts to integrate further into the world economy, most transition economies have at the same time opted for new forms of regional coopera-

tion. In addition to a number of new regional arrangements and institutions, two major integration initiatives are under way: 10 central and eastern European and Baltic countries are making efforts to gain admission to the EU, while 12 newly independent countries of the former Soviet Union have been trying to promote economic and financial cooperation within the framework of the CIS.

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

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

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

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

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

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

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

\* \* \*

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

Countries that have delayed stabilization and reform efforts still have little prospect of receiving significant private financing in the near future.

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





## Annex

# Globalization in Historical Perspective

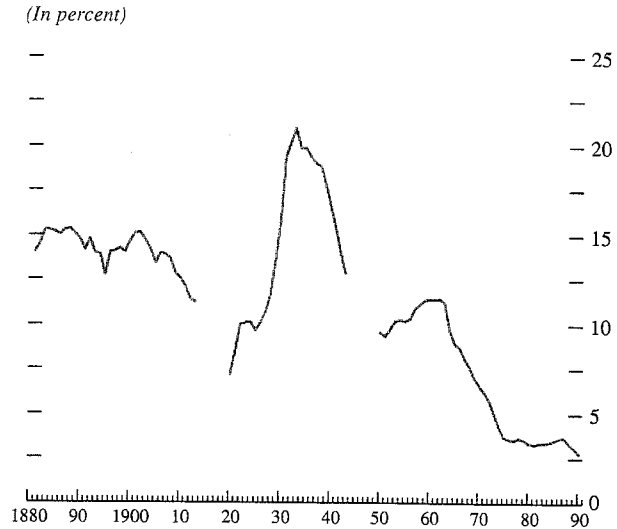
The post-World War II phenomenon of globalization—the increasingly close international integration of markets both for goods and services, and for capital—may in many ways be viewed as a resumption of a trend observed in the world economy a century ago. By some measures, international economic integration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

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

### International Trade

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

Chart 46. Advanced Economies:  
Effective Tariff Rates



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

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

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

<sup>1</sup>Paul Baïroch and Richard Kozul-Wright, “Globalization Myths: Some Historical Reflections on Integration, Industrialization, and Growth in the World Economy,” United Nations Conference on Trade and Development Discussion Paper No. 113 (March 1996), p. 5.

steamships.<sup>2</sup> The period also witnessed a marked convergence of commodity prices across countries.<sup>3</sup>

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

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

The outbreak of World War I led to a series of quantitative restrictions on trade by the belligerents. After the war, many countries reduced their restrictions but substituted tariffs instead. A renewed movement to-

ward liberalization under the Gold Exchange Standard (1925–31) ended with the Great Depression. In the face of plummeting agricultural prices a number of countries raised tariffs in 1929. In June 1930, the United States passed the Smoot-Hawley tariff, which raised duties on imports by 23 percent; most countries retaliated. In addition to tariffs, countries instituted quantitative restrictions and other trade barriers in an attempt to stimulate their economies.

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

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

## Capital Market Integration

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

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

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

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

<sup>5</sup>See Irwin, "Multilateral and Bilateral Trade Policies."

<sup>6</sup>Ibid.

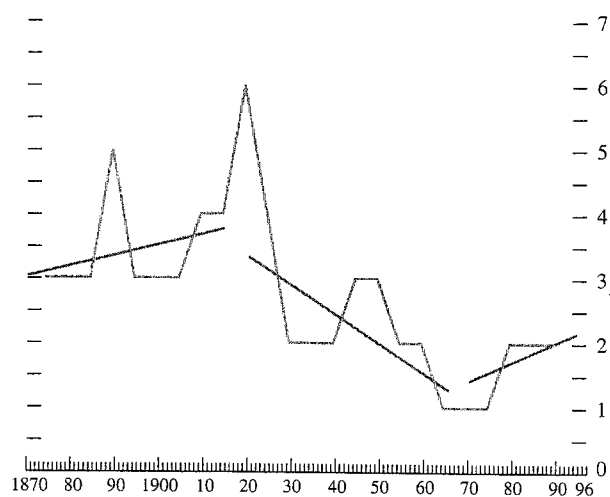
<sup>7</sup>Forrest Capie, "Tariff Protection and Economic Performance in the Nineteenth Century," in *Policy and Performance in International Trade*, ed. by J. Black and L.A. Winters (New York: St. Martin's Press, 1983).

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

<sup>9</sup>See Bairoch and Kozul-Wright, "Globalization Myths."

**Chart 47. Selected Countries:  
External Capital Flows<sup>1</sup>**

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



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

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

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

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

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

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

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

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

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

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

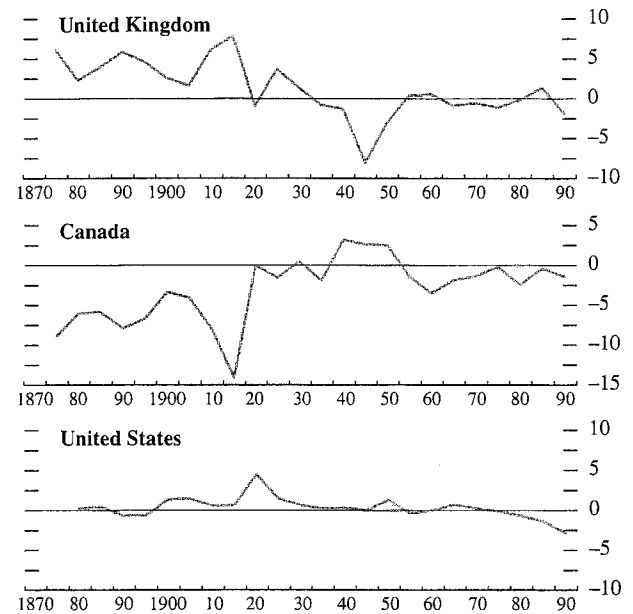
<sup>14</sup>This perception was strongly influenced by Ragnar Nurkse's study for the League of Nations, *International Currency Experience* (Princeton, New Jersey: League of Nations, 1944).

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

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

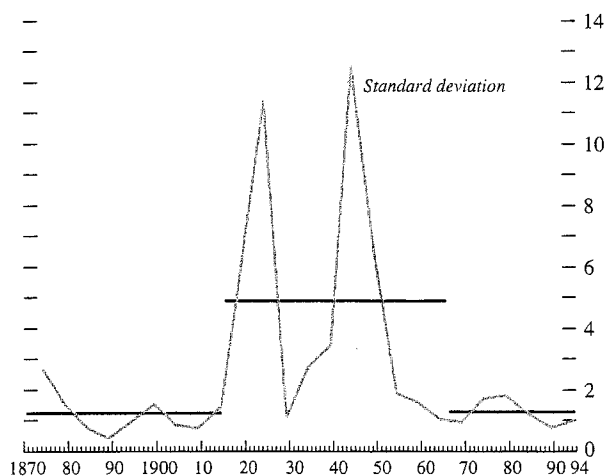
**Chart 48. Selected Major Industrial Countries: Current Account Balances**

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



**Chart 49. Selected Countries: Dispersion of Real Interest Rates<sup>1</sup>**

(In percent)



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

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

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

Free capital mobility was incompatible with monetary policy independence under the interwar gold

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

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