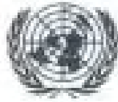

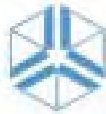

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World Development Studies 13

Aspects of Transition

Edited by Harriet Matejka and Mihály Simai

August 1999

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Development Economics Research
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Aspects of Transition

Edited by
Harriet Matejka and Mihály Simai

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FOREWORD

The essays in this volume all address the core problem of the form, pace and character of the relationship that is evolving between the general world trading system and the countries of Eastern and Central Europe and the former Soviet Union. They approach this question from diverse analytical perspectives, in some cases looking to historical examples of the dissolution of other economic-political systems. In other cases the focus is on the analysis of comparative performance in the transition period itself. Others address the specific policy and conduct of various international entities, in particular the IMF and the World Bank, but also the specialized agencies such as UNDP, UNICEF and FAO.

These studies are united in a healthy skepticism that such a 'transition' or 'transformation' process is automatic or self-guiding. They point to the need to understand the relationship of these countries with the emerging world system in light of the way in which the special features, conditions and attitudes—the 'heritage' of the old system—influence their on-going behaviour and performance. The simultaneous external reintegration into the world market and internal creation of a viable, sustainable democratic market economy are daunting tasks, especially when access to western export markets is limited and international entities expect the transition economies to open their internal markets as a token of their good faith in moving toward open, market-controlled systems.

Several authors call for special regimes to make the entry of the transition economies into the world trading system less traumatic and reduce the chances of major economic set-backs which could have politically dangerous implications. The prolongation of the Russian economic collapse (and its intensification after the failed recovery in 1996-8), the continued crisis in Ukraine and many other states of the former Soviet Union, and even the recession in the Czech Republic, all point to the continuing nature of the problems and the still unanswered need for a workable policy framework.

Many UNU/WIDER studies have played a role in the now more than a decade long debate over the usefulness of transition policies taking inspiration from the Washington Consensus. The papers in this volume play an important role in this on-going dialogue, and as such I strongly recommend them to scholars and policymakers interested in the debate.

Giovanni Andrea Cornia
Director, UNU/WIDER
August 1999

ABSTRACT

The six studies, selected from those contributed to the research project entitled *The Integration of the New Market Economies of Europe and Asia into the World Economy: the Changing Internal and External Factors and Global Implications,* open with Mihály Simai's introductory survey. After identifying the enterprise and listing its participants, he discusses the themes of the project, emphasizes the lessons to be drawn from Chinese experience, and interweaves his analysis with a description of eastern European, and particularly, Hungarian, reactions to the process of transition and its social cost.

The next three studies are devoted to the international organizations and their response to the transition. Norman Scott discusses and assesses UN assistance. He focuses on the United Nations' Economic Commission for Europe and describes its attempt, and failure, to be entrusted with the administration of a new Marshall Plan designed for eastern Europe and resting, in contrast to the original, on the technical assistance needed to establish a market economy, rather than on grant aid. Reimut Jochimsen considers the role of the IMF, presents its action in support of the transition economies in detail, and concludes that macroeconomic assistance and adherence to the Washington consensus are insufficient. He recommends that greater emphasis be put on the microeconomic foundations of the market economy and on the creation of market institutions. Peter Naray considers the transition economies in the Uruguay Round and the WTO. He discusses the expected benefits of the Round for the central and eastern European countries, seeks to explain, and draws attention to, the few provisions introduced in the WTO agreements in favour of the transition economies, and convincingly pleads for special transition solutions to promote the accession of the majority of transition economies still waiting to become members of the organization.

The final two studies, written by Max Engman and by Harriet Matejka, depict the stark contrast between Europe as it emerged after the First World War and the collapse of two empires, and Europe as it revives following the end of the Cold War, the division imposed upon it at Yalta, and the fall of the Soviet empire. Although the creation of new states, with its train of territorial, monetary and institutional change, are common to both periods, division and the segmentation of markets was the mark of the first. What singles out the second, instead, is transcontinental integration, together with the transition from plan to market in the East. Max Engman discusses the period following the First World War and compares it with the post 1989 years. Harriet Matejka considers the impact of transition on the trade, investment and integration of the European continent.

CHAPTER 1

THE TRANSITION ECONOMIES, CHINA, VIETNAM: INTEGRATION INTO THE GLOBAL MARKETS

Mihály Simai

> *...it seems to me that the fate of the so-called west is today being decided in the so-called East. If the west does not find a key to us, who were once violently separated from the west (with no great resistance on its part), or to those who somewhere far away have likewise extricated themselves from communist domination, it will ultimately lose the key to itself. If its own consumer affluence remains more important for it than all the foundations of that affluence, it will soon forfeit that affluence.*[1]
>
> *I would venture that among the next countries to burst upon the global economy will be a number of the transition economies, . . . In many cases, we will no longer think of these countries as 'transition economies,' for the 'transition' as such, will be over.*[2]

1.1 Introduction

The national socioeconomic background of the reintegration into the global markets in central and eastern Europe is the transition process to a democratic market economy. In the social sciences the concepts, causes, consequences and the manageability of social change, including systemic transition, occupy an important place.[3] Karl Polanyi in his analysis of the European modernization process introduced a concept of transition in the context of the industrial society of the 19th century. In spite of the fact, that he was focusing mainly on the internal aspects and consequences of the process, his analysis may still offer interesting analogies in the end century world, for the former socialist countries (Polanyi, 1944). Transition, according to Polanyi, is made necessary by the breakdown or the serious limitation of former systems, their cultural, social and political control of economic activity. It is indispensable to introduce a new system of political and social control, completely different from the former. Transition in general, particularly in the former socialist countries however cannot be properly understood without taking into account the international environment and the interactions between national and international forces and factors. It is their analysis, which was the main goal of this

---

1 Vaclav Havel, 'A Call for Sacrifice: the Co-responsibility of the West', *Foreign Affairs*, Vol. 73, No. 2: 6-7.

2 From the address of the IMF Managing Director, Michel Camdessus, in Prague in March 1996. See, *IMF Survey*, 19 March 1996: 90.

3 I define economic system as the interactive relationship of ownership, information, incentives and institutional patterns which are embedded in, and influenced by, a given socio-political structure.

UNU/WIDER research project on the transition economies.[4] The approach built on the earlier UNU/WIDER programmes dealing mainly with domestic institutional change and its socioeconomic implications.

The issues which have been raised in this project are relevant to all the transition countries and their interaction with the rest of the world:

- How, and to what extent, do the domestic reforms promote the reintegration process?
- What are the global implications of institutional and economic change, in central and eastern Europe, China and Vietnam?
- How is the increasingly competitive global market system, the rules and standards of which are set by strong business groups and powerful states, reacting to the change?
- To what extent are the transition economies' severe socioeconomic problems rooted in their past, or related to the high costs of transition, including the reintegration process?
- What are the opportunities offered by integration into the global markets for the promotion of modernization of the European, Chinese and Vietnamese transition economies?
- Is the democratization process a precondition of integration into the global markets? Will the changes in these countries be the source of greater global security?

In the framework of this project, the different studies[5] analysed first the institutional and policy changes in a number of the transition economies,[6] and in some other countries, in order to reveal, how they have been influencing, promoting and hampering the participation of the former socialist countries in the global markets. The analysis included the effectiveness of the internal adjustment process, the social costs and the benefits. The countries fall into three groups, namely the early starters with the 'first best' policies, the slow movers, and the latecomers. China and Vietnam have also been subjects of the analysis to compare their

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[4] The UNU/WIDER research project on 'Evolving new market economies in Europe and Asia: Integration into the world economy: Internal and external factors and global implications' developed along two lines. One focussed on the international implications of domestic changes in the former socialist countries; this part of the project was co-directed by Padma Desai of Columbia University, New York. The papers of this part of the project were published by MIT press in 1997 in the volume entitled *Going Global.* This volume contains some of the studies written within the other part of the project (co-directed by Harriet Matejka of the Graduate Institute of International Studies in Geneva) devoted to the more general problems of reintegration in a comparative perspective. The papers include the external and domestic problems related to systemic change; expectations and realities in central and eastern Europe and in Russia; the differences between the East European and the Chinese experiences in global trade and capital networks; the role of the political, cultural and institutional factors in the reintegration process, the role of the international capital markets, the IMF and the World Bank, of the international trading system, and of the UN agencies. Some of the papers consider the changes from the perspective of some of the main external partners such as western Europe and the United States. An important study discusses the lessons which can be drawn from historical experience, namely from the disintegration of the Habsburg and the Romanov empires. Another chapter deals with the specific environmental and energy problems of the former socialist countries and their global implications.

[5] See the end of this volume for the list of project participants.

[6] The criteria of the selection of the countries was related first of all to the specificities of their integration with the global markets. The country studies included the Czech Republic, Hungary, the Eastern part of Germany, Poland, Estonia, Latvia, Lithuania, Russia, Kazakhstan, Uzbekistan, China and Vietnam. Two other countries, India and Finland have also been included in the project, because of their special relations with the former socialist countries and the specific patterns of the required adjustment.

reintegration process and its domestic and international consequences. The republics of former Yugoslavia were not included owing to the unsettled political situation and the ensuing uncertainty.

Second, the project has been extended to the policies of some important countries, special regions, and the most important institutional actors. It has searched for answers to such questions as to what extent are the policies of these actors motivated by longer term common goals, or subordinated to short-term interests? In the case of the developing countries, the question was whether the new market economies would be partners or competitors in the global markets.

Third, the research considered some of the main issues in international cooperation: the role of comparative and competitive advantages, the factors shaping the reintegration process into the system of global finance, the global trading system, the European economic space, which is particularly important for the central and eastern European countries.

Fourth, historical analogies have also been analysed when the world system had to integrate new states and the successor states of disintegrated empires had simultaneously to face the tasks of national institution-building and the new global political and economic challenges.

The results of the project reflect the fact that transition is still at a relatively early stage.

1.2 The international dimension of systemic change

During the past decades the interactions between the former socialist countries and the rest of the world have been complex. They were strongly influenced by the systemic competition, the Cold War and related national security interests. The political and ideological debates on national institutions focussed less on the advantages or disadvantages of abstract models of the command economy, and the textbook model of the market system, and more on the failures of functioning 'socialism' as it had evolved in the Soviet Union and in central and eastern Europe, and on vistas of the modern capitalist system, as it had developed in the industrial west. These showed the high standard of living of the developed industrial countries, their democratic systems, the individual freedom and social welfare.

The regimes in central and eastern Europe legitimized the political system to a large extent by promising economic achievements and constant improvements in the standard of living. The declining economic power potentials, the external economic problems, the growing indebtedness, the stagnation or deterioration in living standards due to failures in economic performance, added new sources to the already existing sources of political conflict. Popular uprisings took place at a relatively early stage of the new regimes and they were crushed by Soviet forces. The domestic political structure of the Soviet Union was relatively stable. The internal political stability, however, eroded gradually as a result of the external and domestic political and economic failures, the long economic stagnation and the declining standard of living. A great number of internal conflicts, social, ideological, political, and ethnic, increasingly undermined the domestic structure of the regimes in the post-Stalinist era, when the most direct forms of oppression and intimidation were replaced by less violent measures. The policy of '*perestroika* and *glasnost*', which was an attempt to change the character of the regime and replace the traditional rule of the party bureaucracy with certain democratic forms,

opened the floodgates, unleashing the tide of popular dissatisfaction. It also resulted in important conflicts within the ruling elite. Ethnic conflicts also came to the surface. Another aspect of Gorbachev's policies was the cessation of active and visible intervention in the internal affairs of the central and eastern European countries. This encouraged not only the communist reformers but also those in opposition to the regimes, their goal being systemic change and not only systemic reform. The disintegration of the Soviet Union, Yugoslavia and Czechoslovakia has also been related to the systemic change. The new countries which emerged had not only no independent or autonomous relations with the rest of the world before, but they were part of a non-market system. They had to face the tasks of restructuring external economic relations, starting to cooperate with old and new partners on new foundations, of transition to a market system, and of the establishment of a national state This has been a source of unprecedented economic difficulties for a number of countries. The tasks of these countries were very similar to those which the new developing countries faced a few decades ago.

The disintegration of the eastern bloc and the Soviet Union brought about immediate and radical changes simultaneously in economic and political relations. From among the changes in the power structure influencing the region, the new geostrategic position of Russia will have major long-term consequences for the system of international relations of the former socialist countries. First, Russia no longer has direct frontiers with her former allies.[7] A belt of independent states, large enough to be more than just a traditional 'buffer zone', has been interposed between western Europe and Russia. This belt has pushed Russia far away, geographically, from central Europe. While there is a strong effort in the ruling elite of Russia to increase the Russian sphere of influence, this will not be the same as the Soviet sphere.

The central and eastern European countries are situated in the traditional buffer zone between great powers, and such conflicts have played catalytic roles in precipitating the two world wars in our century. But at the end of the 20th century the region is not a stage for great power confrontation. Potential tensions and conflicts of the region may be internationalized, however, through new forces or through traditional special interests of one or another regional power. Strong security guarantees are needed in this region of the world to avoid a repetition of the past.

Another external political change has been the lifting of the strategically motivated restrictions in the field of finance, trade, particularly in new technologies, introduced by the western powers during the Cold War.

In practical terms there were no static market systems with universal characteristics in the western world and even less in the developing countries. There have been important systemic differences even between the developed industrial countries, particularly in the role of the state, in ownership patterns and incentives. While the central institution in the abstract model of the system was the liberal and free market, where the master was the 'invisible hand', in real life it could not solve the problems and conflicts of the production and distribution process. Self-interest, which was the main motive driving the factors of production where they would be best employed, had to give way to public interest in a number of areas. The role of price signals that guide production together with the sovereignty of the consumer was 'distorted' by a complex interplay of manipulation, subsidies, and other factors. Competition on which, in principle, the

[7] Poland has a small direct frontier with the territory of Kaliningrad.

free market system depended for the control of the institution, and for the protection of the consumer, not only changed character, but also its role became increasingly limited in many areas. Even the American free-market model, which has often been presented as the most efficient manifestation of the market system, came to be regulated by political forces and economic factors in key areas. On a global level, the market system became increasingly plural in its characteristics and functioning. It has resulted in great, and still increasing, inequalities between and within countries, sustained or increased poverty, and social exclusion. The differences in the relative roles of the visible and invisible hands (the state and the market) in the allocation of resources, in the distribution and redistribution of incomes, in protecting the weak, in making long-term commitments in the interests of the society, at the same time resulted in various 'hybrids' of the market system. In the developed industrial countries, three main economic models (the American, the European social market, and the Japanese coordinating-corporate) emerged. Each represents specific patterns of development with resulting differences in innovative capacities, production and consumption structures, international competitiveness, and in attitudes towards the handling of social problems. While the global inter-connectedness of economies is a source of similarities in organizational forms and policies, the national historical, cultural, social, and institutional environment has had a major influence on the development and performance of the economies. The hybrids, or mixed economies, represent a greater variety in various developing countries - in Africa, Latin America, and Asia. Central and East Europe, the CIS, China are different hybrids, composed of elements of the centrally planned economy and of features of the various market economies. Nor are the hybrids static. They change under the influence of domestic and international pressures and processes such as liberalization and privatization. The character of the hybrids is also influenced by the different socioeconomic challenges.

The relatively successful hybrids serve as proof that the visible and invisible hands should not be considered as mutually exclusive, but as reinforcing each other. The optimal hybrid solutions would imply market regulation, wherever feasible, to fulfil traditional and new government functions more cheaply and efficiently. They would imply decentralization and downsizing central government in a number of areas, like the direct participation in production and distribution.

One often-overlooked characteristic of the former socialist countries was the survival of markets. There were 'markets' in all the former socialist countries. Neither the dominating ideology nor the practical functioning of the economy eliminated market exchange. It is interesting that Marx in his writings never denied the historical role of the market in the development process. In his analysis, the market was the solvent that would break down the traditional rigidities of society and allow development. After the short period of 'war communism' in Russia, Lenin initiated the New Economic Policy. This was abolished by the end of the 1920s, but it served as an example for many of the socialist reformers or believers in 'market socialism'. Even Stalin accepted the necessity of the 'socialist market' as a controlled instrument of economic policy. These markets however were very specific and highly distorted. The main source of information was the central plan, and the actors of the economy received it either through mandatory targets or through a system in which the central targets and the bargaining process were the dominating factors. Price signals played a very limited role in the state sector. Prices, even in those countries where important reforms had been introduced, were basically subordinated to social or economic goals and priorities determined by the political process. These goals were not constant. The sustainability of such a system depended on the

constant redistribution of incomes through the budget: depriving the functioning part of the economy of a large part of its rewards and subsidizing the rest including the consumers. Strong state monopolies dominated the market. The other market element was the private sector, the size of which differed from country to country (between 10-40 per cent of GDP in 1989). This sector depended on the 'gaps' in the state sector and the permissiveness of the regimes. A large part of the private market exchanges were illegal, and the actors persecuted by law. Price formation in this sector was influenced by the laws of supply and demand, by the shortages and shortcomings created by the public sector, and by the risks that the illegal private entrepreneurs had to take.

Internationally, the former socialist countries isolated themselves from the world market. Moreover, their efforts to achieve a planned international division of labour failed, even though some elements of specialization emerged between them (Simai, 1990).

1.3 On the concept of reintegration into the global markets

Integration, or reintegration, is, in fact, not quite the precise word for characterizing the changes. In a broader understanding, every country in the world is a part of the global economy. The concept of integration, and reintegration is used here as a process of re-entering the global markets through different channels of cooperation under new political and economic conditions.

One of the basic institutional conditions of the efficient reintegration into the global markets is the building and development of the domestic markets. The tasks of market-building have been multidimensional and difficult and each has had some consequence for integration in the global markets (Simai, 1994). They have included the establishment of the legal framework for the functioning, regulation and limits of the market, the 'creation' of the actors of the market, the introduction of new incentives.

As a result of the character of the systemic changes there was a very important contradiction from the very beginning between the ideological assumptions related to the tasks of market-building, and the practical measures. Both the domestic and the external ideological advocates of the free market system demanded the fast downsizing of the governments in the former socialist countries. For those, familiar with the great global debates on development this approach was of course not unknown. The most important 'transition indicators'—serving as a checklist for those international organizations which were assigned by the main industrial powers to 'command' the transition process—included the democratization of the political system; the establishment of a new legal framework for the economy, particularly in areas of competition and liberalizing market entry; macroeconomic stabilization; monetary and fiscal reforms; price liberalization; the liberalization of the trade and foreign exchange system; banking reform and interest rate liberalization; the restructuring of enterprises; introducing effective corporate governance; market-building, with special emphasis on the labour and capital markets; integration into the global markets based on openness. Privatization, the dismantling of the economic administration of central planning and the creation of a new business elite were the backbone of all the changes. These postulates were not enshrined in any generally agreed framework or action programme which would have defined their optimal sequence.

The tasks of market-building could not be implemented without the active involvement of governments. The tasks of the transition in certain cases gave them greater power, particularly in the redistribution of wealth and incomes, than what they enjoyed in 1989, before the systemic changes, in a mainly command economy. The experiences of the former socialist countries in the transition process offered some interesting conclusions also for the global debate about the role of the state and the market. First of all, the issues cannot and should not be confined to the traditional 'market failure' and 'government failure' approaches, or to the issue of 'externalities'. The role of governments, and their different functions in the economy, as active participants, actors, regulators or agents of change, cannot be dealt with in isolation from the achieved level of development, from its institutional and structural implications. Second, there is no such thing as a purely neutral or autonomous state. Every state is embedded in the society it governs and it is closely linked to, and penetrated by, social forces. The state is dependent on the economy, the resources of which allow it to function. The state does not exist in a political or power vacuum. It is a reflection of the balance of power within society. All this influences the state in defining and fulfilling its functions. Third, the role of the state at this stage must be looked at also in the perspective of those external challenges, which have been created by the new interconnectedness, like the internationally integrated global production of the transnational corporations, the different types of capital movements, the greater dependence on trade in goods and services and the international information flows. In the present world economy, the former socialist countries, because they are price-takers in the global market and/or do not have the same historically accumulated experience and policy instruments, are much less powerful than the key industrial countries to deal with the internal consequences of exchange rate fluctuations, speculative capital movements, instruments. The experiences of the former socialist countries also suggest that a better, more democratic, transparent, accountable and cheaper, not necessarily smaller, state is the solution.

From the perspective of the tasks of market-building and of the other components of systemic change, the years which have passed since the political transformation constitute too short a period to evaluate the successes and failures in a comprehensive way. The clocks of change move with different speed in the various areas. The fastest is the clock of political change. The clock of political institution-building is moving somewhat slower, but faster than the building of market institutions. The clock of the major structural change in society and the economy is moving even slower. The evaluation of the progress of the countries on the hard and bumpy road to the market is therefore a highly complex task which cannot be related to any ideal model. The above mentioned 'checklist' which serves for the evaluation of the changes is probably the best indicator for measuring the speed of the transition. Those criteria are however not related, even in general terms, to modernization, increasing economic efficiency, and the better satisfaction of needs.

The movement of the former socialist countries towards a market system, which started in the early 1990s, is still far from complete and it has been uneven—as between countries and over time. There have been spectacular achievements in changing ownership patterns. Close to 30,000 large, and a much greater number of small enterprises were privatized in the Czech Republic, Poland, Hungary and Russia. There were different forms of privatization, like restitution and compensation, direct sales (firms, shops, apartments, restaurants, land) through auctions or other methods like liquidation and sales at scrap value, commercialization of the assets through joint-stock companies, (transformation and inviting new owners), sales through stock market, buy in by workers, management, sales to foreign firms or to investment funds.

The character, the speed, and the outcome of the process were very different. Some countries preferred voucher privatization, stock ownership of holding companies, which left the structure of the large firms by and large intact (Czech Republic). Others, like Hungary, preferred the direct sales of assets to foreigners or nationals. The Russian model was a mixture of different approaches. An important similarity in the outcomes has been a major loss in the value of the national assets. There were some important achievements in fulfilling some other important institutional postulates of global market integration. In almost all states efforts were focussed on the establishment of a comprehensive legal framework. This has not been instituted in some crucial areas, like property ownership and titles, forms of incorporation, mergers and acquisitions. Laws related to foreign direct investments and international business in general progressed somewhat faster. In order to attract FDI, the governments had to introduce new legislation on national and foreign entrepreneurship,[8] and also different economic policy measures, stimulating foreign investors, like tax concessions or in certain cases, direct subsidies. It was also necessary to conclude a number of bilateral agreements for the protection of foreign investments and on double taxation with a number of countries. Close to 60 specific bilateral investment treaties have been concluded between the former socialist countries in Europe and the industrial market economies.[9]

The first comprehensive legislation was introduced in Hungary in 1989, together with a company law.[10] Later, after the political changes, it was amended. In certain countries, the rapidly expanding legislative framework did not always result in a favourable legal environment for FDI. UNCTAD's World Investment Report of 1994, referring to the experiences during the first years of the changes, drew attention to the fact that the new laws were enacted in some countries rather quickly, and in certain cases without fully considering their implications; e.g., the obligations related to the repatriation of profits or capital were not in a harmony with the availability of foreign exchange reserves. They often had conflicting objectives (aimed at the increase of government revenues, they at the same time offered important tax concessions), and their implementation suffered from inadequate transparency (there were many individually offered concessions and subsidies). The conflicts of competence between the central and local governments (which is of course a more general problem and not just a characteristic of the transition economies) are also often mentioned as a shortcoming of the new legislation (UNCTAD, 1994: 105). This issue is especially important in Russia, where the hierarchy of constitutional laws, federal laws, provincial laws and presidential decrees is

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[8] The new legal and regulatory framework had to ease or liberalize the entry procedures, the rights of establishment, the repatriation of profits and capital investments. It had to deal with the taxation of foreign investments, (including agreements on double taxation), with the ownership of land, currency conversion, protection of intellectual property rights, and other measures, like the conditions of acquisition. Another set of regulatory measures were related to accounting practices. In some countries, for example Russia, the piecemeal approaches characterized the development of the necessary framework, in others, like Hungary, there were more comprehensive legislative measures.

[9] There are, of course, a number of multilateral agreements related to FDI which the former socialist countries joined, or wish to join, like the World Trade Organization's TRIM, and the Multilateral Investment Guarantee Agreement (MIGA).

[10] It was discovered by the legislators, that the Company Law, introduced in the late 1880s, on which the new legislation was built, was in fact still in effect, allowing also foreign investments. The communist regime had never abolished it.

confusing. However, the weaknesses of the legislative infrastructure have been considered more as constraints, than as obstacles to FDI.[11]

Regulations of intellectual property rights are also developing rather slowly. Those countries, which are associate members of the European Union, and particularly those with which accession negotiations have started, have made special efforts to establish a legal system corresponding to the norms of the European Union. Important progress has also been made in the field of foreign exchange legislation and policies in a number of transition economies. As a result of these measures, many transition economies have been able to introduce some form of convertibility within a short time.

The markets for goods, labour, and capital, developed at different speeds and had different constraints and results in the various countries mainly due to the different political and institutional heritages and macroeconomic starting points.[12] In most cases, there has been a consistent movement in the direction of liberalization, which also influenced market-building.

There were a number of favourable and adverse consequences of the very fast liberalization process, which was historically unprecedented in its speed and scope. There was a radical improvement in the supply situation in almost all the transition economies in the consumer markets. Prices however increased everywhere very fast. The high rate of inflation resulted in a drastic decline in real incomes and financial assets. Import competition was an additional blow to the national producers. In certain countries, the local agricultural producers, deprived of the bulk of earlier subsidies, had to compete with heavily subsidized food imports from the European Union. Another result of the strong pressures for liberalization was a historically unprecedented opening to foreign capital investments, which grew very fast. The greater was the difference between the past and the outcomes of the measures, the greater was the shock for the countries concerned.

Liberalization of trade policies in a competitive market system can be sustainable and effective if the country is sufficiently competitive or if the liberalization process helps increase competitiveness and adaptive efficiency. In certain sectors, mainly in those which became foreign-owned, there was an increase of international competitiveness, as there was in the case of transport equipment in Hungary. The external and internal problems and constraints in many cases, however, disorganized the transition economies, weakening their R&D capabilities, depreciating human capital, and so on.

Among the tasks of market-building, the labour and capital markets were particularly important. They did not exist at all in any of the former socialist countries. The restructuring of the markets for goods, which existed in all the countries also implied specific tasks, and was influenced by the general liberalization trends.

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[11] Except of course those cases, when the weak and uncertain legal system has been the consequence of the overall political chaos.

[12] See, From Plan to Market: World Development Report 1996, The World Bank: Washington DC.

1.3.1 Building and internationalizing the domestic markets

The reintegration process is taking place in the modern, global economy, with its institutions, organizations, power structure, hierarchies, markets and competitors. The patterns and forms of competition and the institutions of the global market system are shaped mostly by strong corporations and powerful, developed, industrial countries. The former socialist countries in central and eastern Europe, China and Vietnam, not to speak of the former Soviet Union, are facing a completely different world economy in the 1990s, than the one from which they 'dropped out'. The fact that in the 1990s globalization is a key factor in the world economy, is in itself a source of unprecedented opportunity for the countries which have been isolated from the mainstream of economic and technological change during the past decades. The globalization process will, however, be a source of a number of problems for countries which cannot adjust fast enough to the new needs. Globalization is of course developing with uneven spatial spread and sectoral intensity in technology, economics, finance, trade and culture. Its implications are conditioned by the great inequalities characterizing world markets. The process has its roots, first of all, in the increasing role and ongoing transformation of the capital and money markets, in the global diffusion of new technology, the global consequences of environmental change, in the development of global organizations, intergovernmental cooperation regimes, transnational corporations, and in the consequences of their policies and actions. In the global system, a great number of relations have developed among these different actors in a wide variety of fields. Some of these relations are integrative; others can lead to disintegration and fragmentation.[13] Empirical research on the current global system revealed that in fact three simultaneous, interrelated and interacting processes can be observed, not only globalization, but also regionalization and fragmentation which are shaping events and the life of the people, states, and of the international community. These processes are not necessarily developing as contradictory forces, which are crowding each other out. At the end of the 20th century, globalization, is the strongest regulatory force in the system and represents the greatest challenge for all the regions and countries. It influences the reintegration of the former socialist countries, China and Vietnam in all of its dimensions.

Globalization is reflected and promoted by the increasing role of international actors, transnational corporations and international organizations. A number of large transnational corporations have, of course, been present in the economy of the countries of the east. More often than not, they have been the most reliable trading partners of the former socialist countries in the past. The adaptation of the TNCs was faster than that of the other international agents. Export orientation, deregulation, liberalization, privatization and other tasks of the

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[13] There are many different understandings of the 'global', 'world', or 'international' system. For instance, Wallerstein has posited its foundation in the capitalist world economy, whereas Ougaard has emphasized the system's connection to social formations. See Sorensen, Georg (1991: 85-116), 'A Revised Paradigm for International Relations: the 'Old' Images and the Postmodernist Challenge', *Cooperation and Conflict,* 26. A more recent and comprehensive definition is offered by Stanley Hoffman:

'The world system today is …a complex game played at three levels: a world economy that creates its own rewards and punishments and provides both opportunities and constraints for the players (not all of whom are states); the states themselves; and increasingly, the peoples who intervene insofar as they are unhappy with the effects, inequalities and inefficiencies of the world market, or with the inadequacy of established borders or with the nature of their governments.'

See, Hoffman, Stanley (1991), 'Balance, Concert, Anarchy, or None of the Above', in Gregory F. Treverton (ed.) *The Shape of the New Europe,* Council on Foreign Relations: New York.

transition process imply such new challenges that they can only be responded to with the active involvement of the TNCs and the multilateral cooperation regimes.

Due to the crucial role of science and technology, and of the innovative capabilities in placing the countries on the ladder of the global hierarchy of political and economic power and also in the transformation of the global system, the technological dimension of the globalization process is of particular importance for the reintegration of the transition economies. In the 1990s, the process of transition to a new technological era is taking place in a highly diverse and increasingly two-track global economy. During the past 15-20 years, the majority of the industrial countries and a small group of developing countries were able to implement policies which have allowed and supported the process of technological transformation. The countries on the lower level of development can no longer compete only on the basis of cheap labour or abundant natural resources. More sophisticated and efficient production systems must be developed in order to enable them to produce tradable goods and services in a competitive manner, including capacities to sustain and control quality and manage flexible, information based systems. This requires a more educated labour force, highly skilled technicians and managers, and more intense participation in intra-industry trade in which the transnational corporations are playing a major role.

The majority of the countries of the world, struggling with grave social and economic problems, were unable to develop the capabilities for sustainable techno-economic progress and became increasingly marginalized in scientific and technological relations. The peculiar technological capabilities of the former socialist countries, which was distorted by a number of factors, including strategic considerations and the predominance of defence-related programmes, as in the case of the former Soviet Union, resulted in a closed and very costly scientific and technological bloc, with little or no spillover to other sectors. Their entry into the new technological era has been slow, uneven and strongly influenced by political, strategic and economic systemic factors.[14] For them, it is a crucial question whether the transition to a market system be shaped in such a way which will facilitate the radical improvement of their innovative capabilities, which will promote the successful utilization of their capacities in science and technology, or which will destroy most of the capabilities which they acquired earlier. China, still behind the industrial world in R&D capabilities is making major efforts to reduce this gap, with massive imports of technology and the development of its national technological infrastructure.

1.3.2 Changing consumer markets

The greatest and the most conspicuous changes occurred in consumer markets. In spite of low purchasing power (about half of the population in central and eastern Europe, and 75 per cent in

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[14] I use the concept of the 'technological era' in a meaning similar to that developed in the theories of long cycles. A technological era is thus defined, first, by the dominating technologies which comprise the foundation of a social production system. Those technologies are primarily important in shaping the structure of output and consumption, in determining the increase of total factor productivity. Their 'logics' and postulates influence skill and employment patterns, investment needs, and so on. The dominating technologies influence the style and quality of life, transform the system of organization, infrastructure, information and entrepreneurship and the choices available to society. They bring about major changes in the patterns of the international division of labour and of the functioning of global markets. They may have major consequences for national security policy and influence military doctrine.

Russia, cannot afford anything beyond household expenditures and essential food items), the region is a large consumer market. Consumerism is spreading everywhere. In the vanguard, there is a relatively important group of the new rich, the successful entrepreneurs, the better-paid managers and professionals, and often the criminals, with substantial purchasing power. The total number of the high-income earners in the region, is about 30-35 million. The shortages, the empty shops, the poorly packaged, low-quality goods, and the long queues, are problems of the past. The markets offer unprecedented choice, in almost all the categories of consumer goods and services. The inward internationalization of the consumer markets has been very fast, reflecting one of the primary interests of the global business community in the context of the transition process. The modern western advertising and retail distribution systems are present everywhere. Luxurious shopping centres are popping up and western style shopping is becoming an important leisure activity for some segments of the population. Motor showrooms offer the most up-to-date car models. Mail order and credit card systems are spreading very fast. The main transnational corporations in food, beverages, consumer electronics entered the market through the privatization process with their own global brands, which resulted in higher prices, increased imports of raw materials and the crowding out of domestic producers. In addition, consumers are also learning some of the lessons of the market system from their own adverse experiences as the victims of dishonest advertisement and of low-quality imported goods.

1.3.3 Labour market creation

Labour markets are not just exchanges, reflecting supply and demand. In modern market economies, they are sophisticated institutions, reflecting social, economic and political factors. They are in general much less internationalized than the markets for goods and capital. The socialist ideology did not consider labour as a factor. In the earlier years of central planning, the plan dealing with human resources included the allocation of labour, the patterns of education, the number of participants in the educational system, wages, and so on. It offered job security, essential benefits were guaranteed through employment, workers were involved in enterprise matters, and labour force participation was high (Barr, 1994: 122-3). While the central allocation of labour was abolished in most countries even before the systemic changes, important consequences survived in the rigidities of wage policies, allowing narrow differentials and little open unemployment. Labour hoarding was encouraged by the system, resulting in a highly inefficient use of labour. In a number of countries skilled workers earned more than engineers, and in a number of cases, semi-skilled workers earned more than skilled workers did. Labour mobility was restricted by legal measures and socioeconomic outcomes of the functioning of the system. Employment offices existed mainly for the distribution of labour among enterprises.

The building of a labour market so that it could support sophisticated employment services, increase the mobility of labour, facilitate market-oriented wage determination, was an important task in all countries. Institutions, such as labour exchanges and retraining offices, had to be built up to disburse unemployment benefits, to provide job counselling and to conduct both active and passive labour market policies.

The development of the labour market in the central and eastern European countries has been relatively fast. The region had a relatively well-educated labour force, which facilitated the adjustment process for the majority. The high educational level and relatively low wages

generally enabled the labour force to adapt to new market conditions and to meet the demand for labour. The components of the demand changed following changes in ownership structures due to the privatization process, foreign direct investment, the dismantling of many large state enterprises, the low level of new domestic investment, and the pattern of new entrepreneurship.

Major problems emerged however in all countries. Full employment which was artificially maintained by huge state-financed investments in the labour-intensive sectors of the economy has come to an end. Unemployment, due to declining output, the obsolescence of skills and the changing structure of labour demand created almost insurmountable problems. There was a marked decline in trade union membership.

In certain central and east European countries, the employment rate in the large firms has declined more than in the case of the smaller establishments. These, however, still only employ a small segment of workers. The highest declines and the lowest participation rates for the workforce in the formal sector have been reported in Bulgaria, Hungary and Poland. The labour hoarding indicator which measures the changes in the output-employment relationship remained very high in the territory of the former Soviet Union and in Romania, exceeding the 30-40 per cent level. In other words, output has declined significantly without substantial changes in employment rates.

A very important area of employment creation has, however, been the growing informal or parallel sector of economy that has created new jobs and absorbed part of the displaced labour force. In Hungary for example about 22 per cent of the labour force was in this sector in 1995. For many job seekers, this was a source of degradation. They found informal activities which did not correspond to their wishes, education, or income expectations Unfortunately, there is little information on the employment and incomes earned in this sector, and therefore it is complicated to evaluate objectively the importance of the informal sector for employment.

The service sector was another source of new employment opportunities. The tertiary or service sector was formerly undersized, except for the social services, health care, education, science, and culture. But as the statistics for these occupations were missing, or included in the former labour statistics for other economic activities, they were heavily underestimated. Trade, catering, banking and insurance, communications, and real estate activities were poorly developed but have boomed since transition.

Employment in agriculture fell faster than total employment. Large-scale agriculture in the form of collective or state farms and agro-industrial complexes were one of the major employers in central and eastern Europe, particularly for the unskilled rural labour. Many workers in the rural areas were employed in other supporting occupations, or in the industrial or service sector of the collective and state farms. Private farming previously prevailed only in Poland, in Romania and in former Yugoslavia. The transformation of collective into private farming, the loss of state subsidies and guaranteed markets, falling domestic demand and the loss of CMEA markets, have significantly reduced labour demand and employment in this sector. The number of small farmers however increased substantially. This fact may become an important problem in the future, due to the low level of competitiveness of small-scale farming.

Since 1994 there has been an obvious stabilization or even a decline in the unemployment rates throughout the region. In some cases this trend did not reflect improvements in the labour

market because many of the long-term unemployed have disappeared from the statistics. A large number of workers have retired or gone on prolonged parental leaves. The stabilization of unemployment rates can also be explained by the rapid growth of non-participation rates and the share of the inactive population, a status that has been forced on many.

The reintegration into the world markets also became an interesting and important issue in the context of the labour markets. In the territory of the former Soviet Union there has been a de-internationalization of the labour markets. International labour migration from the former socialist countries to the west increased mainly in the highly qualified category and there has been a growth of emigration in those categories which in the west require lower qualification. This was a source of illegal employment in the host countries. In fact, one of the main concerns of some of the member states of the European Union as concerns eastern enlargement has been the inflow of cheap labour.

1.3.4 The creation and internationalization of capital markets

In the *World Development Report 1996*, there was a rather controversial statement: 'Capital markets, at their most basic, are easy to define and almost as easy to create'.[15] Considering capital markets just as instruments of buying and selling, this may be true. If, however, one is looking at the functions of capital markets, the promotion of savings, the effective allocation of resources including the promotion of the efficient international transfer of resources, the financing of budget deficits, the task may not be as easy. A well functioning capital market is a crucially important condition for undertaking and sustaining systemic changes in the economy. The progress in this area was rather unequal, slow, and conflictual.

The creation of capital markets proved to be rather difficult in all the former socialist countries. Capital markets in the centrally planned economies did not exist. The financing of the budget and of the firms was more or less automatically secured even beyond the planned targets. There was no bankruptcy, so even when firms failed to fulfil the plans, they were bailed out by the budget. The network of the central bank fulfilled practically all financing functions either directly or through specialized sectoral banks, for agriculture, industry or foreign trade. Their activities went on within the framework of the annual or five-year plans, according to directives for the distribution of loans and credits. There was no real risk involved in the banking sector. The savings of the households were managed by the state saving banks, which financed all the private credit and loan activities as well. Foreign exchange was the monopoly of the state, managed by the central bank, which was subordinated to the finance ministry. There were of course certain differences between the countries in the actual functioning of the system. The Soviet Union carried out important external financial activities, through its banks established abroad. These differences increased as a result of the reform measures. In Hungary, for example, central and commercial banking activities were separated already before transition, in 1987 when a two-tier banking system was introduced. The domestic commercial operations of the national bank were taken over by commercial banks.

The economic environment for the establishment of the capital markets was characterized by some general, and a larger number of country-specific factors, most of which were rather adverse. One was the sudden increase of inflation, which had a major influence on incomes,

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[15] See page 106 of The World Development Report 1996.

savings and the propensity to save everywhere. It had a major influence on the setting of interest rates. The other, more or less general, problem was the large budgetary deficit partially inherited from the past, partially created by the changes in revenues and expenditures. The financing of the budgetary deficit through the market was the source of a major demand for capital. The governments had to pay high interest on the bonds they issued, which crowded out a large part of the private sector, particularly, the small firms. The volume of non-performing loans inherited or created in the banking sector undermined the stability of the new financial institutions from the very beginning. The high level of domestic and external indebtedness also became a critical issue, particularly for some transition countries, like Hungary, due to the high costs of debt servicing, which absorbed a large part of domestic savings and demanded constant external borrowing.

One of the most important postulates for the establishment of the capital markets has been the introduction of realistic exchange rates and the reform of the price system, including the price of capital. This task was fulfilled in Poland, Hungary, and the Czech Republic at a relatively early stage. It was a source of major economic shocks everywhere.

The restructuring of the banking system was a basic postulate of capital market creation. This included the transformation of the central banks into independent institutions, which could formulate and implement monetary policy. The other task was the creation of market-based financial institutions, commercial banks, stock exchanges and so on. The central banks, even in the socialist regimes, had a certain macro-economic expertise. In the commercial banks, the new skills, which were needed for assessing the creditworthiness of the potential borrowers or for the running of the different operations of modern retail or wholesale banking were missing. Management weaknesses also characterized the central banks in their new monetary policy and supervisory functions.

The legislation on new entry, disclosure and supervision was generally inadequate on account of ignorance. Almost all the former socialist countries adopted a highly liberal policy for the establishment of new banks. In certain countries, there were differences in this respect between nationals and foreigners, in favour of the first. The absence of mandatory disclosure, combined with free entry was a factor in banking crises, and the declining popular confidence in the new financial sector. The other approach, which favoured the old banks and wanted to protect them from competition, could not avoid the emergence of similar problems either, particularly due to the large proportion of non- performing loans. The governments, in order to avoid the collapse of the capital markets at a nascent stage, had to authorize a large amount of money for the consolidation of the banks. The banking crises, poor capitalization, overbanking, bad loans, the costly consolidation measures are, of course, not unknown in the industrial countries. But the resulting problems were much more serious and devastating in the former socialist countries. The example of Albania is probably the most striking example. The weaknesses of the capital markets and their institutions created major constraints for the transition process everywhere. The lack of experience in bank supervision and the absence or weaknesses of prudential regulations have been additional problems in some countries; for instance in Bulgaria fifteen banks went bankrupt. In Hungary, where the foreign banks as strategic investors played a crucial role in the privatization of the banking sector, prudential regulations were better and bankers more experienced, the run on the second largest bank in the spring of 1997 was an example of another set of problems caused by the coincidence of managerial errors, weak bank supervision and declining popular confidence. Collapse was finally avoided by concerted

action, but at a very high cost for the bank, for its partners and clients and for the government. It is evident that there will have to be further restructuring of the banking system in the coming years.

The stock, money and commodity exchanges were also characterized by a number of weaknesses. Forty years after its closing, the Budapest stock exchange was re-established in 1989, as the first in the European transition countries. In the following years, a large number of acts were adopted, which created a framework for the capital market and facilitated the establishment of new institutions. An interbank market for foreign exchange was established in 1992, and a futures' market in 1993. The Warsaw stock exchange was opened in 1991, the Bulgarian in Sofia in 1992, and the Prague stock exchange started functioning in 1993. Stock exchanges are underdeveloped. Market capitalization (with the exception of the Czech Republic) is in general, below 10 per cent of GDP. The volume of transactions is small and the impact of stock trading on the reallocation of capital resources in the economy is still very limited. On the basis of practical experience in central and eastern Europe, one may agree with Joseph Stiglitz, who drew attention to a number of important shortcomings of the stock exchanges. According to Stiglitz, reshuffling existing state ownership, is essentially a zero-sum game driven by rent seeking and by perceptions, rather than by information on the fundamentals, with at best minor effects on aggregate efficiency. According to his analysis, stock markets are primarily the rich man's horsetrack or the middle-class gambling casino with little effect on raising funds and allocating resources efficiently. Even mature equity markets may destroy enterprise behaviour by linking managers' rewards to short-term stock price fluctuations (Stiglitz, 1994: 338).

Capital market creation in the former socialist countries is also influenced by a number of external factors, like capital movements including foreign direct and portfolio investment, loans, and capital flight. The presence of international banking or financial conglomerates became an important source of internationalization. The foreign banks and insurance companies, as strategic partners of the national financial institutions, or as 'green grass' investors in the financial sector, brought in greater security, new types of business (financial innovation), new technologies and expertise. These were important contributions to the financial deepening of the economies. Through these channels, there was a rapid increase in the internationalization of the capital markets of the former socialist countries. The degree of internationalization depended mainly on two factors: the degree of liberalization and the domestic political and economic conditions. In Hungary, about 60 per cent of the banking sector and close to 100 per cent of the insurance business are in foreign ownership.

The most spectacular change took place in the field of foreign direct and portfolio investment. The major political changes which took place in the countries of central and eastern Europe and in the former Soviet Union in the early 1990s resulted in fundamentally new conditions for the relations between the former socialist countries and TNCs. The political-systemic constraints, which were considered in the past as the most important risk factors and strategic obstacles for foreign investors, were removed by the political changes. All governments in the main western countries encouraged the corporations based in their countries to invest in the transition economies. Some of them offered favourable insurance and other incentives. The liberalization measures had a favourable influence on foreign investments, the stock of which increased rather fast in the former socialist countries in Europe from less than US$1 billion in 1990, to above US$59 billion by the end of 1997. This was distributed among the countries in a highly

unequal way, reflecting also the degree of 'microintegration' into the global market system achieved by a given country.[16] In the region as a whole, the FDI stock corresponded to 4.9 per cent of the GDP. In Hungary, it was 31.5 per cent, in the Czech Republic 8.7 per cent, in Poland 7.2 per cent. The average cumulative inflows per head in the region amounted to US$179 in 1997. In the case of Hungary, with the highest share of FDI stock, they were US$1,548, about half of the average of the developed industrial countries. In the Czech Republic, the per capita FDI stock was US$838, in Estonia US$760, in the Russian Federation US$100 and in Ukraine US$36.[17] At the end of 1996, more than 60 per cent of total exports came from joint ventures and other foreign-owned firms in Hungary.

The contribution of FDI to favourable structural change and an increase in international competitiveness depended to a large extent on the degree of integration into the global production system of any given TNC. In many cases, however, the aim of the acquisition was the entry into the domestic market. As a result of liberalization, the strong competitive position of the western firms is felt in practically all important segments of the market. In certain cases, state monopolies were transformed into private monopolies. The integration of a number of firms in the Czech Republic, Hungary, Poland and Slovakia into the international production system of the transnational corporations increased the role of intra-firm trade, with important consequences for foreign trade, incomes and tax revenues (through the transfer prices).

The TNCs' adaptation of their investment criteria to conditions in the transition economies has resulted, so far, in great differences in the different investment ventures, extending from sales promotion or servicing (characterizing Japanese investments) to large-scale ventures, integrated into the international production system of a given TNC (*General Motors, Volkswagen-Audi, General Electric*, and so on) or serving the domestic market only (*Coca-Cola, K-Mart, Pepsi Cola*). It is also evident that the specific advantages of foreign firms, related to the locational advantages of the transition economies, produce different investment outcomes. Some enjoy competitive advantages offered by cheap, skilled labour (*General Motors*), others gain from the extension of the life cycle of certain products in consumer electronics (*Samsung*) or from the rent from an oligopolistic position in the domestic markets of the host country, or from the acquisition of a former competitor (*General Electric*). The natural resource endowment as a motivation for FDI is, and will continue to be, important in the territory of the former Soviet Union, especially in Kazakhstan and Azerbaijan where about 90 percent of the total FDI is concentrated in the extractive industries, mostly in oil and natural gas production (*Chevron, British Gas, Mobil, Penzoil, Shell, BP, AGIP*).[18]

Most of the smaller transnational corporations have adopted a country-specific approach in their investment and market strategy. The large TNCs however are looking at their investments in a subregional, regional, and in some cases even in an European regional framework, which is dealing with the countries more in a future-oriented way, for example as potential members of the European Union.

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[16] UNCTAD, *World Investment Report 1995,* UNCTAD: New York and Geneva, pp.99-103, and *World Investment Report l997,* UNCTAD: New York and Geneva, p.350; UN Economic Commission for Europe, *Economic Survey of Europe 1998 No. 1*; UNECE: New York and Geneva, p.163.

[17] See above.

[18] *Le Monde Diplomatique*, 14 juillet 1995: 14-15

At the end of 1996 the FDI stock in China was about US$170 billion and in Hong Kong US$24 billion. In China alone, the FDI stock was the same as in Germany. In China's pursuit of development, the issue over who sets the terms in foreign investment has been a constant battle. This battle is first of all fought between China and foreign investors. China's low ranking in world income has undoubtedly enhanced the power of foreign investors to set the terms of their involvement there. On the other hand, China's vast size, huge resources of cheap labour, and enormous market potential are almost irresistible for international capital which seeks large-scale profitable investment. This, in turn, increases the bargaining power of the Chinese government and business organizations which try to improve the terms of trade and investment for their own benefit. One of the most crucial issues is technology transfer. The Chinese government had hoped that by opening up, advanced technology would be coming in with investment. In reality, the overwhelming majority of foreign investment in China is concentrated in labour-intensive, low value-added manufacturing which uses little advanced technology. While foreign investments have created employment and increased exports, their contribution to the upgrading of the industrial structure has been less significant than the Chinese government had anticipated.

To reverse the situation, the Chinese government formulated a policy of 'exchanging market for technology' in the late 1980s. This was supposed to be a guideline for foreign investment, but in reality little progress has been made. From 1979 to 1991, 2.6 per cent of accumulated contracted foreign capital investment went to the first sector, 63.5 per cent to the second, and 24.7 per cent to tertiary sector. Since the 1990s, the situation has not changed for the better. In fact it probably changed for worse. Proportionally, foreign investment in the first and second sectors, as well as infrastructure of the tertiary sector have all declined, whereas in commerce, real estate and financial insurance it has increased sharply. The battle over technology transfer continues. Neither party can afford to lose. Technology transfer in the area of foreign investment poses a particular challenge to the success of China's relinking strategy.

In the absence of credible data, it is too early to judge the effectiveness of the capital markets on savings and resource allocation. What is evident , however, is that the financing of certain sectors proved to be more or less impossible through the capital markets, particularly in the case of small and medium-sized enterprises, the agricultural sector and private housing. There is another important problem. Financial deepening, the rapid progress of the paper economy is a new phenomenon in all the former socialist countries. Many people understand its importance much less, than they do in the west. They look at the new banks as places of speculation, of large unjustified incomes, as instruments of growing external influence. They blame the banking system for many of the countries' economic and social troubles. The banking sector has become the main target of populist attacks in a number of the former socialist countries.

1.3.5 The new capitalists

A central task of transition in the former socialist countries was the creation of a well-functioning market. This is a long-term task which was achieved in the western countries and in the pre-socialist period of the central and eastern European countries through centuries of capital accumulation and the development of firms and entrepreneurship. The conditions in the former socialist countries fundamentally differed from those in the developing countries or from the classical process of initial accumulation in the western capitalist countries. Most

transition countries had a middle-level economy, with important industries of varying competitiveness and technological standards. The educational system was well developed. Many of the countries had a large group of highly skilled professionals, and a relatively well educated labour force. Both in Hungary and in Poland, there was a group of private entrepreneurs, who comprised the private sector in agriculture, services and in some industries. In Hungary for example, there were close to one hundred thousand private entrepreneurs by the end of the 1980s. In Poland, the agricultural sector was basically dominated by private farming.

There were several patterns in the creation or expansion of a new entrepreneurial elite in these countries. The organic development of capitalists from the grassroots resulted in small and medium-size enterprises which comprise about 90 per cent of the entrepreneurial class. About half of the small capitalists were men and women who lost their jobs. In Hungary, for example, the number of entrepreneurs increased from 120. 000 to over a million between 1990 and 1997. Many were micro-entrepreneurs resembling the barefoot capitalists of developing countries in the informal sector.

In Hungary, the transnational corporations became the most important and the largest business enterprises. In all the countries, the large local entrepreneurs, comprising about 0.1-0.3 per cent of the entrepreneurial class, were the former top managers of the state-owned enterprises. They emerged, in most cases, as the result of the privatization process. The most important ways of becoming very rich within a relatively short time may often have been immoral, but were basically legal. The following major patterns can be distinguished:

- The understanding and grasping of those opportunities in trade which were offered by the evolving market in certain new segments or niches, as the result of liberalization and the opening up of the economy (foreign exchange, information technology, car imports and industrial consumer goods). The largest fortunes were obtained through trade.

- Insider privatization, or buy-out, pushing the state-owned firms into bankruptcy and purchasing them for a low price, often on borrowed money, restructuring them, selling parts of them and investing in other branches or keeping a part of the originally purchased firm and modernizing it. This method was often combined with active participation in the stock and currency exchanges, using inside information.

- Obtaining and commercializing an important invention or patent, which was not properly valued and utilized in the state-owned enterprises, mainly through partnerships with foreigners with whom joint ventures could be established.

In most of the republics of the former Soviet Union, the creation of the new business elite was more complex and controversial. The loss of government control, and the fact that a large segment of the illegal markets were in the hands of organized criminals during the 1970s and 1980s, opened the door to criminal elements on a scale unprecedented in the history of capitalism. The capitalism which is developing in Russia is one of the most greedy and lawless systems that the country has ever experienced and may be described as 'gangster economics' or kleptocapitalism. The Russian Mafia is possibly the world's largest group of organized criminals, consisting of about 5000 gangs with close to 3 million members. They 'privatized'

more than two- thirds of all shops, hotels and services, particularly in banking (World Bank, 1994: 6).

Beyond the role of the criminal element, 'nomenclature privatization' is the other factor behind the emerging entrepreneurial class in Russia, a country that has 15,000 joint-stock companies with 40 million shareholders, the word's largest on both counts, but insider-owners continue to dominate. Russian privatization was rapid and extensive . Almost 90 per cent of industrial output and 80 per cent of industrial enterprises passed mainly to private hands. Seven groups of bankers and industrialists controlled 50 per cent of the Russian economy before the crisis of August l998 (World Bank, 1997: 11-12). The result was large monopolies, particularly in the extractive industries. The former state monopolies were transformed into private monopolies, owned by a handful of persons. Russian capitalism resembles the western free market system less than the kind of capitalism depicted by the communist propaganda machine there. Economic power is heavily concentrated, banks are establishing ownership positions in industry, economic power means political influence.

There is at the same time a large informal sector of small entrepreneurs, in practically all the former Soviet republics. The future of Mafia capitalism is a particularly important issue. Will it be whitewashed or will it remain a dominating force, extending its grasp to political life as well?

1.4 New interactions with the world market and the reintegration process

The period, close to a decade, since the beginning of the systemic change in central and eastern Europe brought about important changes in its external economic relations. The reintegration , through trade flows, of the former socialist countries in Europe has so far been unimpressive and rather diverse. Their share in world exports in 1960 was 10 per cent, in 1988 about 7 per cent, and 4 per cent in 1996 (UNCTAD, 1997: 246). There are a few success stories, but in general, the changes are slow and there are also setbacks. Trade flows have been influenced by a number of factors. The changes in trade volumes reflected the collapse of the eastern markets, which were very important for all countries, and the recovery is rather slow. The regional distribution of exports and imports has changed radically. The territorial restructuring of trade relations was the result of both political and economic factors. There has been a fast increase in trade with the OECD countries, and particularly with the members of the European Union. This was facilitated by improved access to the western markets and the export promotion programmes of the eastern countries. These efforts were often constrained by the fact that most of the traditional product categories, in which they may have certain competitive advantages in western markets, belong to regulated or protected sectors. Data on the composition of exports indicate that, with the exception of a few countries, there has continued to be a concentration on some traditional export products, with a high energy and capital intensity. FDI contributed to the growth of intra-industry trade. Most of the increases in manufacturing exports have been related to western subcontracting and foreign direct investment.

Trade relations between the former members of the CMEA comprise also an important and interesting area of reintegration. The dissolution of the CMEA and the collapse of the regional cooperation regime, resulted in radical changes in the role of the 'eastern markets. ' The share of mutual exports in total exports was 40 percent in 1988 and 15 percent in 1993, and the share of

mutual imports in total imports was 38 percent in l988 and 16 percent 1995.[19] Since then, a small recovery started in trade within the region, and a free trade area(CEFTA) has been established . In this context, the former trade partners are not too eager to give free trade or other concessions to each other, and they now consider each other often more as competitors than partners.

Imports of the central and eastern European transition economies declined at a slower rate than their exports and GDP between 1990-5, resulting in large current account deficits. In the case of most of the former republics of the Soviet Union, there has also been a sharp decline in imports. The differences between the countries were not only the result of variations in the degree of domestic institutional change, but also of the size of the domestic market, and the stability of the political system. The abolition of import quotas and the increase of imports brought more consumer goods into the shops, in many cases at the expense of the local producers or at the expense of consumers faced with the higher prices of new monopolies. The expected advantages of import competition have so far not materialized.

As a result of the diverse economic consequences of the changes, on the different sectors of the economies and on the firms, within the countries, new lobbies are emerging. Some of the new entrepreneurs are asking for special protectionism measures against imports, others want not only the liberalization of exports, but also more incentives for exporters. Certain foreign firms are also looking for fast returns on invested capital (risk-justified ultra-high profits) and monopolistic positions in the shrinking domestic markets.

The success of China in its economic relations with the rest of the world was based on the combination of a number of factors. The aggressive outward-oriented strategy of the central government, with the active support of the provinces and local governments, promoted the development of an export culture. This policy accompanied geographical and sectoral targeting for exports and offered important tax concessions and exemptions of duties on inputs used in export production. An increasingly open foreign investment regime encouraged the presence and growing interests of the investors from Hong Kong, Taiwan, Japan and other countries, looking for cheap and disciplined labour. Foreign direct investments played a much more important role in China's economic reintegration into the global market system than in central and eastern Europe. Until the end of 1995, commitments of more than US$390 billion were made and more than US $135 billion were actually invested by foreign firms. A large part of the foreign direct investments went to the southern provinces and to the special economic zones, using cheap Chinese labour for export production. By 1996, however, while still encouraging FDI, China wanted to divert it to bottleneck and high-technology areas, such as energy, infrastructure and advanced manufacturing. China is using both tax and tariff measures for redirecting foreign capital inflows.

China has been doing particularly well in foreign trade. With trade growth double the world average in the 1980s and early 1990s, China's share in world merchandise trade more than tripled, rising from 0.8 per cent in 1978 to 2.6 per cent in 1993. As a result, China became the 11th largest trading nation in the world, far up from its 27th position in 1978. But it still cannot be described as a 'trade giant'.

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[19] UN Economic Commission for Europe, *Economic Survey of Europe in* 1992-93, and *Economic Survey of Europe in 1994-95*, UNECE: New York and Geneva.

At the end of the century, it would be wrong to draw general and over-optimistic conclusions regarding the European transition economies' reintegration process. There will be countries more successful in the process, and probably a large number of transition economies will have to face long and difficult periods of adjustment. China and Vietnam will also have to confront a number of new challenges related to the domestic and external problems. Establishing relations with the rest of the world on new foundations has different implications for the transition economies in Europe, China and Vietnam. What may be especially important for the transition economies in the 1990s in Europe are not only the growth and structure of world trade, the evolution of capital markets, the strength of competitors, the policies of international organizations, but also the integration process in Europe and the European Union. The EU is considered by most of the countries as the main anchor of their reintegration in the international market system. For Russia, China and Vietnam, the institutional patterns of reintegration are different; Vietnam is interested in ASEAN, China in APEC.

The policies and the practical measures of the main external partners have an important influence on the process, speed, character and consequences of reintegration. There is an important political dimension here, particularly in the case of Russia which is the most important power in the eastern part of Europe. It has 'inherited' most of the economic, research and development, and military potential of the former Soviet Union.[20] This being so, some experts have asked whether western support to the former socialist countries, especially Russia, would not result in the emergence of new competitors. But this argument has not gained strength so far in the post-Cold War situation. The dilemma of what should be the guideline for future relations with Russia - weakening, marginalization and isolation, or building it up as a new democratic power - has not been solved in the policies of its former opponents, especially the USA.

In economic terms, the process of reintegration requires mutual adjustment measures, more than direct aid, and the adjustment of the partners in order to accommodate their markets to the new realities created by the needs of the transition The process is not an easy one. There are a number of reasons for this. One of them is the rather slow global economic growth, and the relatively large unemployment in Europe. Since the 1960s, there has been a deceleration of

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[20] Russia has strong interests (which may be also converging with the interests of other successor states of the Soviet Union) to sustain close economic and in certain cases security cooperation with the other republics. The CIS (Commonwealth of Independent States) has been conceived as the key instrument of this cooperation. . Russia has a strong interest to hold together, as much as possible, those areas of the former Soviet Union where large Russian minorities reside. Russia will certainly protect the interests of these minorities and use them to exert as much influence as possible (there are about 25-30 million Russians living outside Russia in various Commonwealth states). Indeed, Russia will sustain its efforts to hold all the Commonwealth republics together for economic and for strategic purposes. Russia's primary security concerns will be focused within its frontiers. It will be concerned with blocking secessionist trends and preserving, or even strengthening, traditional relations with the ruling elite, with the technocrats, through cooperation in education. The Russian minorities in a few countries may play an important role in this process. Under certain conditions, Russia may also engage in territorial disputes with some former republics and some potentially expansionist Islamic powers in the region. It will also sustain certain interests in central and eastern Europe. In this context, there are experts who predict the revival of certain traditional factors related to the cultural heritage of pan-Slavism or religious affinity. Following a long tradition, Russia will maintain a relatively strong army for domestic purposes, prestige, and regional security. This strong military capacity will remain important for some time in Russia's political relations particularly with former members of the Soviet Union.

global economic growth which accompanied growing regional differences in growth rates, both in general and per head. The present growth rates are below those in a large number of countries which contributed to unprecedented economic and social improvements, helped to sustain the welfare state and the high level of employment. The systemic changes in central and eastern Europe in the 1990s also contributed to the slowdown of global growth.

The second problem is related to the high fiscal burden and to the goals of the governments in the western countries to reduce budgetary deficits. This not only constrains their commitments, but is also a source of domestic political problems not only in the context of the resource transfer to the former socialist countries, but also to the developing countries. The third problem is rooted in the emerging new forms of competition and new competitors, particularly the fast growth of manufacturing in the more developed parts of the developing world, which is creating a number of new difficulties also for the industrial world, demanding important adjustment measures. The former socialist countries are looked upon by a number of politicians in the western and developing countries as potential competitors or as important backyards for some of their present competitors. This also has important implications for their policies.

Relations with China and Vietnam also require adjustments from the industrial countries, but with clearer immediate benefits. The emergence of China as a new world power of the 21st century will have major consequences for a number of countries, those with an important Chinese population, states around China, and other world powers, particularly the United States, Japan, India and Russia. The character of these implications will depend greatly on the future of Chinese politics. The economic transformation and further opening of China offers markets but also opens new areas of competition and potential global tension related to the struggle for economic and political influence. China has been seen increasingly as a potential competitor in the world market. The fact that its reintegration into the global economy has been a key factor in promoting rapid domestic economic growth, which has also contributed to the growth of world trade , and that China and Vietnam belong to the group of rapidly growing countries has increased the interest of the main industrial powers in cooperating with the two Asian countries.

The shaping of future of relations with the former socialist countries has raised different issues and has been formulated in different ways in the USA, in the European Union, in Japan, and in the developing countries (including also China and Vietnam in this context). But even in the western world, there are different dimensions of the problem related to security, business, employment, resource transfers and humanitarian assistance.

The capacity and will to provide the necessary external support to the transition process in these countries—meaning simultaneously the support for the consolidation of democracy, economic and political modernization and the integration into the global economy resting on new foundations—is the greatest challenge for the rest of the world, particularly for western countries in the 20th and a large part of the 21st century. A number of experts suggest that the large-scale modernization of the central and eastern European countries and the successor states of the Soviet Union offer unique opportunities for the member countries of the European Union because of their geographic vicinity and historical ties with the region. They should therefore be, first and foremost, responsible for the external costs of it. The political future and the economic integration of the transition economies into the global market system has, indeed, created opportunities but also new challenges for the western European business interests,

countries, and the regional integration process itself. At this early stage, the scope of the problems and challenges are more visible than the economic opportunities. The fear of mass immigration, potential armed conflicts in the eastern part of Europe, may be stimulating different measures supporting the transition process, and promoting the modernization and integration of the transition economies into the EU. There are great differences among the present members of the EU concerning the forms, the magnitude of assistance to, and the suggested timing of, the integration of the potential eastern member states.

The attitude of the European Union towards the former socialist countries in Europe is based on the traditional relations of some of its members with the east, and the new geopolitical and economic realities of the European region. It is rational to expect that future relations between the EU and the transition economies will depend on a number of factors. Among these are the diversity of interests and policies of the EU's present members which determine not only the possibilities for reconciling the 'widening and deepening' of the Union, but also their individual attitudes toward the European transition economies. The experiences gained through the Association Agreements have proved that the Union and its members must play a more active role in increasing the capacity of the transition economies to fulfil not only the institutional, but also the structural, conditions of membership.

It is also clear that the potential transition members must gain sufficient strength and competitiveness to survive in the Union. This requires a much greater and early opening of the markets of the European Union for the goods of these countries, also in areas in which the transition economies enjoy a stronger competitive position. A large proportion of the currently exportable goods of the countries in central and eastern Europe fall into the category of 'sensitive' imports to western Europe and also North America. The former socialist countries require not only easier market access in areas where they are more competitive, but also more development assistance through massive inflows of new technology, expertise and capital under more equitable conditions to generate a new structure of activities, capacities and interactions to produce more competitive goods. All this would mean a faster restructuring of the transition economies, with adjustments and temporary sacrifices on both sides. The former socialist countries argue, however, that they have already made important sacrifices in their adjustment to the new market system in terms of closing down inefficient firms, unemployment, and austerity programmes.

Among the main western partners of the transition economies, the USA has been playing a very important role in promoting their integration into the global markets, through a multiplicity of channels and instruments There is a major difference in this context, between the policies of the USA towards China, Vietnam, Russia, and central and eastern Europe. With regard to Russia and China, national security considerations are still playing an important role, but with different emphases. Economic factors are more important in the policies of the USA toward central and eastern Europe. The original idea of the Bush administration was that it would be the American private sector which would play the leading role in the marketization process of the transition economies through foreign direct investment, trade and technology exports. The countries were assisted by government funds, technical assistance and advice in institution building as well. The American administration in the early 1990s, encouraged also the advisory, the managerial and the funding role of the Bretton Woods institutions. American private investment grew very

fast in China. By 1994, their commitment was over 6 billion dollars[21] (the USA was the third largest investor, after Hong Kong and Taiwan).[22] The volume of American private direct investments in central and eastern Europe, and in Russia, taken together, was below that figure. The early ideas of the American administration were also very optimistic. Some key experts of the Bush administration anticipated a rapid and successful transition, based on broad popular support. They also expected that the debt of a number of east European countries would be 'grown out' by a fast increase in trade. Five years after the beginning of the transition process in Europe, it is evident that the role of the USA remained below the expectations of the east European countries, while in the case of China, both as a source of capital and as a trading partner, the United States proved to be extremely important. US-Chinese relations became one of the most important elements of future Asian and global politics.

The developing world is one of the most controversial and critical areas of the 'external environment' of the reintegration of the former socialist countries into the global markets. It is itself a very special part of the market system. Due to similarities in development levels, structural and institutional weaknesses, many of the developing countries have faced similar problems in the past in the global economy, as the former socialist countries did and do, both then and now. The collapse of the Soviet Union influenced the global position of the developing countries in many ways. In political terms, they lost some of the bargaining power which they had had in a world divided into two hostile blocs. With the disappearance of the 'Second World', the 'Third World' as a concept lost its justification. This change is not just symbolic . Some of the developing countries lost an important source of assistance and political support as the result of the disintegration of the Soviet Union. The north does not need the south any more as proxy or ally in Cold War conflicts. A number of factors, such as non-alignment, which united the south in the Cold War, lost their strength. In economic terms, the asymmetries in interdependence between the north and the south have not only been Cold War-related. The minerals and agricultural commodities of the south became much less important for the industrial world because of structural changes as a result of the new technological revolution. Economic interests and factors will play a much more important role not only in the future north-south, but also south-east relations. The cheap qualified labour of the former socialist countries, their export potential, and especially commodity exports, mean increasing competition with many developing countries. There is also competition for external resources, foreign assistance, and foreign direct investment. At the same time some of the former socialist countries, especially Russia owing to its economic interests, are making new efforts to increase mutual trade with a number of developing countries, particularly in Asia, where the continuity of relations from the Soviet era is supported by mutual interests. Relations between Russia and China will become more significant, as they will be based more on economic rationality and complementarity. The success of the consolidation of the former socialist countries and their integration into the global economy may, of course, also open important opportunities for many developing countries as markets and investors.

The research on the causes of the gap between expectations and reality has revealed that the west was not prepared for the high cost of change in east Europe. The costs of German reunification point this out. No other transition economy can expect anything like the

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[21] *Far Eastern Economic Review*, 12 October 1995: 55, Hong Kong.

[22] *Financial Times*, 27 June 1996: IV.

commitments of Germany towards its eastern region. The commitments undertaken by the European Union imply resource transfers. They are however negligible as compared to the funds received by the eastern parts of Germany. Besides the understanding of the limited availability of resources, there is a growing concern in a number of the former socialist countries, that the policy-induced approaches to the transition process in the western world may be gradually fading, and may be being replaced by profit-motivated approaches. In Europe, this may not be the case for a while, but in the longer term, as the transition will be considered as institutionally completed, such problems may emerge.

1.5 The reintegration process and the tasks of the international organizations

Accession to the multilateral system of international cooperation has been a fundamentally important component of the reintegration of the former socialist countries into the global markets. Some of these countries joined GATT, the World Bank and the IMF before the systemic changes. Their participation, with the exception of China and, to a certain extent, Yugoslavia, has been marginal however. The systemic changes resulted in a new era. In the early 1990s, when the main western industrialized countries discussed the international institutional support for the transition process in central and eastern Europe, the third key actor, beyond the World Bank and the IMF, was the European Union, which received specific tasks. The role of the UN in the process was raised more in general terms. The initiative came from the delegates of the transition economies, from some of the industrial countries, particularly in Europe, and from the secretariat and the specialized agencies.

The World Bank and the IMF became the most important multilateral agencies in orchestrating the transition process. Liberalization and the introduction of free market policies have been one of the most important underpinnings of the new contractual relationship between the transition countries and the Bretton Woods institutions. This is not the place to evaluate the outcomes of their role. In many cases, the policies of the two institutions have been blamed for many failures and errors in the transition economies. The contribution of these two institutions to the macroeconomic stability and their role in providing additional resources, assistance and advice in institution building received much less recognition. Membership in the World Trade Organization has been particularly important in influencing the evolving legal system and the development of trade policies. Those central and eastern European countries, which were members of the GATT, were involved in the negotiations from the beginning. From among the CIS countries, 10 out of 12 applied for membership in the WTO. Relations with the European Union represented another set of problems. A number of the former socialist countries entered into some form of contractual relations with the EU. The association agreements were important forms of cooperation. Five countries—the Czech Republic, Estonia, Hungary, Poland and Slovenia—are in the process of negotiating their accession to the Union, and five more are preparing to do so.

As for the UN system, the situation is much less complicated. Political and economic transition, reforms and changes in political regimes are not unknown to it . The United Nations and the specialized agencies have supported a large number of new countries, born on the ruins of the colonial empires, in the establishment of their statehood. The UN accumulated experience in many new countries, in handling the legal problems of successor states, in institution building and undertook the impartial, unbiased analysis of the socioeconomic and administrative processes of transformation. It was also playing an advocate's role in the global system, for the

support of the new countries in solving their problems, suggesting policies and measures for the moderation of the human cost of the changes. In a number of cases the UN was the first to provide humanitarian assistance and technical cooperation. There are, of course, important new and historically unprecedented problems for the UN as well in dealing with the transition process in the former socialist countries. First, the dismembering of the Soviet Union and the systemic changes in Russia were the first time that a global power, one of the founders of the UN system and a major force in the world organization, faced the tasks of domestic systemic change and integration into the global system on a new basis. Second, the special role given to the World Bank and IMF by the main industrial countries in guiding and helping the transformation process also implied important constraints on the UN, which has a more diverse and heterogeneous economic philosophy, a much more limited mandate and fewer resources than the Bretton Woods institutions. Finally, in a number of areas, particularly in the case of technical and humanitarian assistance, there was a certain competition for resources as between the developing countries and some of the transition economies also in the framework of the UN.

From among the members of the UN family, the contribution of the UN Economic Commission of Europe has probably been the most important, and comprehensive, since the very beginning of the changes in Europe, particularly in analysing and evaluating the successes and failures, and in comparing the performance of the transition countries. The Commission has also been playing an important role in raising the issues of the transition process in an integrated European framework. The contribution of the UN system has been meaningful in a number of areas, including:

- helping in conflict management and resolution in the region, which may have a longer period of political, social and economic instability;
- humanitarian assistance;
- a critical and impartial analysis of the main factors, processes and outcomes in the transition process, including the role and attitude of the different actors;
- technical cooperation in institution building and in the management of the new organizations of the market system;
- transfer of knowledge and information about country experiences and solutions in similar circumstances;
- a critical appraisal and analysis of the different national and international programmes, related to the transition process;
- analysing the implications of the transition process for the different groups of countries, and particularly for the developing countries, with a view to strengthening global cooperation;
- helping democratization in the former socialist countries by projecting the democratic and humanitarian values of the Charter, of the Universal Declaration of Human Rights;
- promoting the reintegration of the transition economies into the global system of cooperation by the critical analysis of their own policies and practices, successes and failures, and of the ways in which the rest of the world is handling the process.

The UN has been playing also an important role in keeping the transition process, and the reintegration of the former 'second world' into the global market system, on the global agenda in such a way as to take into account the interests of all the partners involved, including those of the developing countries.

1.6 Conclusions

The successes and failures in implementing the domestic tasks of transition, and also the process of integration into the global market system, is and will be influenced by the new interactions between the former socialist countries, China, Vietnam and the rest of the world. The new interactions are shaped by a number of political, economic and cultural factors, and while there are certain general and global consequences of the changes, their influence may not be the same on the different groups of countries

The transition process and reintegration into the global markets opened historically unprecedented opportunities for the transition countries to concentrate on the modernization process and on the settlement of the traditional sources of distrust and confrontation between them. The reintegration into the global economy is however a long-term, difficult, and multidimensional process, involving many actors and influenced by different, often diverging interests, values and policies in the global system.

There is no chance of success for 'passive' world market integration, which focuses only on the institutional changes and neglects or disregards the creation of competitive advantages, both at the level of firms and of countries. The main regulating force in the global markets is competition. The competitiveness of an economy is shaped by interrelated activities, undertaken simultaneously at different levels and by a number of actors: macroeconomic policies and national institution-building by governments, specific sectoral policies, particularly those related to infrastructure, science and technology, education, trade, microeconomic activities undertaken by firms, dependent on managerial skills, correct strategies in the field of innovation, production, marketing, sourcing and sales. Neither privatization, nor the other often-mentioned pillars of transition to a market economy, like liberalization of international transactions, are sufficient guarantees themselves for the establishment of internationally competitive and efficient firms and economies. The transition process must serve as an instrument for modernization (a key condition of competitiveness) which should be considered higher on the agenda of the countries and of international organizations. This is more than the goal of catching up in GDP per head. It requires greater institutional flexibility and a capacity for constant adjustment, in order to profit from reintegration into the global market system. This latter requirement, related to the quality of governance has important and long-term welfare implications for the countries concerned.

The historical experience of the developing countries and their difficulties in integrating into the global economy after decolonization, raises the following question about the reintegration of the transition countries: how will the potential gains and the actual costs of reintegration be distributed? A new partnership is needed, which takes into account not only mutual interests, but is based on firm commitments on the part of all the actors involved. This partnership should help institution building, mutual adjustment, and a more equitable distribution of costs and benefits. It is also important, that the developed industrial countries should fully understand the role they are playing in shaping the new interactions and their responsibilities in providing a comprehensive and active assistance to the transition economies in the transfer of technology, management techniques and resources through different channels, including the opening up of their markets and the triggering of innovatory forces.

Through the new relations with the world markets and the internal consequences of the process, the domestic legitimacy of the market system has become an important international issue. Many western economic advisers to the new regimes have suggested that fast liberalization is the key remedy for curing all the economic ills of the transition countries, including the rapid improvement of their export potential. Their assumptions were based more on mainstream theories than on practical experiences. On such foundations, for example, it was thought that, regardless of their structural impediments, the opening of the previously closed economies would result in an increase in exports in exchange for increased imports, as the new exports sectors expanded and, following import competition, certain inefficient sectors disappeared. There would be winners and losers, and due to cost differences between the industrial countries and the former socialist countries, the winners would soon compensate the losers. The reality proved to be different. The introduction of the market system and reintegration proved to be a difficult challenge to the whole of society in the transition countries.

One of the most conspicuous consequences of the problems the transition countries in Europe encountered was the decline of their GDP. During 1990-95, the total value of GDP loss in the former European Socialist countries, was about 1400 billion dollars. Industrial and agricultural output declined very fast, due to the collapse of the eastern markets, the unavailability or the loss of means which made important inputs unaffordable, the crowding out effect of imports and shrinking domestic purchasing power. The output and income loss was much greater, and proved to be more long term, than in the USA and Germany during the great depression of the thirties. A most difficult and disturbing factor has been the very high human cost of the changes. Unemployment statistics in the region are not reliable. In Russia, for example, workers remain in the factories, and are paid very low wages even in those cases where the capacity utilization is below 50 per cent. The deterioration of the employment situation, the downgrading of skills, are important characteristics everywhere. The consequences for the population are materialized not only in the declining standard of living, but also in the increase of social insecurity, unemployment and long-term poverty. From a working population of more than 220 million in the region—while the number of officially unemployed has 'only' about been 10-12 million—the underemployed may be as much as 30-40 percent of the total labour force. From a total population of close to 400 million, the number of poor increased from 8 million to more than 58 million.[23] The actual figure may be much larger, on the basis of the national estimates which consider the number of poor, or those close to the poverty line, as one third of the population. Sporadic empirical data indicate that the growth of the foreign sector also contributed to the increasing inequalities in income distribution.

The market in central and eastern Europe proved to be an efficient mechanism for matching the supply of, and demand for, goods and services and setting appropriate price levels. But it is not a mechanism for the efficient and equitable allocation of social resources as a whole.

In the light of the structural and human problems of the former socialist countries, there is very little disagreement today that neither privatization, nor the other pillars of the transition to a market economy, like liberalization of international transactions, are insufficient guarantees in themselves for the establishment of internationally competitive and efficient economies. In the 1960s, the leaders of the Soviet Union emphasized the goal of catching up with the industrial

[23] See, *Transition,* Vol. 5, No. 8: 1-4, October 1994.

west within a historically short period of time. The European Bank for Reconstruction and Development in its 1995 report raised this issue in relation to the transition economies, and suggested, that the central and eastern European economies must grow by 7 per cent a year for 30 years to catch up with OECD countries.[24] The catching-up issue is, however, a rather complex one. The countries would need more profound changes and a more supportive international environment than those they benefit from at present, or those which they can expect in the coming years.

In contrast to the transition economies, China, and to a lesser extent Vietnam, have so far been able to reduce poverty and to increase gainful employment. Through township industrialization, for example, more than 120 million new jobs were created in China, and the foreign direct investment created close to 5 million new jobs.

The brief history of the transition process shows how quickly market systems can convert equalities into inequalities. The fundamental question in the former socialist countries is how far will the gap between the top and the bottom widen and what will happen in the 'middle'. The sustainability of democracy in these countries depends to a large extent upon the answer to this question.

An important political consequence of the emerging inequalities is nationalist populism. New nationalism in a region with large ethnic minorities, grave social problems and economic difficulties, when placed alongside a historical heritage of hatred, forced assimilation, and oppression, can easily become explosive and result in chauvinism and xenophobia. It could endanger the stability of the whole European continent. One must remember that the two world wars of this century started in central and eastern Europe (including the Balkans), and in the 1990s the longest civil war of the post-Second World War era has been waged there. The violent nationalism and chauvinist policies in certain countries in the past have resulted in serious conflicts, global tragedies and were also used in the competition between certain great powers to gain control over the region, and in their policies of 'divide and rule'[25]

The populist groups at this stage in practically all the countries are opposing foreign ownership of assets, including land. They are also against national capitalists. The populist views were summarized in the following way in Hungary: 'There is a general opinion that one cannot become rich in an honest way. If somebody actually became an important capitalist in Hungary, this was not the result of his knowledge, persistence, risk-taking, in short of his talent and of course of his luck. It was the consequence of his political connections, corrupt manoeuvring and of his cheating and harming the state, which means the public…How can we build a market economy if we hate national capitalists even more than foreign entrepreneurs.'[26]

With respect to the future, the project drew attention to the fact that in one way or another, the whole world is in a state of transition, from Cold War bilateralism, to the new political realities,

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[24] *The Economist*, 4 November 1995: 87.

[25] The most important sources of international instability in the 1990s are rooted in ethnic problems. Russia has now twenty-one republics within its framework. In central and eastern Europe, there are domestic ethnic problems in practically all states, giving rise to many sources of tension. The domestic sources of instability are the deteriorating standard of living, the increase of poverty, the high level of unemployment.

[26] In the Defence of Hungarian Big Business, '*Népszabadság* , June 2, 1997: 11

to a new stage of globalization and regionalism. The systemic changes in central and east Europe, the marketization of the economies of China and Vietnam also increase the diversity of the global political and economic system, which implies also new concentrations of power and interests. All these, and other, changes have opened an almost endless list of tasks related to the future of global security, which requires the active and long-term involvement of the international organizations in the management of the problems related to the reintegration of the former socialist countries into the global markets.

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CHAPTER 2

THE ROLE OF THE IMF IN THE TRANSFORMATION PROCESS AND THE INTEGRATION OF THE FORMER SOCIALIST COUNTRIES INTO THE WORLD MARKET SYSTEM

Reimut Jochimsen

2.1 A period of historic disruption, economic upheaval and political integration

Rarely has such rapid, deep-seated change taken place in the political map of our world as we have witnessed during the past ten years. The era of transformation for the former socialist countries emerged fully with the fall of the Berlin wall in 1989. After that event, the countries of central and east Europe finally decided to end their isolation from the international community. This movement also included the Soviet Union, which with some of its constituent republics formed the Commonwealth of Independent States (CIS) in late 1991 (excluding only the three Baltic States). This gave rise to the laborious day-to-day task of overcoming the political and economic division of Europe. The liberation of the countries of central, east, and southeast Europe from decades of communist rule was rightly celebrated as a fresh start on the road to wider political, economic and societal freedom. Yet, a resurgence of nationalism has occurred; ethnic, religious, and other conflicts between majorities and minorities have flared up once more. The immense dangers involved in renouncing the 'imperial overstretch' of the Leninist-Stalinist rule of force and ideology in the former Soviet realm are there for all to see, even within Russia (Chechnya being the outstanding example). In Kosovo, too, there are (were?) many hundreds of thousands of refugees fleeing from the atrocities of a post-communist authoritarian regime.

Furthermore, in the early nineties, the world at large underwent major changes—turning-points of truly historic proportions. The failure and the collapse of the communist regimes of centrally planned and managed economies led to a dramatic changeover to a more successful development model. In addition, new, extensive, structural and technological challenges came to the fore which have changed politics, business, the world of work, as well as our industrial, service and information societies. The new media appear to have transformed the world into a global village, and they will continue to cause upheaval. These developments continue to shape the issues of our time; key economic, technological and political trend factors are making their mark on the processes of regionalization and bloc-building in world trade (Jochimsen, 1996). Last, but not least, although Europe's increasing integration is not, in the context of the world economy, the actual trigger or determinant of the changes which are taking place, it has and certainly is playing a crucial role in amplifying existing trends, especially in Europe's neighbouring economies, societies and body politic.

At the same time, in many places, there had been a veritable explosion of previously pent-up hopes and desires that it will be possible, in just a short period, to establish a market economy with a social conscience together with a pluralist democracy. Not only did people hope for a

rapid growth in the scope for restoring social balance, and early integration into the world economy as effective partners with equal rights, but also, in particular, for rapid political and economic integration into the international community of nations, especially the EU. Western countries, and others too, came to realize that their own interests are also at stake in this. Continuing political disorder or even chaos, a lack of law enforcement and constitutional order, deep economic shrinkage and decay as well as tensions between the newly emerging 'haves' and 'have-nots', involving (as illustrated above) ethnic and other minorities—all of these harbour the risk of explosive political and social instability. If this were to erupt along a broad front, it would inevitably have a major detrimental knock-on effect throughout the west—not only in terms of migratory pressures and threats to internal security, but also in quite a general sense. For example, one could hardly expect a German-Polish 'prosperity divide' along border of the Oder and Neisse rivers to remain a peaceful one indefinitely. Yet even here, it ought not to be a question of providing help at any price. All care must be taken to see that the resources made available are deployed efficiently, and that the systematic (re)construction of the institutional, material, and personal foundations continues in future.

We also need to be aware that what we really have to do is provide help towards self-help, and to organize the channels for an inflow of capital, expertise and market access in the form of direct investment determined by reciprocal interests. The crucial contributions to the transformation and particularly towards shaping the institutional infrastructure—in other words, the political, economic and social reforms always have to be made by the countries and peoples themselves. They have to be argued over, and proven in processes of democratic evolution and maturation—even conflict, not 'stolen in' by the dictates of outside experts who are nowhere in command of the full background. However, by providing the right assistance the countries of the west can indeed help to alleviate the most pressing problem, namely the lack of time. Providing assistance is therefore a question of building bridges out of the past and into the future, of accelerating necessary processes and of pinpointing alternative options where they are available. Promising ways need to be found of extricating these countries from the most urgent problems and meeting unsolved challenges, before the 'time-bomb' goes off in our faces. It is here where the peace-sustaining force of European integration comes into play.

Just a few months ago, the process of European unification arrived at a new ground-breaking stage. By successfully starting the final stage of European Economic and Monetary Union (EMU) on January 1, 1999, the eleven participating countries of the European Union have realized what is undoubtedly the most ambitious project of European integration so far. It is certainly the most far-reaching in its political impact that European nation-states have attempted in the entire post-war era. The establishment of EMU including the new exchange rate mechanism with the euro as its hub and its spokes represented by the EU currencies that are not (yet) participating in the Eurosystem—at present, the Danish krone and the Greek drachma—will change the nature of relations among the participating countries, with their other partner nations in Europe and with trading partners the world over. It will do so both in monetary relations and in the real economy. And it openly aims at enlargement, with a number of reform and transformation countries in central and eastern Europe as candidates for full membership. Yet the 'deepening' and 'widening' of the EU is in turn likely to have an impact on broader economic relations and the balance of political power on a global scale and, when successfully implemented and sustained, indeed to bring shifts in them in the longer term. This will be all the more the case if EU countries, especially the EMU participants, are thoroughly successful in gearing their policy-making to stability and sustainability in the long-term.

However, these issues fall under the dark shadows cast by the clouds of financial crises in more and more regions of the world, as we have felt most keenly just recently, on our own continent too. When all is said and done, since the Asian crisis broke out in Thailand in July 1997 the world's finance markets have been shaken at ever shorter intervals by ever larger shock waves, which have also had a significant impact upon the prospects for growth and employment in Europe. The turbulent events of the past year, particularly the collapse of orderly foreign exchange and financial markets in the Russian Federation in mid August 1998, have also posed a severe and ongoing challenge for the countries in transition as a whole—a challenge in many ways greater than at any time since the beginning of transformation. Brazil's abandonment of its crawling peg exchange rate arrangement in mid January 1999 was only the latest dramatic episode in the recurrent bouts of instability that have been marking global financial market developments for the last two years. Financial contagion from the Brazilian crisis has been limited thus far, but it may be several months before the fallout becomes clear.[1]

Beyond the necessities of political reorganization and reforms, an enormous challenge has emerged for the west in the form of economic and financial assistance. No doubt, what is needed here is more capital, preferably accompanied by access to markets and the transfer of knowledge and technology. This implies personal communication and expertise, involvement and assistance, and not just pouring in money, however irreplaceable the latter may ultimately remain. Some useful experience from the recent past has to be put to use when organizing capital inflows. In the debt crises of the eighties as in the aftermath of the 1990 Gulf War (which had a severe impact on the balance of payments of many countries) the international financial organizations managed to play a helpful, and indeed, indispensable role.

One organization which has been particularly prominent in taking on additional tasks, especially since 1982 in the wake of the Latin American debt crisis, is the International Monetary Fund (IMF). The IMF was originally set up to administer the Bretton Woods fixed-exchange-rate system, which was in operation until 1971-3 and to deal with short-term balance of payment crises, addressing inevitably needed adjustments of 'fundamental disequilibria' in the national macroeconomics. After the collapse of the Berlin Wall on November 9, 1989, the IMF found that it had an historic opportunity to take on an active role in reshaping the old system in east and central Europe together with the countries formerly belonging to the Soviet Union. Indeed, this task was quickly assigned to it by the major western industrial countries (G-7), particularly since neither the European Community—which was busy preparing for its single internal market and a further 'deepening' of integration by the creation of a single currency—nor the OECD nor any other organization, not even the World Bank, was available for this enormous and historic task at the start of the decade. Other bodies were lacking at that time. The European Bank for Reconstruction and Development (EBRD) in London, for example, was able to establish its integrating function only after its foundation in 1991.

2.2 The original objectives and tasks of the IMF

The IMF was brought into being in 1944 as one of the mainstays of the world monetary system.

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[1] Recent developments in the emerging markets are examined in the May 1999, *World Economic Outlook* of the International Monetary Fund.

One of its fundamental aims is that it should contribute towards a free global economy which will raise welfare levels around the world. Even though recent events leading up to and in the wake of the Asian crisis may have cast a shadow over its activities, the many concrete examples of the IMF's positive influence must be stressed.[2] The Fund's primary tasks consist in monitoring its members' currency and economic policies, offering them advice, and providing bridging loans to help them cope with temporary balance-of-payments crises. The key task among these is to press for stability-oriented currency and economic policies on the part of its individual member countries, to support a stable international monetary system, and hence at the same time to create favourable conditions for development, growth and employment. It was conceived to be of assistance to developed and developing countries alike, though after the mid seventies, when even Britain and Italy had to take recourse to the IMF, it has been concentrating almost entirely on developing countries, mainly in Latin America, Africa and the Middle East. Neither the communist countries nor the South East Asian tiger economies needed its aid or were eligible for it (because of non-membership).

Funds lent by the IMF are intended to act as a catalyst, by encouraging other lenders or donors to invest substantial amounts of their own. An equally important function of the Fund is its supervisory role in the implementation process of the conditions for assistance programmes agreed upon, as the centre and the coordinating body in the constant interchange of information in the fields of monetary, fiscal and currency policies, with the various consultative mechanisms that also entails. The practical support it provides through its technical and professional assistance programmes is also becoming ever more important in the field of policy advice and the build-up of prudential supervision.

The provision of financial assistance is intended to put member countries in a position to eliminate balance-of-payments disequilibria without having to resort to measures which will disrupt world trade. In contrast to other financial institutions, particularly those involved in funding development, the IMF is a monetary institution—or perhaps one rather ought now to say, it was. Its funds were always meant to revolve relatively quickly. That is to say, those were loans granted only for the short- or medium-terms, after which they had to be repaid. Traditionally, these payouts are tied to a strict concept of so-called 'conditionality' of the assistance granted, thus depending on an agreed quick and sweeping action on the part of the recipient country.

The assistance granted by the IMF is predominantly funded out of the quota subscriptions paid by member countries. Each member is obliged to pay its membership subscription according to a 'quota' system, which in turn is governed by the different countries' relative economic strengths. Given this cooperative structure, the Fund differs from the World Bank in as far as it does not normally have recourse to the world capital markets, although it could do so in theory.

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[2] Empirical surveys of the efficacy of IMF programmes in developing countries show that, in the majority of cases, the positive effects predominate in the long-term when it comes to improvements in countries' balance of payments and mostly reductions, however only slight, in inflation. See, Donovan (1982), Gylfason (1987), Killick, Malik and Manuel (1992), Khan (1990), Black (1994), Schadler (1995a, b). However, critical views are given by Sachs (1994) and Dornbusch (1998).

2.3 Starting conditions for the reform process in the former Soviet bloc

Without exception, all of the former Soviet-bloc countries were saddled with tremendous development and structural policy problems of a long-term nature at the time the transformation process set in, not to mention the systemic deficits and deficiencies for economic agents to act henceforth in a market economic framework and constitution. Following decades of the centrally planned economy, these countries' price and trading systems, not to mention the structure of the producing sectors, were totally distorted. All of the countries concerned had to face the fact that they were behind others—in most cases far behind them—in productivity terms, and that they had an out-of-date range of products below world quality standards and, hence, were no longer competitive in international markets, together with a debilitating, monopolistic economic structure dominated by large state-owned combines. These difficulties were added to by macroeconomic imbalances, some of which were on a massive scale, particularly the monetary overhang situations that had accumulated over the years and which sufficed to set off a price-wage spiral once prices were liberalized. The service sector in these countries was totally underdeveloped, which meant that they also lacked the resourceful banking and finance system which is so vitally necessary for remodelling the economy and for allocating scarce capital. This mixture of problems was then exacerbated still further by environmental destruction, often of considerable dimensions. To this was added the problem that the international pattern of specialization within the former Soviet bloc, established on political grounds and managed by the Soviet-dominated Council of Mutual Economic Assistance (CMEA) (actually better known as COMECON) was shaken to the core when the barter-based trading system using transferable roubles (a non-monetary unit of account) showed signs of erosion right after the transformation phase began (Jochimsen, 1991), before finally collapsing at the start of 1991. It is therefore hardly surprising that the central and east European countries' trade both among one another and with the Soviet Union initially came to a sudden standstill, dramatically amplifying cuts in production which were already occurring for domestic economic reasons.[3]

2.4 The beginning of the IMF's involvement in Central and East Europe

Following the new revolution in the former communist countries, the IMF was involved practically from the outset in rebuilding these countries' economic systems, though with considerably differing degrees of intensity. This was a result of the fact that a number of central and eastern European countries had already become Fund members before the turnaround arrived. Romania, for example, joined the IMF as long ago as 1972, and Hungary and Poland became members in 1982 and 1986, respectively. Bulgaria and what was then still Czechoslovakia were admitted in September 1990. However, the admission procedure for the USSR, then in the process of collapse, proved a more long-drawn-out affair. The Soviet Union had, incidentally, participated in the Bretton Woods conference in July 1944, but did not join the IMF when it was originally founded. Only occasional, informal contact occurred between the organization and the USSR between 1945 and 1989. However, given the revolutionary

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[3] This trend is especially well documented in Poland's case, as it was the first transforming country which, under the 1990 Balcerowicz programme, embarked on radical economic reform. Poland's exports to CMEA countries fell by 71% in 1991, while exports to other countries showed only a slight increase. See Ebrill (1994: 3) and Mylonas (1994: 72).

political changes taking place, it soon became clear that integrating the former Soviet Union into this institution would also be in the west's best interests. It was in this context that the heads of state and government of the seven largest industrial countries called upon the IMF at their Houston summit in July 1990 to take the lead role in a joint inquiry into the economy of the Soviet Union, together with the World Bank, the OECD, and the newly envisaged EBRD.[4] On the basis of the results of the inquiry, the USSR was first granted special associate status in October 1991, entitling the country only to technical assistance in the first instance, though it was also then obliged to accept economic policy advice. This move was the first step towards the admission of all 15 states from the territory of the Soviet Union, which ceased to exist at the end of 1991. The first to come on board in April/May 1992 were Lithuania, Latvia and Estonia, and the last was Tajikistan in April 1993.

2.5 The mainstays of IMF adjustment strategy for the transformation countries

In designing its adjustment programmes, the Fund essentially built upon the experience it had gained over the course of several decades in advising developing countries and monitoring their economic policies. Hence there is a broad similarity between the reform proposals made for east Europe and the usual IMF recipes. However, the Fund's leading officials were certainly conscious of the fact that transition in the reforming countries would present the IMF and its role with new and extraordinary challenges, as the sheer scale and the historical and political dimensions of the task would surpass any of the problems the Fund had to solve in the past. Especially as regards its stance on lending to the Russian Federation, the IMF therefore stepped boldly towards a sweeping pragmatic, flexible course. Even so, that does not alter the 'shock-treatment' character of its policy strategy, consisting of three main elements which also partly overlap, namely the liberalization of prices and foreign trade, macroeconomic stabilization, and institutional restructuring (Camdessus, 1990, 1994, 1998; Wolf, 1994: 114).[5]

These three elements of economic policy strategy are often referred to as the 'Washington consensus' (on free trade, capital convertibility, macro-fiscal stabilization and monetary stability to ensure growth and employment), a consensus forged by US economic officials, the IMF, and the World Bank, catalyzed during the struggle with the debt crisis of Latin American countries in the 1980s.[6] It was all the easier for the IMF to take this approach in as far as the governments of western industrial countries felt unable, for various and varying reasons, to provide the political and financial impetus that was really needed, and also in as far as no

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4 The most important findings of this analysis published in spring 1991 are contained in the Annual Report of the IMF 1991 (Box 3, p. 29).

5 The discussion about the elements of institutional restructuring was initially often narrowed to the problems of 'institution-building' and the debate of 'sequencing versus big bang' (with the extreme position of Jeffrey Sachs who favoured a radical strategy). The understanding of the transition economies underestimated the problem of path dependency, particular the destruction of most of the formal institutional framework (see North, 1998) and microstructural deficits.

6 See Williamson (1990) who created this item. A very critical position towards the Washington consensus comes from Stiglitz. In his view, the policies advanced by the Washington consensus are not complete, and they are sometimes misguided. 'Making markets work requires more than just low inflation; it requires sound financial regulation, competition policy, and policies to facilitate the transfer of technology and to encourage transparency, to cite come fundamental issues neglected by the Washington consensus'; Stiglitz (1998: 1). See also James (1998) and Stiglitz (1999).

alternative international institutions were actually functioning or capable of operating on at least a continent-wide basis, the European Commission wisely refusing to coordinate and to implement technical and humanitarian tasks under its PHARE[7] and TACIS[8] programmes, which started in 1990 and 1992, respectively.

2.5.1. Liberalization of markets

A rapid, comprehensive liberalization of prices and foreign trade is vital at the beginning of the restructuring process so that both producers and consumers receive undistorted price signals. Thus a step-by-step process of price liberalization effectively rules itself out, as it would offer an incentive to hoarding and would delay the adjustment process. Only then will it be possible to carry out the reorientation which is essential to the success of economic reconstruction. In this context, the IMF particularly stresses the importance of ensuring an open economy, as that is essential to the reforming countries' integration into the international community of nations.[9] An associated requirement is the establishment of an open, multilateral foreign trading and payments system in order to attune the domestic economy to competitive conditions in the world market. An additional advantage of this strategy is that it helps to break down monopolistic structures, especially in production and distribution.

Liberalizing the prices of goods and services is also the most rapid way of cutting back the overhang of liquidity which is typical of the socialist planned economies. It will also have a positive impact on the government budget, provided that it goes hand-in-hand with a reduction in subsidies.

However, all of the above considerations are subject to the important proviso that the reforming countries have an effective opportunity to export to the other countries participating in international trade—in other words, the other countries are themselves obliged to adopt a liberal stance, especially the industrial countries with large markets.

2.5.2. Macroeconomic stabilization

Stable underlying macroeconomic conditions are of vital significance to the prospects of success for the adjustment process. Hence it is important to make clear progress in attaining stable prices, a healthy fiscal policy and a reduction in external disequilibria. The IMF also believes it is imperative to establish a stable macroeconomic framework right at the beginning of the reform process. Especially in its initial stages following price liberalization, the process is inevitably accompanied by substantial increases in prices of goods and services. After this initial price surge, any remaining inflationary pressures have to be kept as low as possible. Were structural inflation to develop during this critical phase, producing a concomitant volatility in relative prices, it would not only prevent the urgently needed adjustment of structures to world market prices but would also threaten public confidence in the currency

[7] PHARE: Poland and Hungary Action for Restructuring of the Economy. Initially, the programme was designed for the support of Poland and Hungary. Since 1990 it has been extended to other countries in Central and Eastern Europe (Albania, Bulgaria, Croatia, Bosnia-Herzegovina, Estonia, Latvia, Lithuania, Romania, Slovakia, Slovenia, Czech Republic).

[8] TACIS: Technical Assistance for the Commonwealth of Independent States.

[9] The role of trade-policy reforms in IMF programmes is described in Calika and Corsepius, 1994.

right at the beginning of the reform process, possibly triggering off capital flight. Another danger is that the detrimental effects of inflation on the distribution of income and wealth might be perpetuated. Hence combating inflation and macroeconomic stabilization have to take high priority for more than just economic reasons. Stable prices are a necessary lateral condition for the political workability of restructuring, and disregarding this factor can put the entire reform process at risk.

To prevent the seeds of a price-wage spiral from germinating, the IMF requires reforming countries to institute an incomes policy to keep rises to a minimum. The reason this step is necessary is that it is often impossible at the beginning of the transformation process to impose tough, microeconomic budgetary restrictions on state-owned enterprises, i.e. to effectively cut the umbilical cord of subsidies from the general government budget. It would be all too easy for these enterprises to yield to demands for wages to be adjusted for inflation if they knew that, when it came down to it, they could call for and receive government loans to cover any resulting liquidity problems. All eastern European and Baltic countries which participated in an IMF programme therefore introduced wage controls at least for the initial phase of their transformation processes.[10]

2.5.3. Institutional restructuring

The third component of the adjustment strategy consists of structural reforms in all areas. For example, institutional changes are a prerequisite for the implementation of efficient fiscal and monetary policies. In the fiscal policy field, the IMF's adjustment programmes call for cuts in government expenditure to take effect within a short period, the main priority being to reduce the wide variety of subsidies on staple goods and support payments made to enterprises. However, major changes are also needed on the revenue side, including a restructuring, or indeed complete rebuilding from scratch, of the entire tax system, as government revenues soon tail off after the initial price surge, threatening the financial collapse of the state. A key component of such changes is the introduction of a value-added tax and of a transparent, profit-related system of corporate taxation.

A central role is also played in the Fund's scheme of things by a reform of the monetary sector towards establishing a two-tier banking system. One element of this, which is of the utmost urgency, is the development of an autonomous central bank—in terms of personnel, and also politically and institutionally—a crucial precondition for credible anti-inflationary policy. In addition, the IMF encourages central banks to move interest rates in line with the markets, and especially to permit positive real interest rates.

Also very significant are institutional measures to break down monopolies and to strengthen competition, convincing moves to privatize state-owned enterprises, and in-depth reforms of the legal system. Finally, social safety nets need to be established to safeguard the adjustment process by alleviating the burden of adjustment for the poorest and weakest sections of the population and for those who have become unemployed. On the other hand, the Fund demands that the social welfare systems either already in existence or brought into being must be subject

[10] In Poland, wage norms were introduced in the latter half of the 1980s, with a punitive tax imposed on 'excessive' wages to counter rising labour costs. Between 1990 and 1992, this tax was levied at a rate of 500% on the differential between actual wages paid and the wage norm. See Schwartz (1994: 21).

to strict controls including expenditure caps. There is also a need for measures to improve the functioning of the labour market.

The numerous changes are very time-consuming to implement, especially when it comes to reconstructing or establishing new institutions. The IMF therefore advises its new member countries to carry out the most important reform steps right at the beginning of the process, thus enabling them to build up a 'critical mass' of the most important reforms as early as possible.[11] The Fund also believes it makes sense to look for straightforward solutions in the early phases of the process, rather than striving to achieve 'the perfect reforms'. On the other hand, there remain serious doubts whether the specific concept of 'institutional restructuring' has not been shaped by the IMF's experience with debt-crisis-ridden developing countries in the eighties, especially in Latin America, which basically share large parts of economic institutions and market foundations with the industrialized countries of the west, elements of market constitution lacking in the transformation countries of the former communist type of economic and political regime in the Soviet Union and its satellites.

2.6 Recent experiences with exchange rate-based stabilization

The three mainstays of IMF system transformation strategy (liberalization, stabilization, restructuring) allow governments a certain amount of scope as to how they will determine what detailed measures to take and how to sequence them. For example, it leaves them to decide what form of exchange-rate system they want, and different countries have come up with widely differing responses: Estonia (1992), Lithuania (1994) began their stabilization processes with currency board arrangements (the most 'fixed' form of exchange rate regimes), followed later by Bulgaria (1997), while Latvia pegs its currency to the Special Drawing Right basket. Hungary opted for a staged flexibility of a pre-announced crawling peg; the National Bank of the Czech Republic had to give up its target band for the koruna in May 1997, since then it changed the exchange rate policy to a regime of managed floating.

The experience in the transition countries has tended to confirm the benefits and pitfalls of using the exchange rate as the nominal anchor for reducing high inflation.[12] All these programmes had remarkable success in reducing inflation from extremely high levels, but maintaining a fixed rate can become problematic once inflation has stabilized at moderate (but not low) rates, with nominal rigidities slowing the decline of inflation, particularly into the single-digit annual rates (in a realm close to that of industrial countries). With a fixed nominal exchange rate, continued inflation higher than trading partners enjoy implies an appreciation of the real exchange rate that erodes external competitiveness, hinders growth unless matched by productivity gains in the traded goods sector, and leads to a concomitant increase in the external current account deficit.

During the past few years, in many transition and emerging market countries the external deficits were financed by substantial capital inflows, widely attracted by a restoration of

[11] That means that the IMF counts among the participants in the 'sequencing debate' (Fischer and Gelb, 1991) who attribute an important role to the time required by transformation. See also Fischer (1997).

[12] For a recent overview with different forms of exchange rate-based regimes in transition and emerging market countries see the IMF's *World Economic Outlook*, May, 1999: 35-9.

investors' confidence and the expectation that the exchange rate commitment would be honoured at least in the near future. These capital inflows often permitted international reserves to be maintained or even increased, but in general they implied a considerable build up in external, short-term liabilities. As a result, the economies implementing a fixed exchange rate regime became increasingly dependent on international capital markets and more vulnerable to sudden reversals in capital flows.

In this context of heightened external vulnerability, inconsistencies between economic policies and the exchange rate regime led in some cases to severe currency crises, including the collapses of the Mexican peso in December 1994, five countries in South East Asia (Thailand, South Korea, Indonesia, Philippines and Malaysia) in the spring of 1997, the Russian rouble in August 1998, and the Brazilian real in January 1999. In each of these cases a combination of domestic and external factors led to the attack on and subsequent devaluation of the domestic currency, but policy slippages invariably played an important role.

In Asia, in particular, a set of adverse developments coincided. After a long period of exceptional growth, confidence in the future development of Asian markets remained high. So current account deficits were easily financed by large private capital inflows, more and more of the short-term portfolio investment type, not as much as before of foreign direct investment. And there was no doubt that the peg of Asian currencies to the US dollar would be sustained for some more years. But capital inflows also helped to boost domestic prices. In 1993-4 the Chinese renminbi depreciated sharply; accompanied by an appreciation of yen which came to sudden halt in mid 1995 when the United States got worried about overheating US dollar exports. Now the US dollar started to appreciate, owing also to the US budgetary problems being overcome and to the surprisingly long-lasting boom in the US economy. Thus, with nominal rates linked to the dollar, the real effective exchange rates of Asian economies also appreciated. External competitiveness deteriorated, and so did the confidence of foreign investors. In line with that, foreign capital started to leave the host countries. And this seems to have been the starting point for all the problems to come.

Nevertheless, it would be misleading to reduce the causes of the Asian financial crisis just to specific unfavourable macroeconomic developments. An additional and crucial reason for failing was the concealed increasing vulnerability of some economies which seemed to be designed for fair-weather conditions only. A major problem was the fragile banking system with its inadequate capital base, the lack of efficient supervision as well as the practically unchecked inflation of asset values in stock and real estate, fostered by the inflow of foreign capital and uncontrolled monetary expansion. Specifically, the banking system was inefficient, in that it encouraged in many cases a misallocation of assets; there were insufficient rules for balancing the inherent risks in assets with the domestic and foreign resources (bubble phenomena); and the foreign debt was not adequately structured to worst-case scenarios which, sooner or later, may occur in almost any country trying to guarantee a specific exchange rate or even debt repayment in foreign exchange. To be more specific, the maturity structure of banks' foreign liabilities was dangerously biased toward short-term positions, and the denomination of liabilities in US dollars was rather risky in the face of the huge increase in outstanding assets. The consequences are well known; the abrupt withdrawal of funds ultimately led to the collapse of domestic currencies as well as many financial institutions.

Russia's problems are even worse than those of Asia. True, the banking sector is also quite

weak, the exchange rate was also linked to the dollar; external competitiveness was low, the current account deficit widening, and foreign debt increasing, fuelled also by massive capital flight. In addition, however, the confidence of both domestic and foreign investors has been, and still is, extremely low. The implementation of existing legal norms continues to be completely inadequate. Up to now, institution-building has broadly failed, and the impression in Russia largely prevails that the average human being cannot see his or her personal efforts somehow paying off. Very briefly, belief in the future is poor.

Thus, the authorities were unable to collect taxes, government wages could not be paid out, the public sector deficit still did not come down, output growth continued to be negative, and confidence in the domestic currency was almost non-existent, so that everyone held his reserves in hard currency at home or, increasingly, abroad. The failure for many years to bring the fiscal situation under control led to levels of public debt and debt-service payments that became increasingly unsustainable. And, on top of all this, the IMF—while in principle standing by ready to help—was not convinced that the outlook would improve in the near future. As a result, in August 1998, the eruption of the crisis could no longer be kept back. In this situation, when Russia had to give up its exchange rate peg, it was a disastrous decision on the part of the government also to introduce a 90-day moratorium on all principal repayments for debt of corporations and banks to foreigners and to announce the conversion of short-term government debts (GKO) issued in roubles. As a result, domestic financial markets collapsed and the banking system came under severe pressure with bankruptcies soaring. For the first time, the G-7 and the IMF were forced to acknowledge that Russia is not (any longer) 'too big to fail', but rather already 'too big to be bailed out', considering the ensuing 'implosion' which the Russian state crisis amounted to. This hitherto unique event—at least for the last decades of the century—sent shock waves to brokers, investors and creditors, as well as capital markets the world over. A rash reversal of judgements on expected returns and risks was reflected by a 'flight into stability and into liquidity', resulting in an overnight shift in the whole outlook for financial assessment, sending sound financial institutions, notably hedge funds, to the brink of collapse and failure.

Other countries in transition did not experience a currency crash, because the consistency of macroeconomic policies was better attained by accepting some degree of exchange rate flexibility. In Poland, for instance, the exchange rate regime during the stabilization started with a fixed peg to the US dollar, later being modified, first to a fixed peg to a basket of currencies, then to a pre-announced crawling peg, and subsequently to a pre-announced crawling band with ± 7 percent margins. Even the currency board systems in the former Soviet republics Estonia and Lithuania were able to withstand the spillover effects of the Russian crisis.

A general key condition for such success, however, was that disciplined macroeconomic and structural policies be implemented while the exchange rate anchor is firmly in place, i.e. solidly sticking to its preconditions. In addition, a decision will need to be made on whether a longer term binding commitment should be made to a fixed exchange rate, or whether some degree of flexibility should be sufficient to be consistent with fiscal and monetary policies being implemented. For the countries in middle and east Europe that have achieved low double-digit annual inflation and aspire to membership in the EU and ultimately want to participate in EMU, a more flexible exchange rate may only be a temporary option. However, the adoption of the euro as the currency of the future participants of the European Union implies the

consequent further convergence of their economies, as ultimately all new member states must introduce the euro.[13] For this purpose, the newly established Exchange Rate Mechanism (ERM II) will provide a helpful framework. Nevertheless, the question arises of how to adjust the exchange rate regime smoothly, in a way that preserves hard-won credibility in combating inflation and does not abandon the currency anchor used to bring inflation down further. Where the IMF has laid down a clear line though, is in insisting that all three of the components cited above (liberalization, stabilization, restructuring) are very important, ought to be implemented as swiftly as possible, and need to be realized in a mutually compatible way, increasing its awareness of sound and sustainable micro and structural foundations in the institutional infrastructure.

2.7 The IMF's non-financial contribution to the transformation process

The effective contribution of the IMF not only consists in supplying the funds needed for the adjustment process—looked at in more detail later on—but also includes economic policy advice and technical assistance.

It had to be accepted at the outset that the IMF could not provide very large financial contributions, or certainly not on the scale which many believed was right and necessary. To have done so, it would have needed to have attracted substantial national contributions particularly from the large western industrial nations, but such contributions, for a variety of reasons and despite the so-called 'peace dividend' of a global détente, were not forthcoming or were postponed (the Gulf War 1990-1 serving as a 'perfect excuse'). The intention, then, was to put the transforming countries in a position, once they had passed through the initial transformation stages, to resort increasingly to domestic savings and foreign private-sector investment. It is generally recognized that a long road has to be travelled down before such mechanisms begin to operate effectively on a larger scale. It is absolutely essential, therefore, that the individual countries concerned maintain rigorous budgetary discipline, generally carry out stability-oriented policies and nurture the confidence of the private sector.

In this context, the first major contribution the IMF provides is its policy advice which, on the one hand, is input into the design of the proposed adjustment programmes (and also into the conditions for approving assistance) and, on the other, is provided as part of the Fund's monitoring role, particularly on the basis of Article IV consultations. When consultations began at the turn of 1989-90, for lack of other alternatives the IMF had to rely on its more than 40 years of experience in dealing with the problems of ('capitalist') industrial and developing countries.[14] The situation was inevitably affected by the fact that the IMF, like other national and international institutions, was unfamiliar with or lacked any deeper analysis of how communist command economies had functioned or failed, though such knowledge would have been helpful, if not to say very necessary, in determining the treatment needed to overcome the old system in a practical and effective manner.

The Federal Republic of Germany was to learn in its own way just how serious this analytical

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[13] For an envisaged scenario for a gradual process of adapting to EMU see European Commission (1998: 9-11).

[14] It should also be borne in mind that the Fund does not have a political mandate to offer its assistance to potential member countries on its own initiative.

and theoretical deficiency can be, in adopting extremely costly procedures for the country's reunification, and that process is still by no means at an end.[15]

However, it should be stressed that the IMF proved it had some good learning capabilities when it came to the detailed work on the transformation process and on the situation in individual countries, and that it generally developed a more pragmatic approach over time.

Another of the pillars of the support provided by the IMF is its technical assistance. This assistance goes beyond economic policy advice. It essentially consists in training experts from the transforming countries who can in turn pass on the acquired knowledge and skills needed in a market economy to others at home. By way of what are known as technical missions or local advisers, the IMF also helps countries establish a properly functioning central bank and an effective banking system. It trains experts to act for the banking supervisory authorities, and also helps to reform both the tax system and the revenue administration. Another important task is the development of reliable statistics, which are absolutely essential in order to judge the measures which have been instituted and to operate an efficient monetary policy.

Given that technical assistance is required in practically all areas by the central and eastern European countries, including or as well as those of the CIS, and that the IMF's capacities are insufficient to meet those needs fully, both quantitatively and in certain respects also qualitatively, the two Bretton Woods organizations were joined in these tasks from the end of 1991 onwards by the EC (now the EU), the G-24, the OECD, the BIS and the EBRD. Also worthy of note is the 'Joint Vienna Institute', which began operating in that city in 1991; it offers courses for participants from eastern Europe to familiarize them with the basic rules of the market economy.[16] Today, the IMF alone provides approximately 300 person-years of technical assistance to its member countries.[17]

2.8 The IMF's lending activities to the transforming countries

When they started their transition to a market economy, many post-communist economies had during the past decade or so accumulated external imbalances in the form of onerous debt-service schedules, depleted foreign exchange reserves or external payment arrears. For obvious reasons, immediately after the switch from communism, the Fund was initially only able to use its conventional lending instruments. The credits provided by the IMF were used to replenish hard currency reserves, avoiding the recurrence of external arrears and easing debt-servicing difficulties. The first of these to be put to use were its 10 to 12-month Stand-By Arrangements, Hungary being the first transforming country to receive such credit in June 1989. The IMF only gradually moved on to issue longer term loans and to create new instruments for this purpose.

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[15] See Heilemann and Jochimsen (1993), Sinn and Sinn (1991) and Sinn (1996).

[16] In this regard, it is worth recalling that the Deutsche Bundesbank has now been active for many years giving advice and practical assistance in establishing central banks and/or in developing and adapting the monetary system. Substantial elements of this work have now been delegated to the Bundesbank's main administrative components, namely the *Landeszentralbanken*. The North Rhine-Westphalian *Landeszentralbank* has taken part, and continues to do so, in assistance programmes in former Czechoslovakia, Lithuania, Kazakhstan, Poland, Russia, Belarus, Georgia, Ukraine and Uzbekistan.

[17] See, IMF Factsheet, Technical Assistance, March 1999.

Poland and Hungary were the first countries able to make use of the Extended Fund Facility (EFF) in the early nineties, borrowing US$1.7 billion and US$1.5 billion, respectively. In addition, the majority of the reforming countries were granted Compensatory and Contingency Financing Facilities (CCFF) to cope with loss of export earnings and/or the higher cost of imports. These loans, with terms of between 3.25-5 years, totalled US$2.2 billion between June 1989 and October 1991.[18] The first CIS country to reach a specific loan agreement with the IMF was Russia in August 1992; the facility was valued at approx. US$1 billion. Latvia, Estonia and Lithuania followed in the same year. The historic factor of the opportunity for the former USSR to become integrated into the world economic community also lay behind the creation of a temporary instrument known as a System Transformation Facility, which is specially tailored to the needs of the economies now in transition. This facility, opened in April 1993, was originally only intended to remain available until the end of 1994, but in view of the tremendous demand it was subsequently extended so that purchases were possible until the end of 1995.[19] More recently, in July 1998, there was an augmentation of commitments under Stand-By and Extended Arrangements amounting to US$ 8.4 billion (SDR 6.3 billion) for Russia, financed under the General Arrangements to Borrow (GAB).[20]

For all practical purposes, with the only exception of Turkmenistan, there is no longer a single transforming IMF member country which has not received credit from the Fund, or which is not at least about to agree on the terms of a facility. In total, the Fund provided credits amounting to about US$27 billion during 1989-97 (Lenain, 1998). At the end of April 1999, Fund credit outstanding to the countries in central and eastern Europe (without CIS)[21] reached a level of approximately SDR 1.857 billion (US$2.509 billion); Fund credit to the CIS totalled SDR 16.627 billion (US$22.467 billion).[22]

In the light of the strong increase in the mobility of international capital flows, and its resulting potential financing gaps, many member states of the Fund considered the IMF's traditional credit facilities inadequate for a number of reasons. In particular, the access limits for the usual facilities seemed to be inappropriate for providing rapid and adequate financial assistance to members experiencing sudden pressure on their capital account and their hard currency reserves, and the usual conditions (rather long maturities, low remuneration) appeared unsuited to the current crisis. In December 1997, the Executive Board therefore opened a new lending window, the 'Supplemental Reserve Facility' (SRF), intended to enable special financial assistance to be provided in the event of exceptional balance of payment difficulties.[23] The

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[18] See, *The Economist*, 12th October 1992.

[19] See, *IMF Survey*, January 9, 1995: 13, and Bundesbank, Annual Report 1998: 117.

[20] See, *IMF Survey*, Supplement on the Fund, September 1998.

[21] Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovenia, Slovak Republic and Yugoslavia (Serbia/Montenegro).

[22] Compared with the situation at the end of 1997, liabilities of the countries in Central and Eastern Europe (without CIS) to the Fund in CEE decreased by 12 % till end of April 1999, whereas IMF outstanding credits to the CIS grew by 27%.

[23] In the light of the widespread international support, the Deutsche Bundesbank agreed to the establishment of the new facility. However, in the end, this was only upon putting aside the concern that massive IMF assistance could run counter to the objective of involving private creditors in the solution to the crisis. It is therefore to be hoped that the current international discussion on limiting 'moral hazard' leads to solutions which make future activations of the facility as unnecessary as possible. See Bundesbank, Annual Report 1997: 116.

situations being borne in mind were, in particular, a sudden loss of confidence on the part of the international markets and associated outflows of capital and reserves. This new facility was the IMF's reaction, in particular, to the experience of the balance of payments crises in Thailand, Indonesia and South Korea. Countries borrowing under the SRF are expected to repay within 1-1.5 years from the date of each purchase but, depending on the improvement of members' balance of payments and reserve position, the Executive Board has the authority to extend this period for repayment by up to one year. To prevent a wasteful use of this instrument and to minimize moral hazard, interest rates for the SRF are 300 up to 500 basis points a year above the regular rate of charge applied on other use of IMF resources.[24]

As a result of the currency crises in Asia, eastern Europe and Latin America, the IMF's outstanding loans reached a record level of approximately SDR 67 billion or US$ 90 billion at the end of 1998.[25] An additional SDR 30 billion was approved at the end of 1998 but had not yet been paid out. In comparison with the end of 1997, the IMF's claims rose by SDR 14.2 billion. On balance, lending to Asia increased by SDR 8.7 billion, to Russia by SDR 3.6 billion, and to Latin America by SDR 1.8 billion. A large part of the new aid extended to Russia and Brazil was disbursed under the SRF.

However, the large volume and 'nose-heavy' disbursement pattern of such crisis aid pose problems since the large-scale provision of public sector loans must not be allowed to bail out or, in general, to replace private creditors. Hence, the Bundesbank advocates subjecting the extension of the SRF, which is already voluminous and quickly accessible, to conditions. Such an extension was envisaged by the G-7 in its declaration of October 30, 1998 in connection with the current debate on the architecture of the international monetary system.

Here it is also noted that these manifold instruments for assistance were suitable in the event of an existing crisis , but not for preventing a crisis from occurring at all in the case of a country with (basically) sound fundamentals and policies. In the meantime, the supplementary 'contingent credit line' (CCL), which was introduced into the discussion in the autumn of 1998, is now (at the end of April 1999) a settled matter. The 'contingent credit line', with its prophylactic effects, bears a high interest rate and is repayable at short notice; in accordance with certain very narrowly defined criteria.[26] It is intended to help protect economically healthy

[24] See IMF Press Release No 97/59, IMF Approves Supplemental Reserve Facility, December 17, 1997.

[25] See the Bundesbank Annual Report 1998.

[26] To ensure the effective use and safeguarding of IMF resources, the following criteria for access to the CCL will be established: (1) at the time of IMF Executive Board's approval of a commitment of CCL resources, the member is implementing policies considered unlikely to give rise to a need to use Fund resources, and is not already facing contagion-related balance of payments difficulties; (2) the member's economic performance should have been assessed positively by the Fund in the last Article IV consultation and thereafter, including (3) its progress in adhering to relevant internationally accepted standards; (4) it should have constructive relations with private creditors with a view to facilitating appropriate private sector involvement, as well as satisfactory management of its external debt and international reserves; and (5) it should submit a satisfactory economic and financial programme, including a quantified framework. When a member requests actual use of CCL resources, a special 'activation' review will be conducted—expeditiously—by the Board. At that review, the Board will need to ascertain that the member, having successfully implemented its programme to date, is nevertheless severely affected by a crisis stemming from contagion and intends to adjust its policies as needed. Cf. IMF Tightens Defenses Against Financial Contagion by Establishing Contingent Credit Lines, IMF Press Release No. 99/14, April 25, 1999.

countries from the crisis contagion.[27] Still, without the adoption of appropriate measures to ensure the participation of private creditors, there is a risk that the IMF will increasingly assume the role of a general, and virtually unrestricted, lender of last resort. This could undermine efforts to improve the functioning of the markets.

In addition, the exponentially growing vulnerability of the emerging and transformation economies to crises has, for a long time now, been dramatically reducing the Fund's financial capacity for action or reaction. So large was the amount of credit extended by the IMF that in 1998 it even became necessary to draw on the recently created New Arrangements to Borrow (NAB) as well as on the General Arrangements to Borrow (GAB): This was after the IMF had brought available liquidity down to a historical low and after both the general increase in quotas agreed upon—with its catch-up opportunities for new members—and after the delay in those quota regulations still to be adjusted owing to the US Congress's failure to ratify. In July 1998 the GAB was activated for IMF loans to Russia and the NAB in December 1998 for loans to Brazil. The NAB, which had been negotiated separately on account of the scarcity of IMF resources to be made available by its 25 member states, had only been in force a short time before they were first exercised. NAB participants include members of the Group of Ten as well as other financially potent countries worldwide.[28] Through their participation the IMF currently has at its disposal a 'reserve tank' totalling SDR 34 billion. In the event that its own resources do not suffice even with the aid of loans to avert system-threatening crises, it can draw on this reserve tank with the consent of NAB participants.[29] The NAB supplements the GAB of the large western nations, which were already in existence at the end of the sixties, and is primarily to be used to refinance the IMF when necessary. An availment of GAB credits, even one prior to the NAB, is charged up against the total amount available under the NAB (and vice versa). When the GAB and the NAB were activated in July and December 1998, respectively, to the tune of SDR 6.3 billion (GAB) and SDR 9.1 billion (NAB) each, it was agreed that the IMF would repay the amounts as soon as the increase in quotas decided at the beginning of 1998 had come into effect and the majority of payments had been executed. In keeping with this agreement, the IMF redeemed the GAB and NAB loans in March 1999.

2.9 Conditionality as the core principle in providing assistance

The principle of conditionality is central to the work of all the multilateral organizations, i.e. not only the Bretton Woods institutions but also the EBRD established in April 1991, with its specific mandate to issue loans to the private sector in the central and eastern European countries including those of the former Soviet Union. It is designed specifically for small to medium-sized enterprises, complementing the EU's PHARE and TACIS programmes of grants

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[27] The key difference to the Supplement Reserve Facility is that the SRF is for use by members already in the throes of a crisis, whereas the CCL is a preventive measure intended solely for members that are concerned with potential vulnerability to contagion, but are not facing it at the time of commitment.

[28] Participants include the G-10 (including Switzerland) as well as Saudi-Arabia, Denmark, Finland, Luxembourg, the Netherlands, Austria, Spain, Hong Kong, Korea, Malaysia, Singapore, Thailand, Australia and Kuwait (also to be numbered among the participants are, of course, those countries, which, as victims of the financial crisis, require NAB assistance—for example, South Korea).

[29] At SDR 6.7 billion, the largest credit line extended the IMF under the NAB was from the USA. The Bundesbank and Japan each extended credit worth SDR 3.6 billion; France and the United Kingdom likewise assumed a claim of SDR 2.6 billion each.

and technical assistance. The principle entails tying the provision of assistance to an agreement on the recipient country's part that it will pursue certain specific economic policies which are developed, laid down and monitored in a dialogue with the country concerned. The conditionality principle is built on the past experience that, in the macro- and microeconomic fields alike, certain important preconditions must be met if the funds provided are to be of genuine help in the longer run. Especially since the onset of the international debt crisis in the eighties, which in turn had its roots in the oil crises and broke to the surface in 1982 when Mexico suspended its repayments, experience with the strategy of conditionality has been encouraging on the whole.

Also, the recent developments occurring in Asia and Latin America give grounds for some optimism. Despite sharp criticism of the Fund's strategy, the IMF-supported programmes are bearing fruit even if each country still faces the continuing challenges of undergoing deep structural changes and consequent policy implementations. However, Thailand, Korea, Argentina and Mexico which have enacted substantial economic reforms, are gradually emerging from the acute crisis. In some countries, pursuing these rigorous adjustment policies has already led to an incipient return of capital which had previously 'taken flight'. Stock and bond markets as well as currencies are recovering and interest rates are declining. Another positive sign of success is the fact that some of the countries which had been in such a critical condition have now regained access to the international capital market. Not only Mexico but also Argentina began issuing new international loans again in the spring of 1999, and have been able to mobilize substantial volumes.

In the reforming countries of east and southeast Europe too, the experience gained with developing countries has been confirmed. Determined macroeconomic stabilization measures and structural reform (or rather, in this case, structural rebuilding) programmes, given a seal of approval by international organizations, combined with visible successes in implementing them, have proved to be a crucial prerequisite for involvement by private sector investors (Mizsei, 1994: 101).

Some of the more advanced transition economies, such as the Czech Republic, Hungary, Slovenia and Estonia, have been affected only slightly by the recent turmoil in Russia, Asia and Latin America. That is an encouragement to continue along the path chosen. There is no doubt, however, that recent experience demonstrates the necessity of implementation with up-to-date monitoring of the progress achieved with the reforms and the volume of capital inflows. It is essential that any potential sources of instability in macroeconomic and macro-financial conditions, as well as in a country's external position, are correctly identified in order to ensure that appropriate steps are taken to deal with any critical situation.

In particular, liberalization and deregulation of capital movements (including financial transactions) may turn out to be premature, harbouring the danger of an influx of short-term portfolio capital, which is not only difficult to monitor but also much more difficult to control. In such a situation, if investor confidence wobbles and/or if changes in interest rates on the international markets cause an abrupt, massive withdrawal of 'hot money', this can put the solvency of companies, banks and the state itself into jeopardy. Indeed, it can even topple the reform process itself. There is, in fact, the danger that such crises could be infectious, sending shock waves through the global monetary system, as in the case of Latin America (Mexico 1982 and 1994-5, Brazil 1999), Asia (1997-8) and Russia (1998). It is logical that one of the

working groups set up by the new international financial stability forum addresses precisely the issues of controlling short-term capital movements raised in this context, surely reflecting the successful Chilean practice of neutralizing short cyclical inflows rather than preventing their outflows, as Malaysia tried to enact.

2.10 A critique of the concept of the IMF

The international assistance provided not only by the IMF, in particular, but also by other participating institutions, is by no means free of deficiencies or controversy. I should like to focus on a number of central aspects here.

One subject of intense discussion is whether the concept of conditionality is not too strict (or narrow) in scope and speed and also too rigorously enforced. The demands made under the heading of 'adjustment measures' have indeed often implied very draconian reform measures in reality, usually arousing a great deal of controversy—both in terms of their time schedule and their scale—in the domestic political arena and during attempts by governments to obtain parliamentary approval for their programmes. Bearing that in mind, particularly at the beginning of transformation, strict conditionality was rather helpful. In order to reduce the domestic pressure applied by interest groups and political parties, weak governments quite often make use of it by pointing to the need to respond to an alternative externally applied pressure.[30]

Another critical debate focuses upon whether it is sufficient or appropriate to the real problems and crises faced by the new member of IMF countries that the conditions imposed are confined to essentially macroeconomic and schematic parameters associated with the central principles of liberalization, stabilization and restructuring. Ought not much more practical attention be paid, so the argument goes, to institutional reforms that are capable of generating the necessary comprehensive impact on all microeconomic aspects as well, such as reforms to the monetary and financial system, the laws of property and the marketplace, the inclusion of public authorities in the reform effort at all levels, the judicial and court system, land surveying and land registration agencies, and so on?

Quite undeniably, we in Germany had to learn all of this the (completely new) hard way. That is true even though the May 1990 interstate treaty on 'economic, monetary and social union' entered into with the former German Democratic Republic, followed by the August 1990 unification treaty and full political union on October 3, was a very model of legislative application to the task at hand. In this case, no doubt, western Germany vastly underestimated the dimension and scale of the task, as well as the time and personnel resources required this work now being projected for another two decades or so. Indeed, even when macro reforms are well advanced and have proved successful, the task still remains of establishing the infrastructure for democracy on a reliable, durable and sustainable basis. Analysing these rules

[30] Characteristically, Russia's prime minister at the time, Yegor Gaidar, himself made a public appeal for strict conditions to be imposed in 1992, to allow his government a better chance of resisting the internal pressures for a premature abandonment of the proposed tough adjustment measures, which he recognized to be necessary. This is not the only example of such a situation, and similar calls quite frequently came from politically unstable countries though these were, for understandable reasons, rarely made public.

and institutions solely from a micro- or macroeconomic standpoint falls short of the target, with matching implications for the prospects of policy advice and assistance yielding success.

To a considerable extent, the debate on conditionality—how rigorous it should be and what aspects it should cover—also has the strategic issue of 'shock therapy versus a gradualist approach' hovering in the background. Consequently, there are naturally also crucial differences in the analyses and policy assessments made (Jochimsen, 1993). At an early stage, the IMF (more than the World Bank and the EBRD) soon found itself on the horns of an insoluble dilemma. To what extent does the Fund have a legitimate right to make fundamental issues of political institution-building, and the attainment of solutions (which it itself tends to prescribe) to fundamental political controversies, into *sine qua non* conditions for the assistance it provides? Yet, on the other hand, how far can it go in distributing scarce resources if the existing structures in a country which needs help hold out scarcely any prospect of the assistance being efficiently used?

To some extent, the transforming countries have in fact provided their own answers to the dilemma. A look at the progress so far made in the Baltic countries, Hungary, Poland, the Czech Republic, Slovenia and, most recently, even Slovakia shows that the most appreciable successes have been achieved in countries which have tended to opt for a rapid transition.[31] By 1993 at the latest, these countries were emerging from their phases of economic contraction and, according to IMF estimates, will register growth in 1999 of between 0.5 per cent (Czech Republic) and nearly 5 per cent (Poland). [32] But it would also be wrong to draw any principal conclusion from this experience, namely that 'shock therapy' is invariably the preferable approach. It is always important to give proper consideration to differing starting conditions (Stiglitz, 1999). In this respect, the IMF has already gone down a long learning path.[33]

In Russia and the other (non-Baltic) successor nations to the former Soviet Union (CIS), the underlying conditions are fundamentally different from those in central and eastern Europe, including the Baltic Countries. In the latter, even after a half-century of totalitarian dictatorship, certain basic elements of experience in operating a (liberal) market economy and a pluralistic democracy were still alive, perhaps even allowing economic structures which formerly existed to return or be renewed. In Russia and the other CIS countries, building has to take place on completely different foundations, which virtually means starting from scratch.

In this respect, it undoubtedly makes sense for each country and every programme to be carefully examined in its own right. The first steps towards greater flexibility, which also means towards less rigorous conditionality, and, alas, more allowance for political opportunism, were made early on. The prime example of this was in 1992 when (under pressure from the USA) a stand-by credit of US$1 billion was made available to Russia in advance without any conditions attached. All Moscow was prepared to do at that time was to accept the reform programme's framework conditions. Another event which did not fit in with

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[31] See also the analysis in IMF (1995, chap. IV), EBRD (1997), Lenain (1998) and Exeter and Fries (1998).

[32] A summary of the growth and inflation performances developments in transforming countries (ex-post facts) is provided in Table 2.1.

[33] For example, after it has brought success, the Fund has completely changed its negative assessment of Estonia's economic and monetary reforms of 1992 into a positive recognition of the currency board model since 1993.

the 'old' pattern of things was the surprise agreement reached between the IMF and Russia on March 23, 1994 to pay out the second, US$1.5 billion tranche of the System Transformation Facility. The decision was made following rather vague promises on the part of the Russian government to restrict its budget deficit in 1994 to 6.5 per cent of GDP and to bring down the monthly inflation rate to 7 per cent by the end of the year.[34] However, the picture which emerged in reality was a sobering one: the budget deficit increased to almost 11 per cent of GDP and the monthly price inflation rate rose to approximately 17 per cent in the closing months of the year, no small part of the problem being the collapse of the rouble (IMF, 1995).

Later on, despite these disappointing developments and the failure to comply with the Fund's macroeconomic stabilization requirements, the IMF Executive Council granted a one-year stand-by credit worth US$6.8 billion in April 1995, on top of the US$4.5 billion already issued. Once again, targets were set which were of almost heroic proportions. The monthly rate of inflation was to be pushed down to 1 per cent in the second half of 1995, and real government expenditure to be cut by more than 15 per cent in order to reduce the budget deficit.[35] This was a political move to help in the re-election of the ailing, but basically reform-oriented incumbent president.

Last but not least, in July 1998 the IMF disbursed another US$4.8 billion of an approved US$ 11 billion financing package to Russia. Although it was far from clear whether the Russian government and the parliament would commit to structural reforms and be willing to implement measures that might be politically unpopular, these efforts simply failed and ended for many months in practical standstill.[36]

Undoubtedly, these examples partly manifest the Orwellian dictum of 'Animal Farm' that all animals are equal, but some are more equal than others. Paul Volcker, former Chairman of the US Federal Reserve System, expressed this fundamental criticism of IMF programmes: 'When the Fund consults with a poor and weak country, the country gets in line. When it consults a big and strong country, the Fund gets in line. When the big countries are in conflict, the Fund gets out of the line of fire.'[37] Discussions of such issues play a major role not only in the donor countries, but also in domestic policies in the countries in difficulties. In Russia, this kind of criticism of international institutions is made by opposition politicians such as Gregory Yavlinski. They explain the problems and failures of Russian reform programmes in terms of an unwillingness on the part of the international community to go far enough in attacking corruption and in imposing reform from the outside.

If one also considers the handling of the recent crisis in Mexico and, to some extent, the crisis of a few Asian countries, where financial resources were thrown into the fire too quickly and too extensively, the IMF's changing role does indeed give much cause for grave concern,

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[34] See, *IMF Survey*, 2 May 1994: 149.

[35] Neue Zürcher Zeitung, 13th April 1995.

[36] Resumption of aid, just to be used to repay accumulated of debt service to IMF, and not disbursed to the country, amounting to a virtual prolongation of IMF credits, though the total sum of 3.3 billion SDR is smaller than the sum of interests to be paid in the next 18 months, all of this is still tied to a strong conditionality to be achieved by the Russian government and the Duma, both of which had not performed in the years before.

[37] Cf. James 1998. See also the IMF's Factsheet on 'Good Governance—The IMF's Role' (1997).

opening the door as it does to moral hazard and general bail-out.

Fortunately, the IMF is now embarking on dealing with issues of governance. In August 1997, a new set of guidelines promulgated by the IMF's Executive Board instructed the staff that, in policy advice, 'it is legitimate to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation.' The IMF's interest in governance was already reflected in a number of very high profile decisions in 1996-7. Conditionality has come to the fore here in several new areas (James, 1998).

- First, military spending had never been a topic of explicit discussion by the IMF during the era of the cold war. Since 1993, however, it has been discussed in the Fund's World Economic Outlook as a major problem of misallocation of resources. In a number of cases, notably those of Pakistan and Romania, it became a central element in IMF discussions.

- Secondly, corruption is explicitly addressed. Not only in Africa, but also in the handling of the Asian crisis (e.g. in Indonesia).

- Thirdly, democracy is also addressed, although there is no specific reference to political regimes in the IMF's Articles of Agreement (unlike those of the European Bank for Reconstruction and Development).

- Fourthly, the 'IMF has increasingly come to recognize the need to address social concerns—such as rising unemployment, malnutrition, and social marginalization—that arise in the context of macroeconomic stabilization and structural adjustment reforms.'[38]

This extension of the concept of good governance into IMF policy emerges from a new look at economic practice and a new world political order that it has helped to produce. It reflects a hope increasingly shared throughout the world that the international economy, and global institutions, could be a better guarantee of rights and of prosperity than some national governments, which may be corrupt, rent-seeking, and militaristic.

However, for the Fund this process of adding new expectations creates a dangerous momentum of its own.[39] The enlarged political agenda may threaten to produce an expectation trap. The more the IMF extends its mandate, the more it is under pressure to undertake and deliver, and, inevitably, the greater the dilemmas it will encounter. The Fund cannot be a substitute for a

[38] See the IMF Factsheet on 'Social Dimensions of the IMF's Policy Dialogue' (August 1998). The IMF's Managing Director already stated at the beginning of transformation 'most essential for the transitional period ... (is) ... the creation of the kind of *social* safety net that we use in the west to cushion the impact of unemployment by supporting and retraining the unemployment, and to alleviate the human cost of adjustment for the most vulnerable parts of the population.' (Camdessus 1990: 132) More and more this emerges as the field of the World Bank. See e.g. the recent proposals of its president James D. Wolfensohn (Wolfensohn 1999) for a comprehensive framework for development.

[39] This found a critical review in the long lasting discussions of the US Congress on the 11th IMF quota increase and the New Arrangements to Borrow, putting into suspense for many critical months the worsened liquidity situation of the Fund in the last year. Since the coming into effect of the 11th General Review of Quotas in January 1999, the Fund's resources available for lending have increased substantially. The liquidity ratio (the relationship between the uncommitted usable resources and its liquid liabilities) rose from a historical low level of 32% in December 1998 to 89% in April 1999, the highest level since November 1997.

lack of world governance: it can be made responsible for these deficiencies only to a limited extent. The IMF ultimately lacks the political mandate. Governments lack the political will to effectively wave their national sovereignty.[40] And both make use of the IMF as a vehicle for substituting IMF action for national government issues. Even if enhancing issues of moral hazard were unavoidable, they at present shape the dominant conditionality practice of the Fund.

Another important problem arises in the coordination of assistance. However, my own impression is that collaboration between the World Bank and IMF, and also the EBRD, is not the real problem. Where the hitches have really been occurring is in the inadequacy ,or indeed total lack, of harmonization between these institutions, on the one hand, and the many advisers, on the other, who have either been forced upon the recipient countries or are touting their own services on a freelance basis. The problem here is that these people are taking part in a race, or enacting a rivalry between different countries' national interests as well as between different concepts. The IMF and World Bank have now been acting in a better concert for quite some time, particularly in the initiative to assist the Heavily Indebted Poor Countries (HIPCs) or in issues relating to sound banking principles and policies.[41]

Nevertheless, the cooperation could be more effective as in the past. That was the reason why Hans Tietmeyer, President of the Bundesbank and Chairman of the G-10 Central Bank Governors, being charged with recommending the necessary steps, proposed setting up a Financial Stability Forum for the next three years to be chaired by Andrew Crockett, General Manager of the BIS. Its secretariat is located at the BIS in Basle and in Washington. As a forum of cooperation among the G-7 and the most important supranational supervisory and prudential bodies (IMF, World Bank, Basle Committee, IOSCO, IAIS, etc.), its task would be to uncover problems and shortcomings in the global financial system.[42]

Another point for effective coordination is the improvement of financial market transparency (Jochimsen, 1999a). Financial market information should be made available to the various international and national authorities, and be analysed thoroughly and comprehensively. The data have to be evaluated with an eye to systemic risks. They also must be made available to the public in some form. Progress has been made in this field under the Dissemination Standards Bulletin Board, which contains key information on member countries' economic and financial data.

On the other hand, as desirable as full transparency appears to be, one has to be very careful with detailed information that may perhaps be evaluated and disseminated carelessly. And the

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[40] 'The nation-state as an externally sovereign actor in the international system will become an institution of the past. But this will only happen if internal sovereignty also finds a new operational context—global public policy. ... Steps should be taken now to support and accelerate the notion of global public policy, so that our societies will be better equipped to respond to the demands of globalization.' (Reinicke, 1998: 230-1).

[41] Since 1986, the two have been consulting with borrowing countries together in the context of structural assistance, drawing up standardized Policy Framework Papers (PFPs), which also set out both the amount of financial assistance to be provided and the conditions demanded by the World Bank and IMF.

[42] The forum started its work on April 14, 1999. The first topics on the agenda were the problems of highly leveraged institutions, offshore centres and short-term capital flows for which ad hoc working groups have been established.

IMF should abstain from commenting on each and every number, because in an environment of uncertainty, there is a risk of misinterpreting numbers. It might even lead to triggering a crisis that would otherwise not have taken place and the prevention of which was intended. However, it is to be welcomed that the IMF actively encourages the release of the 'Public Information Notices' (PINs) in accordance with Article IV on the results of the consultations, the Letter of Intents and the Policy Framework Papers underpinning the Fund-supported programmes. At the end of 1998, 70 percent of Article IV PINs and programme documents were published.[43] In April 1999, the Executive Board authorized an 18-month pilot project for the voluntary release of Article IV staff reports, and shortened the time limits for access to the archives (IMF, 1999).

2.11 On the special one-off allocation of SDRs in 1998

In the early nineties, there had been a persisting discussion as to whether the supply of Special Drawing rights (SDRs) should be topped up given that more than one-fifth of the IMF members had joined the Fund since the last SDR allocation in 1981 and that some other members had not participated in all the SDR allocations so far. The Managing Director of the International Monetary Fund tried to combine this broadly accepted problem of what is known as the 'equity' allocation with a large-scale new allocation of SDRs, even though this would only be a recipe for putting off difficult decisions and worsening the situation rather than helping to solve the real underlying problems.

This artificial reserve instrument which was produced at the stroke of a pen (as a *creatio ex nihilo*), without any conditions imposed, was originally based on the principle that there exists a current 'global need' for more liquidity. In the era of the Bretton Woods stable exchange rates system, which was based on the US dollar and with its gold reserves accessible to central banks' purchases, it was indeed possible to argue that there appeared to be an increasing global need since the gold reserves were scarce and, in any case, not up to the hugely increased volumes of international exchange and balances of payments (on current accounts). Since the world changed over to floating exchange rates in the early seventies, these needs disappeared overnight in technical terms, because adjusting exchange rates serve as mechanism which balances the autonomous (private and governmental) demand and supply for reserves resulting from current and capital account transactions.

Once created however, the possibility of issuing additional SDRs had been constantly demanded by debtor countries as a means of alleviating the problem of falling financing development aid from the industrialized countries. This issue has been brought up again in terms of a fair distribution of SDRs. However, the debate was being conducted not just in terms of development policy, as it always had been in the past, but also with a view to supporting the transformation process. According to Camdessus' plan, issuing new SDRs (practically doubling the current stock), as part of a broader package of reforms to the IMF would simultaneously solve three problems, i.e. providing support for systemic transformation, development assistance, and the problem of fairness.

The motives behind the present rekindling of the discussion on a new issue of Special Drawing Rights had nothing to do with satisfying any supposed global need for reserves. In the sixties,

[43] See *IMF Factsheet* 'Transparency at the IMF', March 1999.

the intention in creating the SDRs was to counteract what was then believed to be a developing global liquidity problem. However, SDRs were intended as 'reserves to hold', allowing the stock of reserves to 'breathe' more easily over the course of cyclical fluctuations in countries' balance of payments; they were not to be treated as 'reserves to spend'. Allocations of SDRs were always supposed to comply with the rule that a 'global need for convertible currency reserves' had first to be established according to economic criteria, the essential focus being on the supply of liquidity in the system as a whole, and not on any shortage of reserves suffered by individual countries.

Rather, the problem lay in the plainly evident need for the industrial countries to supply urgent assistance not only to the transforming countries but also to the poorer developing countries which, because of their specific difficulties, mostly do not qualify to raise funds directly in the international capital market. In addition, the industrial countries were not transferring development assistance as they had done during the sixties and seventies. So, if no new SDRs were issued, they would have to dip into their own government budgets to supply more funds.[44] This debate showed, of course, that what lies at the heart of this debate is a distributional conflict between the rich and poor nations as well as the idea that there should somehow be a miraculous enlargement of liquid funds for all to draw on. This is much like the actual behaviour of many states who take the attitude that internal debt will just have to grow over time, irrespective of the level of indebtedness already reached and their limited capacity to service the debt.

Nevertheless, at the end of a long series of discussions, it was possible to avoid a sweeping formula. In September 1997, the Board of Governors agreed only to a one-off allocation of new SDRs. The cumulative allocation for each member state is being increased by an average of 29.32 per cent of the previous quota. Such a special allocation (without a proven global shortage of monetary reserves) requires an amendment of the Fund's Articles of Agreement. The allocation of the additional SDRs will take place as soon as the amendment enters into force. This requires the approval of three-fifths of members, making up at least 85 per cent of total capital pledged. The process of ratification is still going on.[45]

2.12 The indispensable role of free trade

For properly transforming their planned economies, the central and eastern European countries need to be rigorous in ensuring that they develop an open economy. As the experience of Latin America shows when contrasted with that of the South East Asian, Pacific Basin countries, a foreign-trade policy aimed at shielding the economy from the outside world by means of a combination of import substitution and protection for 'infant industries' is now seen as a road to failure in the medium and long-term, as it systematically places exports at a disadvantage relative to the domestic use of output, limiting imports reducing domestic competition. The performance of the South East Asian countries, on the other hand, provides adequate proof that a neutral system of incentives encourages both domestic and exporting sectors to grow. The

[44] The developing countries' pledge to step up aid to 0.7% of gross national product, started with great fanfare in 1970 by the western donor countries on the OECD's Development Assistance Committee (DAC), has not been met by any means, and in recent years is being met less and less, particularly by the large industrial nations.

[45] In Germany, the necessary steps have been introduced. See Deutsche Bundesbank, Annual Report 1998: 119.

CMEA (or COMECON) philosophy of planned, state-coordinated specialization ordered from the top down—largely for geostrategic and other political, not economic or resource reasons—therefore needs to be superseded by a decentralized exchange of goods and services from the bottom up, built on structures adapted to world market prices. Ultimately, this is the only way in which an open economy can be attained, enhancing a country's welfare via the gains from trade.

The IMF has always accorded a high priority to the fundamental idea of a liberal trading system, and progress in reducing trade barriers has usually been among the conditions it has attached to its programmes. An initial stocktaking of the situation shows that many central and east European countries have advanced considerably by liberalizing their imports. The most problematic instrument of protectionism, i.e. quantitative trade restrictions, had already largely disappeared by the end of 1993.[46]

However, trade liberalization should not be a one-sided affair. The industrial countries must make their own contribution towards the integration of the transforming countries by opening up their markets. After all, the best form of financing is self-financing. Likewise, the reforming countries will not be capable of repaying their foreign debts, some of which are very high, unless they have the opportunity to supply their products and services to markets capable of absorbing them. Taking a long-term view, reducing trade barriers will indeed also benefit western countries, since the average incomes of transforming and developing countries will improve. In a positive-sum-game, this will give rise to increasing demand backed by greater purchasing power. This will enhance investments, thus benefiting suppliers of capital goods and higher quality consumer goods.

Another home truth which the western industrial countries should take on board is that it is simply unacceptable to request transforming and developing countries to 'behave' in accordance with the best practice of regulatory policy and still claim 'exceptional circumstances' for one's own shortcomings. At the beginning of the transformation era, the members of the European Community was not very ambitious in opening up their markets. The preferential agreements the EC has entered into with the Visegrad countries (Hungary, Poland and Czechoslovakia), plus Bulgaria and Romania, initially encompassed wide-ranging exceptions covering sensitive markets, such as steel and textiles in particular. It was precisely in industries such as these in which the eastern European reforming countries were competitive in terms of with commodity standards at a very early stage. However, with the prospect of EU enlargement since the European Council of Copenhagen in 1993 and the following steps of the accession strategy for the associated countries of central and eastern Europe at the European Council of Essen (the bilateral Europe Association Agreements since 1994, the White Paper in 1995, the Accession Partnerships in 1998, most recently the Agenda 2000 of the European Council of Berlin in March 1999), the EU has increasingly opened its markets to industrial products from central and eastern Europe.[47] All this demonstrates the gradual improvement in the EU's capability and

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[46] See Calika and Corsepius (1994). However, the picture is not so clear when it comes to reducing and restructuring import tariffs.

[47] The Europe Association Agreements with Poland (in force since 1994), Hungary (1994), Romania (1995), Bulgaria (1995), the Czech Republic (1995), the Slovakian Republic (1995), Estonia, Latvia and Lithuania (all 1998) and Slovenia (concluded 1996, still to be ratified) envisage a complete, bilateral opening of the industrial markets combined with certain deadlines for sensitive products. Tariff limits of EU imports for textile products

willingness to absorb new member countries. The dynamic growth of exports from the applicant countries to the EU has not only had positive effects on income, productivity and employment but has also stabilized those economies.

In most candidate countries, the economic impact of the Russian crisis in 1998-9 was also only limited—mainly for two reasons. First, from the start of the transition process, these applicants have progressively and successfully reoriented their trade away from the former Soviet bloc and largely towards the EU and other western countries. They have now achieved a high degree of trade integration, around 60 per cent of their trade across the board is with the EU. The second and more fundamental reason is that the prospect of EU accession and the gradual implementation of the Community acquis has had a noticeably favourable effect on market sentiment. Short-term financial assistance from the IMF, no matter how helpful it sometimes may be in the event of crisis, is no substitute for integrating the transition countries into the world market system. Pressing on with trade liberalization, both in Europe and worldwide, is essential for promoting the process of transformation.

2.13 Concluding remarks

Most of the countries in transition have already moved a long way, although some are seriously trailing behind. The IMF—together with the World Bank and other organizations—stands ready to help. For that, we need an effective and efficient IMF. The IMF is required, above all, as an international monetary promoter of open borders and free markets and as an advocate of sound and transparent policies, and of good governance. Thus the task of the IMF is that of a catalyst. It can assist many countries in following and safeguarding the road to the market economy. However, it may be added from the experience of European convergence, it clearly emerges that macroeconomic policy alone is not doing the job. The adherence to the 'Washington Consensus' of the eighties does not suffice here; there will also have to be the broad microeconomic and structural foundation of market economic order and institutions. It is obvious that the responsibility of countries for their own future economic and social development is politically axiomatic and practically indispensable.

Without international cooperation and assistance, however, problems are likely to loom even larger. It ought to be clear, and this brings us back to the introductory remarks, that the peace and prosperity we enjoy can only be protected and sustained by sharing it with others.

(the most relevant industrial products) from Bulgaria, Poland, Romania, the Slovakian Republic, the Czech Republic and Hungary were dismantled on January 1, 1997, the remaining quota limits were abolished on January 1, 1998. See European Commission (1999), p. 276. The asymmetrical nature of these agreements is revealed by the slow opening of the CEEC markets which will be liberalized for industrial products from the EU not until 2002. In the case of agricultural products, the opening of imports of the EU will also take place gradually, yet only in part. See Jochimsen (1999b).

TABLE 2.1
SELECTED COUNTRIES IN TRANSITION, REAL GDP AND CONSUMER PRICES (ANNUAL PER CENT CHANGE)

	Real GDP									Consumer/Retail Prices								
Country	1991	1992	1993	1994	1995	1996	1997	1998e	1999p	1991	1992	1993	1994e	1995p	1996	1997	1998e	1999p
Albania	-28.0	-7.2	9.6	9.4	8.9	9.1	-7.0	9.0	8.0	35.8	225.2	85.0	22.6	7.8	12.7	33.2	21	7
Armenia	-12.4	-52.6	-14.1	5.4	6.9	5.8	3.1	5.5	4.0	100.3	824.5	3733	5273	176,7	18.7	14.0	9	10
Azerbaijan	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.0	6.0	105.6	912.6	1130	1664	411.7	19.8	3.5	-1	-6
Belarus	-1.2	-9.7	-7.6	-12.6	-10.4	2.8	11.4	8.3		83.5	969.0	1190	2220	709.0	52.7	64.0	72	213
Bulgaria	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6,9	4.0	3.7	333.5	82.0	72.8	96.0	62.1	123.0	1082	22	1
Croatia	n.a.	n.a	-8.0	5.8	6.8	6.0	6.5	2.4	1.5	n.a	n.a	1516	97.5	2.0	3.5	3.6	6	4
Czech Republic	n.a	n.a	0.6	2.7	6.4	3.9	1.0	-2.2	0.5	n.a	n.a	20.8	10.0	9.1	8.8	8.4	11	5
Estonia	-7.9	-21.6	-8.2	-1.8	4.3	4.0	11.0	4.0	2.3	210.6	1.069	89.0	47.7	28.9	23.1	11.3	8	4
Georgia	-20.6	-44.8	-25.4	-11.4	2.4	10.5	11.0	4.0	2.0	78.5	887.4	3125	15607	162.7	39.4	7.1	4	20
Hungary	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	5.0	4.3	34.8	22.8	22.4	18.8	28.3	23.5	18.3	14	9
Kazakhstan	- 11.0	-5.3	- 10.6	-12.6	- 8.2	0.5	1.7	-2.5	-1.5	91.0	1516	1662	1880	176.3	39.1	17.4	7	3
Kyrgyz Republic	-7.9	-13.9	-15.5	-20.1	-5.4	7.1	9.9	2.0	4.6	85.0	854.6	772.4	228.7	52.5	30.4	25.6	12	10
Latvia	-11.1	-35.2	-16.1	2.1	0.3	3.3	6,5	3.9	4.0	124.4	951.3	109.1	35.8	25.1	17.6	8.4	5	3
Lithuania	-5.7	-21.3	-16.2	-9,8	3.3	4.7	6.1	4.7	3.5	224.7	1021	410.4	72.1	39.5	24.7	8.8	5	3
Macedonia. F.Y.R.	n.a	n.a	-9.1	-1.8	-1.2	0.8	1.5	5.0	5.0	n.a	n.a	338.6	126.4	16.2	2.1	1.5	1	2
Moldova	-17.5	-29.7	-1.2	-31.2	-1.4	-7.8	1.3	-5.0	1.0	162.0	1.276	788.5	329.6	30.2	23.5	11.8	7	15
Poland	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.9	4.7	70.3	43.0	35.3	32.2	27.9	19.9	15.1	12	7
Romania	-12.9	-8.8	1.5	3.9	6.9	3.9	-5.6	-5.5	-2.0	161.1	210.4	256.1	136.7	32.3	38.8	151.6	59	46
Russia	-5.4	-19.4	- 10.4	- 11.6	-4.8	-5.0	0.8	-4.8	-7.0	92.7	1.353	895.6	302.0	190.1	47.8	14.7	28	100
Slovenia	n.a	n.a	2.8	5.3	4.1	3.1	3.8	3.9	3.9	n.a	n.a	31.9	19.8	12.6	9.7	9.1	8	7
Slovak Republic	n.a	n.a	-3.7	4.9	6.9	6.6	6.5	4.4	2.0	n.a	n.a	23.0	13.4	9.9	5.8	6.1	7	9
Tajikistan	-7.1	-28.9	-11.1	-21.4	-12.5	-4.4	1.7	5.3	3.0	111.6	1157	2195	350.4	610.0	418.0	88.0	43	12
Turkmenistan	-4.7	-5.3	-10.0	-18.8	-8.2	-7.7	-25.9	4.5	24.3	102.5	492.9	3102	1748	1005	992.0	84.0	17	28
Ukraine	-10.6	- 17.0	- 14.2	-22.9	-12.2	-10.0	-3.0	-1.7	-3.6	91.2	1210	4.735	891.2	376.4	80.2	15.9	11	28
Uzbekistan	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	3.4	2.8		169.0	645.2	534.0	1568	116.9	64.4	50.0	29	29

Sources: International Monetary Fund, World Economic Outlook, October 1998 and May 1999.
Notes: e=estimation; p=projection or programme.

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CHAPTER 3

THE URUGUAY ROUND AND THE WTO

Peter Naray[1]

3.1 Participation of centrally-planned economies in the General Agreement on Tariffs and Trade

The history of the General Agreement on Tariffs and Trade between 1948 and 1994 clearly indicates that the GATT never became a really global trade institution. Although the number of contracting parties increased from the original 23 to 128 during its almost fifty years of existence, only three centrally-planned economies, representing a relatively small trade turnover, joined it under Article XXXIII (Accession), namely Poland in 1967, Romania in 1971 and Hungary in 1973.[2] Czechoslovakia was a founding member, and it maintained its membership without any specific modifications in its terms of participation even after the introduction of a centrally-planned economy. Despite this, Czechoslovakia was treated by a number of contracting parties as a state trading country. In 1993, the Czech Republic and the Slovak Republic, as successor states of Czechoslovakia, became contracting parties to the GATT under normal market economy conditions. Yugoslavia joined the GATT in 1966 under market economy terms, due to favourable political conditions and the recognition of the country's market-oriented reforms.[3]

The largest centrally-planned economies, however, the Soviet Union and China[4] which represented more than 5 per cent of world trade, and a number of smaller socialist countries stayed outside the multilateral GATT system.[5] The Soviet Union, after many years of serious reservations, expressed its interest in GATT activities only in the early 1980s. It became an observer in 1990, after the dramatic changes in east-west political and economic relations.

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2 The original GATT, or GATT 1947 as it is called by the WTO Agreement, is still in force. However, its significance is decreasing as more and more contracting parties become members of the WTO.

3 At the end of 1994, Slovenia also joined the GATT as a market economy. (Slovenia became a member of the WTO in l995). Cuba was also an original member. It became a centrally-planned economy only after the Cuban revolution in 1959. Its original terms of participation in the GATT were maintained.

4 In its heyday, the Soviet Union was the world's fourth largest exporter and importer, counting the EEC member states as one. In 1989, Soviet exports amounted to US$109.4 billion, which represented 3.5 per cent of the world's merchandise exports. Its imports reached US$114.8 billion, 3.6 per cent of world's imports. China's share in world exports and imports reached 1.7 and 1.8 per cent the same year. GATT (1990: 3).

5 China was an original member, but, after the victory of the communist revolution in 1949, left the GATT. In 1986, it expressed its wish to resume its status as a contracting party.

China's negotiations for the resumption of its contracting party status were not completed between 1986 and 1994.[6] Since early 1995, China has continued to negotiate for an original member status with the WTO. The basic reason behind the lack of integration of a higher number of centrally-planned economies in the GATT, disregarding political considerations which were very important during the whole period, was that the rules and principles of the GATT had been devised for market economies. However, a number of smaller centrally-planned economies in central and eastern Europe, due to their heavy reliance on foreign trade, made their first steps towards the GATT already in the late 1950s in a period characterized by deep political tensions between east and west.

In the 1960s, as political tensions between the two blocs eased and the policy of 'differentiation' among countries of eastern Europe offered some chances of success, contracting parties made serious efforts to bridge the gap between market and centrally-planned economies and tried to integrate Poland, Romania and Hungary into the GATT system.[7] As Poland and Romania did not have meaningful tariffs, neither of them was in a position to pay the GATT entrance fee for non-discrimination and tariff concessions in the usual form, namely by granting tariff concessions to other contracting parties. Instead, the precedent of trade treaties concluded with the Soviet Union in the 1920s and 1930s and of some articles of the Havana Charter were used to establish the entrance fee for these two countries in the form of quantitative import commitments. Poland undertook to increase the total value of its imports from the territories of contracting parties by not less than 7 per cent per annum.[8] For Romania the main concession was the declaration of its firm intention of increasing imports from the contracting parties at a rate not smaller than the growth of total Romanian imports provided for in its Five-Year Plans.[9] The other specific elements of the Polish and the Romanian protocols of accession were provisions on the maintenance, subject to their progressive relaxation and elimination, of prohibitions and discriminative quantitative restrictions maintained on imports from these countries by some contracting parties which were not consistent with Article XIII of the General Agreement; a selectively applicable safeguard clause to give extra protection against low-priced imports coming from these countries; and some specific provisions on regular and special consultations with the contracting parties. In respect of specific trade institutions, the working party reports included an understanding which stated that in anti-dumping procedures contracting parties had the right to use as the normal value for a product imported from these sources either the price of the importing country or a constructed value, instead of accepting Polish or Romanian domestic prices.[10]

The terms of Hungary's accession to the GATT deserve special attention by countries in transition, because they reflect its market-oriented economic reforms introduced in 1968. As a

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6 China's relationship to the GATT/WTO is covered only to a very limited extent by this chapter due to the complexity of the issue. China has trade policy-related problems similar to those of countries in transition but cannot formally be considered as such.

7 For western policies regarding the GATT accession of socialist countries see Haus (1992: 12-16).

8 Later, the commitment was changed to a growth in the total value of Poland's imports from the contracting parties 'by 7 per cent per annum aggregated and compounded over multi-year' periods. GATT (1968: 46-52), and GATT (1972: 200).

9 GATT (1972: 5-10, 94-7).

10 Paragraph 13 in both the Polish and the Romanian Working Party Reports. GATT (1968: 11) and GATT (1972: 13).

result of these, Hungary at the time of its accession was no longer a classical centrally-planned economy, although for a number reasons, mainly due to the division of Europe after World War Two, its reforms could not go far enough and did not lead to the establishment of a market economy. Effectively, however, Hungary started its transition process in 1968. The new economic management system abolished obligatory plan directives. The foreign trade system was also reformed with the objective of linking the domestic economy to foreign markets. External and internal prices were related subject to foreign trade multipliers, tariffs, taxes and subsidies. State-owned enterprises became autonomous legal bodies, independent of each other and of the State. Business considerations were to guide their economic decisions, including export and import transactions.

However, market reforms were not consistent and the reform of the political institutions could not be put on the agenda. The development of the Hungarian economy remained largely determined by annual and medium-term plans. The state and the ruling party retained major powers in economic decision-making. The state administration had very large discretionary powers in all trade matters and no legal remedies were available for economic units against administrative decisions and interference in enterprise matters by the state and party bureaucracy. Privatization was ruled out for ideological reasons. Wage regulation remained centralized and about 30 per cent of prices were regulated by the State. The State maintained its foreign trade, foreign exchange and credit monopoly. Capital movements between enterprises were limited and foreign investment prohibited or very restricted. Export and import transactions were subject to discretionary licensing; the domestic currency was overvalued which made export subsidies necessary. Centrally-planned CMEA countries remained Hungary's main trading partners. Because of the isolationist CMEA system, Hungary maintained a separate set of trade instruments for trade with CMEA countries, based on plan coordination and a system of bilateral agreements.

Hungary's terms of accession to the GATT, which fell between those of centrally-planned and market economies, expressed the contradictory 'neither plan nor market' nature of the country's economic system. The Hungarian Protocol of Accession[11] included a clause on quantitative restrictions maintained inconsistently with Article XIII of the GATT by some developed contracting parties; a selective safeguard clause and some specific procedural rules like the biannual examination of the implementation of the protocol and so on. However, on the issue of the entrance fee, the Hungarian Protocol, despite the reservation of some participants, followed the solution used in the case of market economies and Hungary was allowed to pay in the form of tariff concessions for the advantages of its contracting party status. Hungary, contrary to Poland and Romania, rejected any quantitative import commitments as incompatible with its economic regime. Regarding CMEA trade, the Protocol allowed Hungary to maintain its existing regulation with respect to products originating in or destined for these countries. In return, Hungary undertook that its trading regulations or any change in them 'shall not impair its commitments, discriminate against or otherwise operate to the detriment of contracting parties'. The report of the Hungarian Working Party, like the Polish and Romanian, included the importer's domestic price or the constructed value concept for the establishment of normal

[11] GATT (1974: 3-8).

value, instead of accepting Hungarian internal prices as a basis of comparison with export prices in anti-dumping procedures.[12]

The provisions relating to import commitments undertaken by Poland, and also by Romania, turned out to be unworkable. Poland could not increase its imports from contracting parties after 1977. The Romanian import commitment was less specific, and its fulfilment more difficult to measure. Meetings of the Hungarian Working Party covered controversial issues which included, beyond the maintenance of the discriminatory quantitative restrictions on Hungarian exports, the operation of the Hungarian price, subsidy and import licensing systems, countertrade, the consumer goods quota and Hungary's relationship with its CMEA trading partners.

The experience with centrally-planned economies in the GATT indicates that the specific terms of accession were not appropriate instruments to bridge over differences between market and non-market economies. The avenue of quantitative import commitments was clearly unworkable. The Hungarian Protocol did not work satisfactorily either due to the inconsistent 'neither market nor plan' nature of the Hungarian economy. The lesson from the experience of these three countries in the GATT for economies in transition is that without the implementation of consistent market reforms the accession to multilateral trade instruments based on market principles, even if ingenious technical interfaces are used, is just not workable.

3.2 The outcome of the Uruguay Round

The Final Act of the Uruguay Round and the Marrakech Agreement Establishing the World Trade Organization, were signed, after more than seven years of negotiations, at the Ministerial Meeting of the Trade Negotiations Committee on 15 April 1994. The WTO Agreement—and the agreements, understandings and ministerial declarations and decisions annexed to it—laid down the basis of a new world trading system. This is of particular importance for countries in transition, because they are going to join a multilateral trade system which has strengthened rules, a more sophisticated institutional framework and a wider coverage than that of the GATT. From the signature of the Final Act to June l998, one hundred and thirty-two countries had become members of the WTO. Three transition economies had become members of the organization, namely Slovenia (1995), Bulgaria (1996) and Mongolia (1997).

The Uruguay Round concentrated on two aspects of trade in goods and services. Its first objective was to increase market access by reducing or eliminating trade barriers. This objective was met by reductions in tariffs and non-tariff supports, the elimination of quantitative restrictions and a reduction in barriers to trade in services. The second goal included the strengthening of the multilateral trading system through the creation of new and improved rules and institutions which contribute to a more stable and legally secure trading environment.

Obviously, it is very difficult to assess precisely the qualitative and quantitative effects of the Uruguay Round on individual countries or the world economy as a whole. However, all available assessments indicate that both the quantitative and qualitative impacts are expected to

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[12] For more details about Poland's, Romania's and Hungary's relationship with the GATT see: GATT (1991), GATT (1993a), and GATT (1993b), and Naray (1993: 425-9).

be significant for all economies, including those in transition which, together with developing countries, look to become the major beneficiaries in terms of trade growth by 2005, the end of the Round's implementation period.

It is estimated that the Uruguay Round will contribute substantially to world economic growth in the years to come. Estimates of the increase in world income from the liberalization of trade in goods range from US$109 billion to US$510 billion, depending on which economic model is used. The view of the WTO Secretariat is that the assumption underlying the US$510 billion figure is a more plausible estimate. It has to be added that even this substantially underestimates the full impact of the Round for three reasons. First, many dynamic elements have not been taken into account. Second, if the Round had failed, the recession would have been deeper, so that the avoidance of the associated losses in trade and income would have to be included in a full accounting of the gains from the successful Round. Third, the estimates ignore aspects of the Round beyond the liberalization of trade in goods because no attempt was made to include the positive impact of market access commitments and rules for services, and of the WTO's strengthened rules, procedures and institutions. The upper range assumptions yield estimated income gains of US$116 billion for developing and transition economies as a group. The estimated percentage increase in the export and imports of the same group is expected to be 50 per cent above the average increase for world trade as a whole.[13]

No estimation has been attempted of the very substantial systemic impact of the success of the Round on the transition process and the resulting accelerated integration of the countries undergoing it into the world trade order.

3.2.1 Market access for goods: tariff reductions on industrial products

As a result of the Uruguay Round, market access for industrial products has been improved for all participants through substantial cuts in tariffs and a wider coverage of tariff bindings. As Table 3.1 indicates, developed countries, the largest importers of products originating in countries in transition, have undertaken to reduce their tariffs on industrial goods from a pre-Uruguay Round trade-weighted average of 6.3 per cent to 3.8 per cent, which represents a 40 per cent reduction. The proportion of industrial products which enter the markets of developed countries under most favoured nation (MFN) zero duties, will increase from 20 to 44 per cent. Developing economies have also committed themselves to reduce their MFN tariffs, so that their post-Uruguay Round trade-weighted tariff averages will also decline substantially—however, with significant variations by country.[14] Transition economies, contracting parties to the GATT (Czech Republic, Hungary, Poland and Slovakia) have also reduced their tariffs between 22 and 38 per cent. These data indicate that their tariff averages are low and comparable to those of developed western economies. Romania's tariff commitments, as a developing country under the GATT, show that its post-Uruguay Round trade-weighted tariff average will increase from 11.7 per cent to 33.9 per cent, because, like a number of other developing countries, it has submitted many ceiling offers.

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[13] GATT (1994a: 6, 27-38).

[14] Post-Uruguay Round trade-weighted averages expressed in percentages for some developing countries, with pre Round averages in brackets: Argentina; 30.9 (38.2); Brazil: 27 (40.6); Chile 24.9 (34.9); Hong Kong :0, (0); India:32.4 (71.4); Korea: 8.3 (18); Mexico: 33.7 (46.1); Philippines: 22.2 (23.9); Singapore: 5.1 (12.4); Thailand: 28 (37.3) and Turkey: 22.3 (25.1). GATT (1994a).

Under the GATT system, an important trade security has been provided in the form of tariff bindings. This means that a country, which agrees to bind a tariff on a specific product at a certain level, undertakes not to raise the tariff above the bound level without negotiations with affected trading partners. Tariff bindings provide predictability for traders. One of the major results of the Uruguay Round is the improvement made in the security of market access for industrial products through increased bindings. As a result of the Round, the percentage of bound tariff lines for industrial products has risen from 78 to 99 per cent for developed countries, from 21 to 73 per cent for developing economies and from 73 to 98 per cent for transition economies. In practical terms, on the markets of the developed and transition countries, industrial products are fully covered by tariff bindings.

TABLE 3.1
DEVELOPED COUNTRY TARIFF REDUCTIONS BY MAJOR INDUSTRIAL PRODUCT GROUP(1)
(billion US DOLLARS and percentages)

Product category	Import value		Tariff average weighted by:					
			Import from all sources			Import from developing economies		
						Pre-UR	Post UR	% Red.
All industrial products	736.9	169.7	6.3	3.8	40	6.8	4.3	37
Fish and fish products	18.5	10.6	6.1	4.5	26	6.6	4.8	27
Wood, pulp, paper & furniture	40.6	11.5	3.5	1.1	69	4.6	1.7	63
Textiles and clothing	6.4	8.2	5.1	12.1	22	14.6	11.3	23
Leather, rubber, footwear	31.7	12.2	8.9	7.3	18	8.1	6.6	19
Metals	69.4	24.4	3.7	1.4	62	2.7	0.9	67
Chemicals & photographic supplies	61.0	8.2	6.7	3.7	45	7.2	3.8	47
Transport equipment	96.3	7.6	7.5	5.8	23	3.8	3.1	18
Non-electric machinery	118.1	9.8	4.8	1.9	60	4.7	1.6	66
Electric machinery	86.0	19.2	6.6	3.5	47	6.3	3.3	48
Mineral products & precious stones	73.0	22.2	2.3	1.1	52	2.6	0.8	69
Manufactured articles(2)	76.1	10.9	5.5	2.4	56	6.5	3.1	52
Industrial tropical products	32.8	14.4	4.2	2.0	52	4.2	1.9	55
Natural based products[1]	80.2	33.4	3.2	2.1	34	4.0	2.7	33

Source: GATT.

Note:(1) =excluding petroleum products; (2) =not elsewhere specified.

If we analyse the Uruguay Round tariff reductions for industrial products from the point of view of economies in transition, we have to consider both the geographical and product pattern of their exports, assuming that they will benefit from reductions either through their membership in the WTO or through bilateral agreements with WTO members or autonomously. Table 3.2 indicates that for central and eastern Europe and the former Soviet Union, western Europe is, by far, the most important market as 55 per cent of their exports goes to this destination. Western Europe is followed by the transition area itself (20 per cent), Asia (16 per cent) and North America (4 per cent). According to GATT calculations, tariff reductions given

by western Europe on imports coming from central and eastern Europe, will bring down the trade-weighted average tariff from 5.2 per cent to 3.5 per cent.[15]

TABLE 3.2
MERCHANDISE EXPORTS OF CENTRAL AND EASTERN EUROPE AND THE FORMER USSR BY MAJOR PRODUCT GROUP AND DESTINATION, 1993
(Billion dollars and percentage)

	Agricultural products		Mining products		Manufactures		Total	
	Value	Share	Value	Share	Value	Share	Value	Share
North America	0.4	3	1.3	4	2.0	4	3.8	4
Latin America	0.2	1	0.3	1	0.8	2	1.2	1
Western Europe	6.8	53	20.7	67	25.4	48	54.8	55
C&E Europe & former USSR	2.7	21	5.7	19	11.0	21	20.1	20
Africa	0.4	3	0.2	1	1.4	3	2.1	2
Middle east	0.2	1	0.3	1	1.7	3	2.6	3
Asia	2.3	18	2.4	8	10.8	20	15.9	16
World	12.9	100	30.8	100	53.2	100	100.5	100

Source: GATT *International Trade* (1994).

Commodity distribution varies substantially country by county. For the former Soviet Union, the share of primary products in exports is about 75 per cent, while for the central and eastern European economies manufactures dominate the product pattern of exports (Table 3.3). Industrial exports consist mainly of labour intensive or simple products such as textiles and clothing, iron and steel and chemicals. Table 3.1 reveals that tariff reductions will be smaller than average in a number of product areas of great interest to economies in transition in developed markets. These include textile and clothing, leather, rubber, footwear and transport equipment. Data indicate that in all these areas substantial tariff peaks (15 per cent and above) remain. In developed markets, about 28 per cent of textiles and clothing imports will remain subject to tariffs above 15 per cent. In leather, footwear and rubber the figure is 11 per cent, while in transport equipment, it is 7 per cent. There are, however, a number of product areas, with export interest for countries of transition, where tariff reductions in developed countries are above average. These sectors include wood, pulp, paper and furniture, metals, chemicals, electric and non-electric machinery.

In practice, all countries in transition enjoy MFN treatment in respect of tariffs in developed countries, normally based on bilateral agreements. As a result of tariff cuts decided on in the Uruguay Round, exports from transition economies subject to MFN tariff rates should increase. However, for the ten countries of central and east Europe which have free trade agreements with the EU and EFTA (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia), account has also to be taken of the negative effects of the reduction in MFN tariffs which result from the erosion of the preferences relative to other countries in the markets of preference giving countries. The same applies also to preferences given under the GSP, so long as preferential rates are not adjusted to the new, reduced MFN

[15] Among developed countries, Japan and New Zealand will implement the largest percentage reductions on tariffs on industrial products, namely 56 and 53 per cent respectively. In the four largest developed markets, in terms of imports from m.f.n sources, the EU, the US, Japan and Canada, the average post-Uruguay Round tariff on industrial products will be between 1.7 per cent (Japan) and 4.8 per cent (Canada). GATT (1994a: 13).

rate. In the case of free trade agreements, the erosion of preferences depends on the entry into force of the agreements. Countries which base their free trade agreements on lower Uruguay Round tariffs, will enjoy speedier tariff elimination. According to certain calculations, 48 per cent of the exports of countries in transition, members of the GATT, will face erosion of previous preferences.[16] There are no calculations available for the erosion of GSP preferences.

TABLE 3.3
MERCHANDISE EXPORTS OF CENTRAL AND EASTERN EUROPE AND THE FORMER USSR TO THE EUROPEAN UNION (12) BY PRODUCT, 1992
(percentage shares of product group)

	Bulgaria	Former Czech/ Slovak Fed. Rep.	Hungary	Poland	Romania	Former USSR
Total merchandise	100.0	100.0	100.0	100.0	100.0	100.0
Primary products	34.6	16.6	28.8	36.1	11.0	74.5
Manufactures	64.8	81.4	69.9	62.8	88.0	17.5
Food	18.9	4.8	19.8	12.9	4.9	2.3
Raw materials	5.3	3.8	3.9	4.4	2.2	6.2
Ores + other minerals	3.8	3.3	1.7	4.2	0.5	2.7
Fuels	1.7	3.1	1.6	7.2	2.8	57.7
Non-ferrous metals	5.0	1.6	1.8	7.3	0.6	7.7
Iron and steel	5.9	10.0	3.3	4.5	7.0	3.1
Chemicals	8.2	8.8	9.8	7.1	4.9	5.5
Machinery and transport equipment	12.1	20.7	19.1	13.4	8.3	4.3
Textiles	3.9	5.2	2.5	1.9	2.1	0.4
Clothing	17.6	7.5	14.5	14.0	33.2	0.5
Other consumer goods	10.4	11.9	11.5	9.1	23.6	0.7

Source: GATT, *International Trade* (1994).

3.2.1.1 Removal of quantitative restrictions on industrial products

Quantitative restrictions on industrial products will be phased out under the Agreement on Textiles and Clothing and the Safeguards Agreement. The most important quantitative restrictions under the GATT system were maintained under the Multi Fibre Arrangement (MFA). The MFA (1974) and its predecessors, the Short-Term Cotton Arrangement (1961) and the Long-Term Cotton Arrangement (1962), constituted a major derogation from the basic rules of the General Agreement, namely non-discrimination and the general prohibition of the use of quantitative restrictions. The general practice was that developed countries, members of the MFA, with some exceptions, did not impose restrictions on imports from other developed countries. However, imports from developing and transition economies, the so-called 'low-cost' suppliers, which were considered likely to cause damage to the developed countries' textile industry, were restricted. According to estimates based on 1990 data, approximately 11 per cent

[16] Economic Commission for Europe (1994a: 62).

of world trade in textiles, and 35 per cent of world trade in clothing, were subject to restraint under MFA agreements.[17] At the end of December 1993, ninety-eight bilateral agreements were in force under the MFA, which included twenty-two agreements concluded with MFA members in economic transition.[18]

The elimination of the discriminatory MFA regime was the main objective of many developing countries. After many years of difficult negotiations this objective has been achieved. The Agreement on Textiles and Clothing has established a legal and institutional framework for the phasing out of the MFA and the integration of the textiles and clothing sector at the end of a ten year transition period. This started on 1 January 1995, on which day each party was under the obligation to integrate into the GATT products from a specific list in the Agreement which accounted for not less than 16 per cent of its total volume of imports in 1990. Seventeen per cent on 1 January 1998, and 18 per cent on 1 January 2002 of this volume are to be integrated, plus on 1 January 2005 all remaining restricted trade is to be made subject to GATT rules. The Agreement also contains a specific transitional safeguard mechanism which applies to products not yet integrated into the GATT. The Council for Trade in Goods has been authorized to take decisions by consensus to ensure that the balance of rights and obligations in the Agreement is not upset. A Textiles Monitoring Body was established to oversee the implementation of commitments and to prepare reports for major reviews of the operation of the Agreement for the Council in Trade in Goods. The Agreement also includes some provisions for countries which have not been MFA members since 1986, new entrants, small suppliers, and least-developed countries. The Uruguay Round, additionally, has a positive effect on the elimination of EU textiles quotas under the Europe Agreements as their elimination is linked to the outcome of the Round: the EU will eliminate such measures in half the phasing out period agreed to in the Round.

TABLE 3.4
THE IMPORTANCE TO TRANSITION ECONOMIES OF THE SENSITIVE SECTORS (%)

	Share of particular items in each identified country-origin 1993 exports to the EU				Share of particular items in each identified country-origin, non FSU exports				
From	CSFR	Hungary	Poland	Romania	Bulgaria	Turkmen.	Uzbek.	Russia	FSU weighted total
Iron & steel	11	4	12	7	7	0	0	3	4.8
Chemicals	8	9	6	4	7	5	5	4	5
Footwear, textiles & apparel	17	23	21	49	38	66	57	1	2.2
Food & ag.	4	18	11	5	18	4	2	2	2.2
Total	**40**	**54**	**50**	**65**	**70**	**75**	**64**	**10**	**14.3**

Source: EBRD, *Transition Report 1994*, October.

Different estimations are available for the economic impact of the quotas used under the MFA. In 1993, the United States International Trade Commission estimated that the average quota

[17] If intra-EU trade in textiles and clothing is excluded, the figures become 15 and 44 per cent, respectively. GATT (1994a: 16).

[18] UNCTAD (1994: 110).

price wedge on clothing products entering the United States from all sources was 16.8 per cent. On a bilateral basis, estimates of the quota price wedge for clothing entering the United states range above 40 per cent. All studies of the costs of protecting textiles and clothing report substantial gains to consumers in the importing countries from the lifting of restraints.[19] As indicated in Table 3.4, for some economies in transition, especially for Turkmenistan, Uzbekistan, Romania and Bulgaria, the importance of a more liberal textiles and clothing regime is vital.

3.2.1.2 Other quantitative restrictions

Article XIX of the GATT enables a member to take a measure to protect a domestic industry from an unforeseen increase of imports of any product which is causing, or is likely to cause, serious injury to the industry. The recourse to Article XIX has declined since the 1980s and at the same time the selective use of so-called 'grey area' measures, such as voluntary export restraints (VERs), orderly marketing agreements (OMAs) and others has become widespread as a direct substitute for Article XIX action. The main reason for taking action outside the GATT framework included the requirement of Article XIX that safeguard actions be introduced on an MFN basis, that is applied to all sources of imports. In addition, the contracting party affected by the measure was entitled to take countermeasures against the country which introduced safeguard measures under Article XIX. Around 8 per cent of the imports (excluding fuels) of the developed countries from the developing countries and countries in transition have been subject to 'grey area' measures. The products affected include agriculture, footwear, textiles and clothing, steel and steel products, machinery, electrical and electronic products, and motor vehicles.[20] The GATT Trade Policy Review Mechanism, until early 1993, identified seventy-five bilateral and unilateral restraints falling in the category of these measures. Their total number, however, remained unknown.[21]

The Uruguay Round Agreement on Safeguards has established a prohibition against 'grey area' measures and set a 'sunset clause' on all safeguard actions. The Agreement provides that a member shall not seek, take or maintain any VERs, OMAs or any similar measures on the export or the import side. Any such measure in effect at the time of entry into force of the Agreement has to be brought into conformity with it, or be phased out within four years after the entry into force of the Agreement establishing the WTO. All existing safeguard measures taken under Article XIX of GATT 1947 shall be terminated not later than eight years after the date on which they were first applied or five years after 1 January 1995, whichever comes later.

The Agreement establishes requirements for safeguard investigations, including the application of provisional safeguard measures and sets out criteria for 'serious injury'. As a rule, safeguard measures are to be applied to a product being imported irrespective of its source. In case of quota allocation, the deviation from the non-discrimination principle is allowed if the member applying the measure can demonstrate, in consultations under the auspices of the Safeguards Committee, that imports from certain contracting parties have increased disproportionately to the total increase in imports and that a departure from the non-discrimination principle is

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19 For other estimates see GATT (1994a: 16-17).

20 UNCTAD (1994: 51).

21 GATT (1994a: 17-18.

justified and equitable to all suppliers. The duration of the safeguard measure in this case cannot exceed four years.

The Agreement lays down time limits for all safeguard measures. It envisages consultations on compensation for them. Where consultations are not successful, the affected members may withdraw equivalent concessions or other obligations under GATT 1994. However, such action is not allowed for the first three years of the safeguard measure if it conforms to the provisions of the Agreement, and is taken as a result of an absolute increase in imports. The Agreement establishes a Committee on Safeguards which, *inter alia*, monitors the implementation of the Agreement and makes recommendations towards its improvement, makes findings upon request of an affected member, whether or not the procedural requirements of the Agreement have been complied with in connection with a safeguard measure, and assists members, if they so request, in their consultations under the provisions of the Agreement.

3.2.1.3 Reductions in import barriers and other interventions affecting trade in agricultural products

Trade in agricultural products in the GATT system has been subject to a lower degree of multilateral discipline and market access obligations than those governing trade in industrial goods. This situation was due to some exceptions included in the General Agreement itself, waivers granted to certain contracting parties and the practices (the low share of bound tariffs in the agricultural sector, for example) which have developed over more than forty years. The result was increasing protectionism, growing domestic support for agricultural production and export subsidy competition. Attempts in earlier multilateral trade negotiations to introduce stricter discipline in agricultural trade failed.

The overall result of the Uruguay Round on agriculture is that a decisive step has been taken towards increased market orientation in agricultural trade, the rules governing agricultural trade have been strengthened and a framework has been established for the long-term reform of both agricultural trade and domestic policies. In the area of market access, the Agreement on Agriculture stipulates that non-tariff border measures are to be replaced by bound tariffs that provide substantially the same level of protection. Tariffs resulting from this tariffication process, which may be as high as 200-500 per cent ad valorem, as well as other tariffs on agricultural products, are to be reduced by an average 36 per cent in the case of developed countries and 24 per cent in the case of developing countries, with minimum reductions for each tariff line being required. Reductions are to be implemented over six years by developed countries and ten by developing countries. Least developed countries are not under the obligation to reduce their tariffs. As a result of tariffication, the share of tariff bindings in all countries has reached 100 per cent. Previously, this share was 58 per cent for developed, 51 per cent for transition, and 18 per cent for developing, countries.[22]

[22] In the tariffication process, countries in transition were allowed to use different calculation methods than those used by other participants. This was because their policies and general economic conditions were not comparable with those of market economies. For this reason, the tariff bindings of economies in transition are unrelated to their conditions in the base period. All have generally bound ad valorem tariffs at a significantly higher level than applied previously.

For products covered by the tariffication process, members are under the obligation to maintain current market access opportunities and to establish minimum access tariff quotas, at reduced rates, where the current access is less than five per cent of domestic consumption. These minimum access tariff quotas are to be expanded from 3 per cent to 5 per cent of domestic consumption over the implementation period. In the case of 'tariffied' products, special safeguard provisions can be invoked which will allow additional duties to be applied in certain cases. Under a 'special treatment' clause, countries are allowed to maintain, under certain conditions, import restrictions up to the end of the implementation period.

Members have committed themselves to bind and reduce support to domestic producers of agricultural products. Domestic support measures that have, at most, a minimal impact on trade ('green box' policies) and some other policies are excluded from reduction commitments. The total Aggregate Measurement of Support (Total AMS) is to be reduced by 20 per cent (13.3 per cent for developing countries and no reduction for least-developed countries) during the implementation period. As a result of these commitments, the total level of support to agricultural producers subject to commitments in the base period will decline by 18 per cent by the end of the transition period, from US$197 billion to US$162 billion.

Under the Agreement on Agriculture members are required to reduce the value of direct subsidies mainly. In the case of the developed countries they are to do so, to a level 36 per cent below the 1986-90 base level over the six-year implementation period, and the quantity of subsidized exports is to be decreased by 21 per cent. In the case of the developing countries, the reductions are two-thirds those of developed countries over a period of ten years. There is no obligation to reduce export subsidies for least-developed countries. These export subsidy reductions are of substantial importance for such heavily subsidized products as wheat, beef, coarse grains, dairy products and sugar. Total outlays on subsidized quantities will decline by the end of the of the implementation period from US$22.5 billion to US$14.5 billion, of which one-half is accounted for by the European Union.[23]

The so-called 'peace provisions' of the Agreement include an understanding that certain actions available under the Subsidies Agreement will not be applied with respect to green box policies and that domestic support and export subsidies will be maintained in conformity with commitments; an understanding that 'due restraint' will be used in the application of countervailing duties under the GATT; and a delineation of the applicability of nullification or impairment actions. These peace provisions will apply for a period of nine years.

The Agreement (Article XVII) has established a Committee on Agriculture with the task to monitor the implementation of commitments and the follow-up to the Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net Food-Importing Developing Countries. The Agreement has laid down a framework for continued liberalization in the sector. It calls for further negotiations in the fifth year of implementation which, along with the assessment of the first five years, would take into account non-trade concerns, special and differential treatment to developing country members, the objective to establish a fair and market-oriented agricultural trading system and other concerns and objectives noted in the preamble to the Agreement. It is expected that in the light

[23] GATT (1994a: 22).

of the results of the Uruguay Round in the agricultural area, the association agreements between the EU and the central and eastern European countries will be revised and accordingly modified to avoid the erosion of preferences in this field.

3.2.2 General agreement on trade in services

One of the major achievements of the Uruguay Round is the integration of international trade in services in the multilateral GATT system. The basic principles of the General Agreement on Services (GATS) are similar to those of the GATT, namely national treatment, most-favoured-nation treatment, transparency, and progressive liberalization. However, the GATS allows particular measures inconsistent with the MFN obligation to be maintained, but no longer than ten years and subject to review within five years. Such measures are specified in national lists of MFN exemptions.

The GATS consists of two parts; the framework agreement, containing twenty-nine articles and a number of annexes, and the national schedules of specific commitments undertaken by each member. In national schedules members indicate the sectors and activities to which they apply the market access and national treatment obligations of the GATS, with eventual limitations. A national schedule constitutes a binding commitment, the supply of services indicated in it is to be allowed under the terms and conditions defined in the schedule and no new measures are allowed that would restrict entry into the market or the operation of the service. Commitments can only be withdrawn or modified after compensatory adjustment has been made to affected countries and not until the Agreement has been in force for three years. Sectors with substantial coverage in the national schedules include tourism, business, telecommunications and financial services. According to the GATT Secretariat, the majority of commitments bind the existing level of access while others incorporate and bind the liberalization of previously existing restrictions.[24]

The GATS provides for future rounds of negotiation with a view to achieving a progressively higher level of liberalization; the first is to begin within five years. Negotiations are foreseen on emergency safeguards, government procurement, subsidies and domestic regulations regarding professional qualifications. In l997, negotiations were conducted on basic telecommunication and financial services and resulted in significantly improved commitments.

At present, the share of economies in transition in world services trade is even lower than in trade in goods. In 1992, the combined share of Bulgaria, Czechoslovakia, Hungary, Poland and Romania in world services exports and imports was about 0.9 and 0.8 per cent.[25] There is no doubt, however, that over the long term the service sector will play a very important role in all transition economies, especially if account is taken of the importance of foreign investments which will be decisive in the development of the services sector there. It is very difficult to assess the precise impact of the GATS on the transition economies. In services there is no equivalent to customs duties; the effect of different measures used to protect the domestic service industry cannot be quantified. In addition, basic statistical problems exist which prevent the quantitative presentation of the national commitments included in GATS schedules. The

[24] GATT (1994a: 41).

[25] ECE (1994a: 49-50).

main importance of the GATS for countries in transition is that it provides a stable multilateral system of rules in the area of services, guarantees a more secure market access for exports and establishes a framework for the continuation of trade liberalization in this sector.

3.2.3 Special rules for economies in transition

When the negotiating objectives of the Uruguay Round were adopted in 1986, the world was still divided politically and economically. At the time there were no countries with a centrally-planned system which could openly put on the agenda the transformation of their system to a market economy. Some socialist countries, especially Hungary after 1968 or Poland as from the mid 1980s, started to implement market oriented reforms. However, due to the division of the world and the resulting limited sovereignty of these countries, the reforms could not call into question the basic elements of the Soviet-type economic system, such as state ownership, central planning and socialist economic cooperation in the framework of the CMEA. The room for manoeuvre in respect of the political structure was even more limited. The establishment of a democratic, multi-party political system was out of the question and independence in foreign or military policies limited. Events in 1956 in Hungary, in 1968 in Czechoslovakia, or in 1981 in Poland, clearly demonstrated that no major deviation was tolerated from the basic principles of the existing system.

For this reason it was understandable that the Punta del Este Declaration did not include any specific negotiating objectives concerning the transition economies. From the provisions of the Declaration on the participation in the Round, it was evident that the intention was to limit the participation of non-contracting parties, including a number of planned economies. Only from the second half of 1989 did it become evident that countries in central and eastern Europe had decided to take advantage of the new geopolitical situation not only to reform their countries but to transform them into market economies. However, due to the timing of the Mid-term Review (end of 1988), to the original plan to finish the Uruguay Round by 1990, and later to substantial negotiating difficulties which prevented the major negotiators for focusing on issues which seemed to be of only secondary importance for the success of the Round, participants did not formally modify the negotiating mandate to take transition into account. Countries in transition did not insist on special treatment either because, at the time, they also underestimated the difficulties of the process and the length of the transition period. The second reason for not insisting on special provisions in different agreements was that they were worried that any specific regulation would result in their continued discrimination. They were also aware that a proposal to modify the negotiating mandate in the final stages of the negotiations would contribute to further delay the finalization of the Round.

Despite this, certain WTO instruments provide for the special problems of economies in transition. Article 29 of the Agreement on Subsidies and Countervailing Measures embodies a provision which allows for members 'in the process of transformation from a centrally-planned into a market, free-enterprise economy' to apply 'programmes and measures necessary for such transformation'. In fact, this is the only meaningful preferential treatment accorded to countries in transition in recognition of the difficulties they face. The Agreement allows them to apply subsidies, which are prohibited under the Agreement, if they are necessary for such a transformation within seven years from the date of entry into force of the WTO Agreement. Developing countries have eight years for the elimination of prohibited subsidies. The subsidies, however, except for debt relief for state-owned enterprises undergoing ownership

changes, are actionable. Countries in transition which wish to use these preferential provisions have to notify the subsidies concerned and have to work out a timetable for their phasing-out.

Article 65:3 of the Agreement on Trade-Related Aspects of Intellectual Property Rights provides that 'Any Member which is in the process of transformation from a centrally-planned into a market, free enterprise economy and which is undertaking structural reform of its intellectual property system and facing special problems in the preparation and implementation of intellectual property laws and regulations, may benefit from a period of delay of five years in the implementation of the Agreement with certain exceptions'.

Finally, Article XII:1 of the GATS provides that a 'member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition'.

The transition process is accompanied by instabilities which make it difficult for the countries involved, especially those at the beginning of the process, to undertake durable obligations in the field of tariff and non-tariff measures like established market economies. In the absence of clear rules on transition, the WTO will have to interpret its rules in a flexible way if it wishes to integrate these countries smoothly. Insensibility to problems of transition or one-sided, selfish approaches by market economies, for example their subordination of general policy positions giving support to transition to short-term export interests, may alienate transition countries from integration into the world economy and also from the implementation of market reforms.

3.2.4 Strengthened rules, procedures and institutions

Beyond the objective of increasing market access, another major objective of the Punta Del Este Declaration was the strengthening of the role of the GATT and extension of the share of world trade under agreed, effective and enforceable multilateral disciplines. This objective was reached by the adoption of a number of understandings and agreements, which constitute 'GATT 1994', which clarify or extend the rules of the original GATT, that being GATT 1947. The Agreement establishing the World Trade Organization has created a single institutional framework encompassing GATT 1994, the GATS, the Agreement on Trade-Related Aspects of Intellectual Property Rights, the Understanding on Rules and Procedures Governing the Settlement of Disputes, the Trade Policy Review Mechanism and the Plurilateral Trade Agreements.[26] As a consequence of the 'single undertaking' approach, membership in the WTO entails accepting all the results of the Uruguay Round without exception. The WTO provides a unique institutional framework where the constituent elements of the system are legally linked to each other under the umbrella of some basic principles such as MFN, national treatment, the exchange of concessions and a strengthened dispute settlement system.

The Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 and the Agreement on Subsidies and Countervailing Measures play an especially important role in the strengthening of the rules of the multilateral trading system from the point of view of economies in transition. The new Anti-Dumping Agreement provides more detailed

[26] The Plurilateral Trade Agreements include the Agreement on Trade in Civil Aircraft, the Agreement on Government Procurement, the International Dairy Agreement and the International Bovine Meat Agreement.

rules on a number of elements of the anti-dumping process such as the initiation of investigations, calculation of dumping margins, determination of injury or threat thereof, requirements for the review of findings and understandings. Generally, the rules introduce more transparency into domestic rules and related procedures. According to the Agreement, anti-dumping measures expire five years after the date of imposition, unless a determination is made that, in the event of termination of the measures, dumping and injury would be likely to continue or recur. A new provision requires the immediate termination of an anti-dumping investigation in cases where the authorities determine that the margin of dumping is *de minimis* or the volume of dumped imports is negligible. The Agreement calls for prompt and detailed notification of all preliminary or final anti-dumping actions to a Committee on Anti-Dumping Practices. It provides an opportunity for consultations on any matter relating to its operation or the furtherance of its objectives, and to the request of the establishment of panels to examine disputes.

In the period 1989-93, the number of anti-dumping actions initiated almost tripled. Exporters from former socialist and later transition economies were particularly hard hit. Between 1985 and 1992, exporters were subject to 1147 initiations of anti-dumping actions world-wide. More than 20 per cent of these initiations were directed against exporters from transition economies, while their share in world exports was well below 10 per cent.[27] The number of similar actions between 1992 and 1994 was 496, of which 129 (26 per cent) were directed against exporters from economies in transition, including China.[28] It was particularly burdensome for countries in transition in anti-dumping procedures that the normal value of their exported products was determined by taking the price of a similar product in a third market economy or by using the constructed value principle based on prices of a similar product in a third market. This special procedure involved arbitrary elements and frequently disadvantaged exporters from the transition area. The new Anti-Dumping Agreement does not include any special rules for non-market economies or countries in transition.

The Agreement on Subsidies and Countervailing Measures defines subsidy and clarifies those that are subject to the provisions of the Agreement. It establishes three categories of subsidy, namely prohibited, actionable and non-actionable. The Agreement on Agriculture modifies the application of subsidy rules on agricultural products. The administration of countervailing measures has also been clarified by greater and more detailed rules on the conduct of investigations; by establishing the criteria to terminate an investigation; by providing interested trade partners with full notice and the right to present evidence; by clarifying the criteria used to determine injury to the domestic industry; by requiring more detailed public notice and the explanation of determinations and by establishing a 'sunset' clause of five years. The Agreement recognizes that subsidies may play an important role in the economic development programmes of developing countries, and in the transformation of centrally-planned economies to market economies (see section 3.2.3).

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[27] GATT (1994b: 29).

[28] In 1993, the combined share of China, central and eastern Europe and the former Soviet Union amounted to 5.9 per cent. Out of the 129 anti-dumping actions initiated against exporters from countries in transition, including China, the most affected country was China with 58 actions, followed by Russia (17), Ukraine (12), Poland (7) and the Czech Republic (5). GATT (1994b: 30).

3.2.5 Settlement of disputes

The Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) substantially strengthens the dispute settlement mechanism of the GATT. The DSU has established an integrated system permitting WTO members to base their claims on any of the multilateral trade agreements included in the Annexes of the WTO Agreement. It lays down a system which gives a complainant the right to the establishment of a panel. Once the dispute settlement procedure has started, no member has the power to delay, postpone or block a decision. Panel reports are submitted to the Dispute Settlement Body (DSB) for approval. The DSB can decide only by consensus not to adopt the report, which seems to be improbable. The appellate review is an important new feature of the DSU. An Appellate Body has been established. Composed of seven members, three will serve on any one case. The report of the Appellate Body is adopted unless the DSB decides by consensus against its adoption. The DSB keeps the implementation of decisions under surveillance until the issue is resolved. In case of non-implementation, if the parties concerned failed to agree on mutually acceptable compensation, a party to the dispute may request the authorization of the DSB to suspend concessions or other obligations to the other party concerned. In principle, concessions should be suspended in the same sector as that at issue before the panel. Where it is not practical or effective, cross-sectoral retaliation (namely between goods, services and intellectual property) can be authorized. The new dispute settlement rules and procedures will be reviewed within four years after the entry into force of the WTO.

For countries in transition, and generally for trading partners with less bargaining power, the improvements in the dispute settlement mechanism constitute a great step forward. Unlike what occurred under the GATT, individual WTO members or parties to a dispute, are no longer in a position to block the adoption of panel reports. This will result in the increased enforceability of all commitments and will strengthen the rule-based nature of the WTO system. Departure from the agreed rules will be prevented and the world economy will rest on a more solid regulatory foundation. Between January 1, l995 and October 31, l997, the provisions of the DSU were invoked in one hundred and five cases. In seven cases, DSB recommendations were already in the process of implementation.

3.3 Systemic advantages of the Uruguay Round package for countries in transition

The Uruguay Round Agreements and the establishment of the WTO strengthen the multilateral trade system, make it more rule-oriented and provide a forum for further negotiations with the objective of continuing trade liberalization in a number of important areas such as agriculture or services. For countries in transition, the failure of the Round would have been very negative as it would have moved the world trade system towards more bilaterism and power-oriented trade diplomacy.

Economies in transition may benefit more from the implementation of the Uruguay Round results than other participants. For them, the strengthened rule-based multilateral trade order may provide not only more trade possibilities and increased predictability but also a reliable and stable point of orientation in their market reforms. This is of particular importance to transition countries which have not yet acceded to the WTO, as participation in the international trading system makes a country's trade regime and domestic economic policy more compatible

with the rest of the world's, helps to do away with economic isolation or one-sided economic dependence, and makes a country more attractive for foreign investors. The WTO system can provide clear support for market reforms, including the establishment of a sophisticated market-oriented trade system, and helps administrations fight against short-sighted domestic, or foreign protectionist, pressure groups. The legal framework of the WTO system is vital for all countries in transition, including those which participate, or want to participate, in regional integration as membership in the multilateral system improves their negotiating positions in relation to the integration areas. It also provides them with access to alternative markets.

3.4 Accession to the WTO

Only WTO members can fully enjoy the benefits of the new trading order. This has been clearly recognized by countries in transition. Practically all of them have applied for accession to the GATT and later to the WTO.[29] Countries in transition which were contracting parties to GATT 1947 (the Czech Republic, Hungary, Poland, Romania and Slovakia) have become original members of the WTO. It should be noted, however, that among these countries there are substantial differences with respect to the legal conditions of their participation in the GATT. Only the Czech Republic and Slovakia are GATT contracting parties under 'normal', namely market economy conditions. These two countries joined the GATT in 1993 as the successor states of the Czechoslovak Federal Republic and their protocols of accession did not include any specific provisions.[30] In sharp, and not easily understandable, contrast, the special protocols of accession of Hungary, Poland and Romania are still in force as GATT 1994, as defined by the WTO Agreement, consists, *inter alia*, of accession protocols. These three countries asked in 1990 and 1991 for changes in their protocols with the objective of eliminating obsolete or inoperative provisions and of terminating their 'second class' participation in GATT. The Polish Working Party has already had several meetings whereas the Hungarian and Romanian Working Parties have not yet met. It is obvious that the provisions of these old protocols of accession are obsolete (quantitative import commitments or rules regarding the CMEA) and raise problems of interpretation in respect of some provisions of the WTO Agreement (those dealing with safeguards[31] or anti-dumping).

The accession of a large number of countries in transition represents a major challenge to the new system. There is no doubt that the WTO cannot be a global trade organization if it is not in a position to integrate these countries. The stable development of world trade needs their participation in the new order to help them not only to solve their basic market-access problems but also to provide them with the stable environment needed for the success of their transition process. It is also clear that the successful integration of these countries in the new trade order

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[29] The following countries have applied for accession to the GATT/WTO (in brackets the year of the establishment of the Accession Working Party): Albania (1992); Armenia (1993), Belarus (1993); Bulgaria (1986); Cambodia (1994); China (1987); Croatia (1993); Estonia (1994); Latvia (1993); Lithuania (1994); Former Yugoslav Republic of Macedonia (1994); Moldova (1993); Mongolia (1991); Russian Federation (1993); Ukraine (1993); Uzbekistan (1994) and Vietnam (1995). The Working Party on the accession of Slovenia to the WTO finished its work at the end of 1994.

[30] GATT (1993c) and (1993d).

[31] Hungary's actively used safeguard legislation is based on its Protocol of Accession which allows to take safeguard actions selectively. GATT (1991: 116-7).

could contribute to the greater stability of political relations. In the achievement of this goal, closer cooperation between different international economic and trade organizations—as envisaged by the Declarations adopted in Marrakech on the Contribution of the WTO to Achieving Greater Coherence in Global Economic Policymaking and on the Relationship of the WTO with the IMF—is of particular importance.

Article XII of the WTO Agreement provides that all countries 'may accede to this Agreement, on terms to be agreed between them and the WTO'. Accession to the WTO, however, is a more complex task than was the accession to the GATT because the 'single undertaking' approach requires that the acceding country assumes obligations in all the areas covered by the WTO, namely trade in goods, services and intellectual property. Acceding countries will need understanding and flexibility from members of the WTO because of a number of difficulties they face in transition process. The general level of economic development is relatively low in these countries and production at the beginning of transition has declined. In addition, a number of economies have only recently become independent which means that their state administration is only just in the making. As a consequence of decades of rigid central planning and centralized foreign trade, their understanding of the operation of a market economy is limited. Tariff regimes are new and poorly developed and the trade regime, in general, lacks the required sophistication. Rapid political and economic changes do not allow the authorities to establish stable trade policies. It is very difficult to recognize the necessary level of protection for a number of political and economic reasons. As a result, trade policies and measures are frequently changed.

Instabilities are rooted in the deep social changes which accompany transition. Some special underlying reasons for it are the political changes which have swept away old protectionist party and state-enterprise pressure groups. This made early liberalization relatively easy. However, with the emergence of newly privatized sectors and foreign investors, demand for protection is on the increase. In addition, at the beginning of the transition process, domestic currencies were undervalued in most countries. But this period is normally followed by a period of real appreciation which increases the pressure for protection and support for exports.[32] Real appreciation has increased trade deficits. Structural adjustments undertaken by the new private sector have further led to increased imports of investment and intermediate products which contribute to a provisional worsening of the trade balance. Trade deficits and budgetary problems due to outdated budget structures and lax budgetary and tax discipline, have put pressure on the balance of payments. These problems are serious even in the more developed central and east European area, where the introduction of import restrictions for balance-of-payments reasons can be regarded as typical. Since the beginning of the transition process, the following countries have had resort to them under Article XII of the GATT: Czechoslovakia (1990); Poland (1993); Slovakia (1994) Hungary (1995) and Bulgaria (1997). The reluctance to phase out the import surcharge in case of improved or even satisfactory balance-of-payments performance suggests that giving more protection to the domestic economy has probably also become a consideration. After a period of almost full reliance on automatic adjustment mechanisms, most administrations are actively working on industrial policies which are likely to result in changes in tariff and non-tariff measures.[33]

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[32] ECE (1994b: 60-4) and ECE (1994c: 177-8).

[33] For the development of an industrial policy in Poland see: GATT (1993a: 138).

As the level of tariff protection in these countries is relatively low, especially in the Czech Republic and Slovakia, and its structure is unrelated to the needs of the economy,[34] there is a tendency to use additional measures of protection in case of balance-of-payments difficulties.[35] The introduction of different monitoring and certification systems, protection given to domestic industries in the form of public procurement, safeguard and anti-dumping actions, or high import surcharges applied to all imports including those originating in the EU and other free trade or customs union partners, clearly indicate that, as a result of serious economic and social problems, the enthusiasm for import liberalization experienced at the beginning of transition has diminished, or disappeared.[36]

The transition-related problems in the CIS economies are generally greater than in central and east European member countries due to differences in development and market-economy background.[37] It suggests that these countries, especially at an early stage of economic transition, are not in a position to assume full obligations under the WTO right away as a number of trade and economic institutions may not yet be in existence or may lack maturity; economic and trade policies and measures are not stable for both political and economic reasons. These considerations indicate the need to work out the necessary special and transitional solutions which may be necessary for a relatively rapid and smooth accession of these countries to the WTO. Accession negotiations are carried out on a case-by-case basis. This explains why some countries' accessions take more time than others. As was stressed by many members at the last ministerial conference of the WTO, accession to the organization requires full respect of its rules and disciplines as well as meaningful market access commitments on the part of the acceding countries.

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[34] In the WTO, the transition economies' basic tariff rates were established in their centrally-planned period when tariffs did not play any economically meaningful role (especially in Czechoslovakia and Romania) or their economic impact was limited (Hungary).

[35] Tariff protection will further decline as a result of tariff reductions under the Association and other free trade agreements.

[36] The initial level of import surcharges introduced for balance-of-payments reasons was the following: Czechoslovakia (1991): 20 per cent (consumer goods); Poland (1992): 6 per cent (all products), Slovakia (1994): 10 per cent (consumer goods) and Hungary (1995): 8 per cent (all products).

[37] According to the views of this author, the term 'transition economies' is not always appropriate as it puts in one category countries which represent substantially different levels of transformation. Some countries in transition, like the 'Visegrad four' and Slovenia are close to the end of the transition process while some others are just at the very beginning of it. Therefore, it would be more appropriate to call the more developed transition economies 'advanced transition economies'.

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CHAPTER 4

LIQUIDATION, NOSTRIFICATION AND ECONOMIC RE-ORIENTATION: THE DISSOLUTION OF THE EMPIRES AFTER THE FIRST WORLD WAR

Max Engman

Economic nationalism found the richest of soils in the wartime burst of national passions, the collapse of empires, the birth of new states, the post-war international revolutionary movements of the proletariat and the growth of nationalist ambitions as a reaction to them. The objective situation in itself would tend to multiply disagreements. The length of Europe's borders had grown by six or seven thousand kilometres; instead of 26 independent economic units there were now 38; instead of 12 monetary systems there were now 27 (Ránki, 1983; Engman, 1994).

It is tempting to emphasize the similarities between the situation after the First World War and the events of the last years. There are many similarities, but the world has also changed considerably during the last seventy years. When the Baltic states re-appeared on the international stage in 1991, they did so in a political and economic situation that is very different from the world of the peasant republics of the twenties. The transition from the planned economy required of the new states emerging on the territory of the former Soviet Union has few parallels. We are witnessing the dismantling of one of the huge experiments of history and the dismantling itself is also something that has never been done before. Ernest Gellner remarked in 1991 that 'the *perestroichiki* have about as good an idea of how to operate a market as the Bolsheviks had of how to build socialism' (Gellner, 1991).

If, however, one looks at the question 'How do you dissolve an empire?', there are many common traits. Empire dissolution and state-making processes have, and must have, many features in common. A new state has to dissolve its legal and economic bonds to the former imperial centre, to create or at least re-establish the central administration, civil service, borders, citizenship and so on.

After the First World War new states were created in what the first president of Czechoslovakia, Tomas Masaryk called 'the danger zone of Europe', the zone of small peoples forced to live between Russia and Germany (Masaryk, 1991). Eight states, from Finland in the north to the kingdom of the Serbs, Croats and Slovenes (from 1929 Yugoslavia) in the south, were able to stabilize their independence in a situation that was exceptional in so far as both Germany and Russia were weak. The Romanov and Habsburg successor states had, in varying circumstances, to solve similar problems of state-making that in the 1990s confronted the new states evolving from the fall of the Soviet Union and Yugoslavia.

4.1 Models

In the light of 20th century European history, one could talk about two basic models of empire dissolution; the Habsburg and the Romanov. The dissolution of the colonial empires could be seen as a third model, but the overseas colonies were never integrated in the structures of the metropolitan powers in the same way as the constituent parts of the continental empires.

Austria-Hungary suffered a total breakdown and dissolution at the end of October and beginning of November 1918, when seven states, German-Austria, Hungary, Czechoslovakia, Poland, Romania, Yugoslavia and Italy partitioned the empire. The dissolution was a mainly peaceful and negotiated process, even if there were armed conflicts and border clashes in Bohemia, Southern Carinthia, Dalmatia. The exception to the peaceful pattern was Hungary, which had border conflicts with all its neighbours and experienced revolution, foreign intervention and civil war in 1918-19.

The dissolution of the Habsburg empire became an international issue at the peace conference in Paris. The Treaties of Versailles, St. Germain and Trianon have been much criticized, but one has to admit that the peacemakers made an effort to create a stable post-war world by regulating questions that might become sources of new conflicts.

The dissolution of the Russian empire was a long and painful process from the abdication of Nicholas II in 1917 to the peace of Riga between Poland and Russia in 1921. The foundation of the Soviet Union in 1922 signified the birth of a new empire. The process saw several consecutive regimes in Russia, civil wars, revolutions and interventions in the central regions and the borderlands. The process was much more violent than the dissolution of the Habsburg empire.

Another important difference was that Russia, in spite of revolution and civil war, did not fall apart as totally as Austria-Hungary. When the civil war was over only the north-western new states, Finland, the Baltic countries and Poland were able to retain their independence while the Bolsheviks reconquered the Ukraine, White Russia, and the Caucasian states. In the Russian case the emergence of new states meant a severance of border areas from a diminished centre, not a dissolution of the whole empire. Even if the victors in World War I refrained from recognizing the Bolsheviks as legitimate rulers of Russia and the Bolsheviks, for their part, declined to accept the commitments of the Tsarist regime, be it international treaties or state debt, there was no denying that the Bolsheviks controlled most of the former Russian empire. The victors would have been pleased to internationalize and supervise the dissolution of Russia, but on this point the Bolsheviks were adamant and ultimately successful. Both the great powers and the border states had to come to terms with them bilaterally.

If one compares the dissolution of the empires after the First World War with the events of the last years one could say that the Soviet Union, at least until the war in Chechnya, has followed the Habsburg model, a mainly peaceful and negotiated process, while Yugoslavia has gone the Romanov way, with as tragic consequences for its inhabitants as for the subjects of the Tsar after 1917. Still, there are several important differences. The Austro-Hungarian and Russian empires fell after defeat in a long war, the dissolution of the Soviet Union and Yugoslavia had internal causes and were not forced on these states from the outside—even if inability to keep

up the arms race was also a defeat. The international community has been rather helpless both to stop the civil war in former Yugoslavia or to influence the political and economic developments in Russia. On the other hand one could say that the victors in World War I in Paris—once they gave up armed intervention—influenced the outcome of the internal developments in Russia even less than organizations like the UN, EC-EU, IMF and the OSCE have been able to do in Russia today.

4.2 Inheritor states

After the dissolution of the Dual Monarchy 'the states that after the World War took the place of the old Austro-Hungarian monarchy by dividing its territory between them' were called *Nachfolgestaate*—successor states (Kofta, 1929; Lehnich, 1923; Engman, 1989). The new states could also be called 'inheritor states' to emphasize that they faced problems arising from the fall of the empires and the taking over of their legacies. These problems could be classified into those relating to integration and those relating to separation. All new states had problems of separation, that is problems arising from the fact that they were parts of a former whole. They had to create viable independent units out of the integrated parts of imperial structures. Empires, by definition, are not unitary national states and include a variety of nations and ethnic groups, economic regions on different levels of development and even different legal systems. Still, centuries of living under the same central authority had created a degree of economic, administrative and cultural integration. The crowns of Bohemia and Hungary passed to the Habsburgs in 1526, the Baltic provinces to Russia in 1721. The Soviet empire did not reach such an age, but could in many regions build directly on its Russian heritage, and seventy years of Soviet rule, command economy and rigorous central direction in any case created an economy with a high degree of regional division of labour. All the new states thus had to create new administrative structures and adapt to a situation where a high proportion of all economic activity had suddenly become foreign trade or international relations.

Some states like Poland and Yugoslavia had to integrate parts from several empires or former independent political units and thus had to cope with a mixture of administrative traditions, legal and fiscal systems as well as economies and communications built according to the needs of the old units. In the new Poland, Prussian law applied in West Prussia, Austrian in Galicia, quasi-French law in Congress Poland, and Russian in the rest of Poland. Yugoslavia initially had seven legal codes. The great schemes of codification which were set in motion had, in most cases, not been completed before the coming of World War II. The heterogeneous administrative and fiscal systems inherited by the new states made it difficult to establish fair and efficient taxation systems (Slapnicka, 1973; Radice, 1985).

The new states created out of the Soviet Union and Yugoslavia had one advantage over the Habsburg and Romanov successor states. There had never existed a Czechoslovakia or Yugoslavia before 1918 and Poland had disappeared in 1795. Even if Czechoslovakia could build on Bohemia and Yugoslavia on Serbia—which of course had its political disadvantages-, the successor states after the First World War were essentially new creations. Finland was an exception as the Grand Duchy had had its separate taxation, administrative, legal and customs systems since the beginning of the 19th century and its own currency and State Bank since the

1860s. On this level the Finnish transformation into sovereign statehood was comparatively smooth (Engman, 1989).

The Soviet and Yugoslav successor states all had a previous existence as Soviet or federal republics or autonomous regions. This autonomy may have been rather illusory, but at least the administrative infrastructure was there; in many cases, but certainly not in all, the borders and the citizenship of the new states were more or less undisputed. The successor states after 1918 and today have one problem in common though; the existence of large numbers of suddenly expatriate members of former ruling groups (Germans, Magyars, Russians) with economic and political demands and grievances that are hard to reconcile with the policies, or in some cases even the existence, of the new states and the new post-imperial order in general. The remnants of the former imperial powers went through an identity crisis, a post-imperial hangover, as well as an economic crisis after 1918. The Austrians debated the *Lebensfähigkeit* of their unwanted republic; most participants in the debate argued that Austria was not viable on its own without *Anschluss* (Kerekes, 1976). Revisionist Hungary did not even want to contemplate a future without the lost provinces.

On the other hand, the new successor states have one disadvantage compared at least to the Habsburg successor states. The restructuring of central Europe took place within the same capitalist economy, even if it was under great pressure during the first years, while the developments of the last years have involved not only the creating of political independence but also the transformation to a market economy.

4.3 Liquidation

The creation of the new states did not only involve borders, territorial conflicts, constitutions, foreign policy orientation, but also a division of the administration, assets, property and traditions of the empire. The successor states had to create their own administration, central bank, currency, citizenship, symbols and identity. In many ways the birth of the successor states could be compared to the dividing of an estate. In that process there were two basic operations that had to be performed; liquidation and nostrification.

Liquidation means a settling of accounts; the administrative liquidation of, for instance, the Austro-Hungarian foreign service or central bank meant its dissolution and the dividing of its assets and liabilities, money, buildings and civil servants, between the successor states (Matsch, 1977). The dismantling of the former imperial administration and the dividing of the estate of the defunct empire took very different forms in Russia and Austria after the First World War, which can be clearly seen in the peace treaties. The peace treaty of 1920 between Soviet Russia and Estonia had twenty-one articles, the treaty between Soviet Russia and Finland later the same year had thirty-nine. The peace treaty of St. Germain with Austria had 381 articles. The multilateral peace treaties concluded in Paris in 1919-20 reflect the ambition of regulating the post-war world with clauses ranging from the internationalizing of the Danube and the restoration of museum pieces to the charter of the International Labour Organization.

The peace treaties with Soviet Russia were made bilaterally by individual countries and concentrated on what was necessary in order to end hostilities. They left many questions to be

settled later in difficult bilateral negotiations. The Romanov successor states never got any real influence over, or even information about, the dismantling and liquidation of the former administration. The successor states claimed their part of its assets but usually got very little, the Baltic states complained that they did not even get back property evacuated into Russia during the World War I.

The administrative liquidation of Austria was complicated because so many states were involved. The former ministries for the empire as a whole (the *k.u.k.* ministries of war, foreign affairs and common finances) continued to exist as *liquidierende Ministerien* for some years. In November 1918 the new Austrian republic took over the old imperial ministries, albeit with the explicit proviso that the rights of the other successor states would be taken into consideration. Until the ratification of the peace treaty, the Republic of Austria was a kind of caretaker for the other states and liquidation commissions with representatives of the successor states were appointed for all ministries (the *k.k.* ministries for the Austrian half of the empire). This cumbersome system was ended in 1919 and after that the liquidation became an internal Austrian affair with negotiations at a diplomatic level.

The central legal basis for a liquidation in international relations is the question of legal succession, that is who is to be considered the direct legal heir to the old empire, which is decisive for rights and obligations. The heir could lay claim to the assets, but at the same time became liable for the state debt. All the Habsburg successor states, including the new Republic of Austria, claimed that they as new creations could not be held accountable for the debt of the empire, but as the American Foreign Secretary Robert Lansing put it bluntly 'Austria-Hungary might have disappeared, someone still had to pay the bill'. After complicated negotiations, the successor states during the first years of the 1920s agreed on a formula based on population and economic resources for dividing the imperial debt.

The liquidation was conducted mainly according to the territorial principle, the successor states got all state property within their borders; buildings, fortresses, railroads, archives and so on. The principle was clear but its realization often controversial, especially concerning non-territorial assets in the former capitals or belonging to the former imperial house. The liquidation of state debts and assets proved very difficult, as did smaller things like the rolling stock of the railroads or the central archives in the former imperial capitals. It was not until 1933 that the international *Fahrparkaufteilungskommission*, which had a British chairman, finished its work, and even then some questions were not resolved until shortly before the *Anschluss*. In the case of archives, appeals like that made by the director of the Austrian state archives that those in Vienna should be allowed to remain untouched as a memorial to bygone days, like the Pyramids of Egypt, fell on deaf ears. The archives were divided during the 1920s and 1930s, but the fact that Austria and Yugoslavia until the fall of the latter had an unresolved conflict over the application of the Austro-Yugoslav archival treaty concluded in 1923 bears witness to the difficulties inherent in issues of this sort (Mechtler, 1964, 1965; Bittner, 1925). After the first years most of the questions could be seen as mere 'irritants', but they were usually difficult to solve in an atmosphere of mutual distrust.

In some respects the Soviet liquidation started along similar lines as the Austrian. President Yeltsin declared in the Autumn of 1991 that Russia would take over the Soviet ministries but that the rights of the other republics would be taken into consideration. This operation started a

conflict about the liquidation of the Soviet administrative apparatus, the distribution of the state debt, the gold reserves and so on (Schweisfurth, 1992). In many ways liquidation resembles an estate inventory and the dividing of an estate. One exhausted Ukrainian delegate at one of the Commonwealth of Independent States meetings for liquidating the Soviet Union actually said the task was like making an inventory of a bankrupt estate. These questions are, however, usually impossible to solve according to abstract legal principles. One could for example draw parallels between the conflicts between Italy and Yugoslavia concerning the Austro-Hungarian fleet after 1918, and the division of the Soviet Black Sea Fleet between Russia and the Ukraine after 1991.

4.4 Nostrification

Nostrification is a continuation of liquidation. Liquidation means ending the old empire, nostrification a selective integration and transformation of the remnants into a new state structure. Put simply, it meant taking over parts of the imperial legacy and putting them into the hands of the new states or their citizens, 'making them ours'. In the economic field nostrification meant a local take-over of the economy, but not nationalization. The Czech minister of finance spoke of 'the naturalization of joint-stock companies' (Rasin, 1923). In postcolonial situations the term 'indigenization' has been used.

The new states also had to 'nostrificate' imperial subjects and civil servants. In deciding the right of citizenship the new states normally applied the territorial principle by using the right of domicile (*Heimatsrecht* or the like) as the basis for citizenship. In theory the solution was simple: a person who had the right of domicile inside the borders of the new state became a citizen of that state. In practice, however, the question was complicated by the fact that in many cases the new state did not want all these citizens or the persons eligible for citizenship did not want to become citizens of that particular state. Most people had no choice but had to stay where they owned land or were employed. The peace treaties foresaw that persons within a certain period had the right to choose, to opt for citizenship in another state (*Optantenfrage*). In the peace treaties with Soviet Russia options and repatriations played an important role in the Baltic states and Poland. The Soviets used the repatriation as a lever to reach other objectives and the negotiations were difficult (Engman, 1991).

Some of the most difficult problems in the nostrification process concerned the former imperial civil servants. In some cases the new states refused to accept them, as for example Russian officials in the Baltic countries and Finland, or they refused to serve the new regime, as for example Magyar officials in Slovakia and Transylvania. Most Magyar officials had to leave Czechoslovakia, which however in Bohemia and Moravia took over most of the former civil servants who were prepared to declare their loyalty to the republic. During the second half of the 1920s, Czechoslovakia introduced language requirements which favoured Czechs resulting in some German civil servants in the railroad and postal services having to leave their posts (Hoensch, 1978).

Austria and Hungary after 1918 took over the many German and Magyar civil servants who left the successor states. An administrative apparatus already overheavy for these small states was thus burdened still more. The finances of both states were overtaxed and an imminent state

bankruptcy was near. The conditions for the League of Nations stabilization loans included radical cuts in the administration. During the so-called *Beamtenabbau*, Austria had to rid its administration of 100 000 civil servants, about a third of the total bureaucracy (Keinböck, 1925).

4.5 Creating new currencies

A national currency has usually been seen as a necessary pre-condition for economic independence, both as an instrument for financial policy and as a symbol. In central Europe after World War I, currency reform became necessary also as a consequence of inflation (Kerschagl, 1920).

The nostrification of the currencies was a lengthy process. In the Habsburg successor states it went through two stages. First the successor states nostrificated the old Austrian crowns by stamping them (in Yugoslavia by stamping the notes, in Czechoslovakia by attaching marks); a few years later they created a new currency, usually in combination with a stabilization plan. The Imperial Bank continued for some years as a bank of issue for Austria and Hungary and was liquidated in 1922, when the last vestiges of the old currency union disappeared.

In central Europe only Czechoslovakia was able to stabilize its currency in a short time due to its stringent stabilization plan, the so-called 'Rasin experiment'. All other states went through longer or shorter periods of instability and high inflation. Those successor states which were created out of parts of different empires or states, like Poland and Yugoslavia, had severe problems because several different currencies circulated on their territory. The problems were aggravated because the constituent parts of these states also had different tax systems. In Yugoslavia the nostrification of the currency created one of the first serious rifts between Serbia and the former Habsburg areas; the latter claimed that the government was unduly favouring the Serbian dinar. Austria and Hungary were able to stabilize their currencies after hyperinflation only with loans guaranteed by the League of Nations in 1922 and 1924. The loans were granted on harsh conditions involving austerity programmes under the supervision of the League (Sundhaussen, 1985; Bloomfield, 1984; Sargent, 1984).

The problems of the Russian successor states were the different roubles and marks that were in circulation since the war and the German occupation. Lithuania had been integrated in the German war economy during the occupation and after the war decided to eliminate the different kinds of roubles and base its monetary system on the German occupation currency *Oberostgeld*. Until the Autumn of 1922 Lithuania did not have its own currency; this made it impossible to finance state deficits through the printing press and created a period of preparation for a currency reform but, on the other hand, limited policy options. By creating their own currency, the lit, in October 1922 the Lithuanians avoided being drawn into the fall of the German mark (Lehnich, 1923).

Estonia chose a different way and soon after independence tried to eliminate the roubles and *Oberostgeld* circulating on its territory by creating an Estonian mark formally at parity with the Finnish mark, but in reality based on the German mark. After a period of inflation a new currency, the Estonian crown was introduced in 1924 and based on the dollar. With the help of

an international loan guaranteed by the League of Nations the currency was stabilized on the gold standard. Latvia nostrificated the rouble by creating a Latvian rouble in 1919. As in Estonia, inflation and the flight into foreign currencies made it necessary to stabilize. Latvia introduced the lat in 1922. The strict stabilization programme in combination with the lack of capital resulted however in a period of stagnation (Lehnich, 1923).

4.6 Economic nostrification

The years after 1918 demonstrated that it is far easier to create a national anthem than a national economy. The successor states came into being during a period of revolution and social radicalism. The new governments had to respond to demands for socialization and land reforms. Even if there was an increase of state property from confiscation of what was defined as enemy property, the nostrification of industry mostly meant transferring economic resources into the hands of the national bourgeoisie, even if the degree of state ownership increased in, for example, Yugoslavia and Romania. Nostrification was, above all, a way of severing the links with Vienna, Budapest and Moscow (Berend and Ránki, 1974; Pasvolsky, 1928; Teichova, 1985b, 1988a).

Most governments immediately promised land reforms and these had a strong element of nostrification as well, as they often were directed against former dominant ethnic groups, like Germans in Estonia and Latvia, Poles in Lithuania, Magyars in Transylvania and Slovakia. In many cases the momentum slowed down later when the social atmosphere changed and when the reform began to affect landowners from the dominant ethnic group (von Rauch, 1974; Teichova, 1988a; Hoensch, 1978).

The Czechoslovak government in 1919 issued a law on nostrification that specified that companies owning factories and subsidiaries in Czechoslovakia had to transfer their main offices. The nostrification campaign comprised all in all 235 major companies and all major banks. During the inflation in Austria, Czech companies bought shares owned by Austrians (Teichova, 1988a, 1988b; Rasin, 1923). Nostrification meant a dismantling of the Austrian banking system; until 1924 all except eight out of 144 branch offices of the ten largest Viennese banks had been sold or made into independent banks. To some extent, however, some of these banks could with international capital retain an influence in banking in the successor states as minority owners (Kernbauer and Weber, 1984; Berend and Ránki, 1974; Teichova, 1988a).

There were limits on how far nostrification could go as Romania found when, in 1925, it tried to limit the extent of foreign capital—the lack of domestic capital forced a reversion of these policies after five years (Berend and Ránki, 1974; Pasvolsky, 1928).

There were inevitable disruptions of communications and economic life when frontiers were erected where people, ideas and commodities had flowed freely. These structural reorientations were added to the damage brought by the war, the destruction of infrastructure and productive capacity, the change from a war economy to a peace economy and the large-scale redistribution of populations.

The changes brought about by the peace treaties and the new borders created an obsession with communications. The peacemakers were well aware of the problem and the uncertainty about the consequences of the new borders. There were extensive discussions on the internationalization of waterways: the Danube, the Memel/Nemunas. The Czechs in vain insisted on a 'Slav Corridor' between Austria and Hungary, linking Czechoslovakia and Yugoslavia; the Polish corridor was constructed to give the Poles access to the Baltic. Many of the new states demanded and got ex-territorial rights to communications, the Czechs, for instance, on Austrian railroads. Other states got free harbours or free harbour areas: Soviet Russia was guaranteed such rights in Tallinn and Riga, and the Finns negotiated about corresponding rights in Petrograd for the traffic from Lake Ladoga. Some states, for strategic or economic reasons, built new ports in order to compete with existing ones in other hands (Gdynia-Danzig and Susak-Fiume).

Before the war, the harbours in Latvia alone had handled about a quarter of Russian foreign trade. When Latvia and Estonia in 1924 discontinued the transit privileges enjoyed by Russia; the latter strove to re-route its trade to its own ports. The high hopes for post-war trade in ports like Riga never materialized and the gigantic plans in 1917-22 to develop Turku/Åbo in Finland into an outlet for Siberia never left the drawing board (Lehnich, 1923; Meyer, 1925; Hiden, 1987; Jungar, 1977).

A lot of energy and resources were spent on building new communications. The railroads of Poland were not constructed to suit the new state but the strategic and economic interests of the empires. Over fifty Austrian and German lines led to the former Russian frontier but only ten continued beyond it. The north-south railroads of Czechoslovakia were unsuited for the new republic's needs of east-west communications (Polonsky, 1980; Teichova, 1988b; Rasin, 1923).

The harbours, the main trade outlets and the end-points of the Austrian and Hungarian railroad network in Trieste and Fiume were in foreign hands. Poland invested quite a lot to develop Gdynia as an alternative to Danzig which was seen as German and hostile—even if it had a customs union with Poland. For similar commercial and strategic reasons Finland planned the building of a canal between Ladoga and the Gulf of Finland.

4.7 Disrupted regional division of labour

The economic system of the Austro-Hungarian monarchy was not and could not have been built with any special reference to a possible dissolution of the country along more or less definite ethnic lines. On the contrary, in the process of its development it had cut across these lines, and when the territory of the monarchy became reorganized on the basis of ethnic boundaries, the new frontiers cut the existing economic system into fragments (Pasvolsky, 1928).

The dual monarchy functioned reasonably well as an economic unit and showed respectable economic growth before the First World War. Inside one of Europe's greatest free trade areas it comprised diverse regions; Mediterranean coast, Hungarian plains and alps. Even without overseas colonies both Austria-Hungary and Russia consisted of complementary regions, of all the major powers they were the least dependent on foreign trade. Austria-Hungary had a functioning regional division of labour between agrarian Hungary, industrialized Bohemia and

Vienna as a financial, administrative and cultural centre; around 80 percent of what was produced was marketed inside the empire. Some contemporaries saw the breaking up of the Austro-Hungarian customs union as the root of the economic and political evils in central Europe (Radice, 1985).

The same can be said for Russia, its economic development before 1914 was not up to the standards of Britain and Germany but was quite impressive on its own terms. Growth was based on regional specialization. Industrialization in Russia's western borderlands, more developed than the political core, was faster and more effective than in interior Russia, but it was a growth directed towards and dependent on the Russian market. Demand in Russia made possible an expansion far above what the modest home market was able to offer industries that were not, or at least not in the beginning, competitive on western markets. About 80 per cent of the products of the Finnish paper industry went to Russia and Finnish firms had a near monopoly of newsprint. The Estonian metal industry was geared to the need of Russian railroads and naval programme and the textile industry to the Russian market. The Polish textile industry exported almost all its production to Russia.

The dissolution of the empires distributed the industrial capacity of the empire very unevenly, Czechoslovakia got about 70 per cent of the industry of Cisleithania. The dissolution also separated industries from their markets, sometimes even different stages of the production processes from each other. In the Austrian cotton industry spinning and finishing were concentrated in Austria, weaving in Bohemia. In some cases centres of production became totally isolated from former connections. Budapest was, after Minneapolis, the world's largest centre for the milling industry, but lost its hinterland. The Kreenholm plant in Narva was the biggest spinning mill in Europe and served plants in the whole of Russia but, after 1918, was cut off from raw materials, weaving factories and markets (Berend and Ránki, 1974; Pasvolsky, 1928; Romas, 1934).

The national economies of the new states were extremely dependent on foreign trade and the import of capital. In some cases the new frontiers caused severe disruptions of economic life. The higher the dependency on the former imperial power, its market and special requirements like armaments, the more difficult the transition. The same is, of course, true today in post-Soviet conditions.

Bohemia and Hungary had been complementary regions but after 1918 Czechoslovakia and Hungary pursued different policies; both tried to build up that sector of the economy that earlier had been dependent on imports from other regions of the Monarchy. The Czech industry was hard hit by the build-up of consumer goods industries in the other successor states; the Czech government at the same time tried to expand its agriculture in order to reduce imports of food. On the other hand, the food industry of Hungary (milling, brewing, distilling, sugar refining) had placed 80 per cent of its production in Austria and Bohemia; it lost a market of sixty million and was reduced to serving a home market of eight million. The emphasis on industry did increase self-sufficiency in Hungary, but it was based on imported technology, low efficiency and protection by high tariffs. It also had an adverse effect on the export of agricultural products. Economic development in Hungary before the World War I had been faster than the European average, during the interwar years it was slower (Berend and Ránki, 1985; Pasvolsky, 1928).

4.8 Integration and separation

It would not be possible to speak of a Yugoslav society existing during the interwar period. There were, in fact, the half-assimilated remains of several societies in various stages of development. Some idea of the complexities of the situation can be gauged by the fact that at its inception, the kingdom had six customs areas, five currencies, four railway networks, three banking systems and two governments (Singleton and Carter, 1982).

Poland and Yugoslavia had the biggest integration problems. Poland has been described as 'a conglomerate of economic areas' (Landau and Tomaszewski, 1985); creating a national Polish economy meant integrating the peripheries of three empires. Before 1914 only about 7-8 per cent of the trade of the Polish areas had been with each other and about as much with the world outside the empires. Thus, about 85 per cent of the trade of the areas of the future Polish Republic was oriented towards the empires. Over 90 per cent of the industrial production of Russian Poland found its markets in Russia, while around 80 per cent of the exported agricultural produce of German Poland went to the German market (Landau and Tomaszewski, 1985; Berend and Ránki, 1974; Radice, 1985).

The former Habsburg areas in Yugoslavia found themselves in a position reminiscent of Hungary; they had lost a market of 60 million and their industry, communications and financial institutions had been erected with that market in view. Now they were restricted to a Balkan market of twelve million. For Serbia it was the reverse: a small landlocked country with three million inhabitants had become the centre of a state four times as large.

In the Estonian metal industry the capital, most of the know-how and the raw materials came from outside; the loss of the large Russian market meant collapse. In spite of relatively cheap labour the industry did not have the strength to break into new western markets and production revived again later only in small and medium-sized shops producing for the home market. The Estonian textile industry, was likewise reduced to serving the small home market. The Latvian industry in Riga was hard hit by first the evacuations during the war and later by the loss of the Russian market (Herranen and Myllyntaus, 1984; Lehnich, 1923; von Rauch, 1974). The separation of the Baltic and Soviet economic structures was also underlined through the 'nostrification' of former Russian companies that faced the alternative of registering and reorganizing according to local laws or of being liquidated (Lehnich, 1923; Meyer, 1925).

The loss of the Russian market did not have the same effects on the Finnish economy, which had not been damaged by war or evacuations and thus could offer commodities in short supply (paper, timber) on the world market. Industries that had expanded during the war boom, especially the metal industry, were reduced to serving the home market, but the paper and pulp industries were able to reorient their export to the West during the period of strong demand after the war. Trade with Russia stayed, however, at a level of a few percent (Ahvenainen, 1986; Pihkala, 1980).

Regionally the dissolution of the empires in many cases had severe economic effects. Cities were separated from their hinterlands. Without Bohemian coal and Hungarian provisions, the Viennese were freezing and starving. One third of the population of the new republic lived in *Wasserkopf-Wien* with its concentration of industrial problems and unemployed (Pasvolsky,

1928). Petrograd went through a depopulation of about one million inhabitants. On the other side of the Finnish-Russian border, the Karelian Isthmus was also badly affected by the closing of the border which led to a considerable loss of income. The population on the Isthmus lost many opportunities for earning money in and around St. Petersburg, fishermen lost their traditional fishing grounds, and the stream of summer holiday-makers ceased; the huge amount of deserted *dachas* forced the Finnish state to enact laws that gave the state the right to take over property without known owners.

The dissolution of the empires created difficult problems of adjustment that the new states tried to solve by increasing their economic independence through autarchy and the regulation of the economy. In the view of the new states, political independence was not possible in combination with economic dependence (Pasvolsky, 1928). The small Romanov successor states or the states of central Europe did not, however, have the size and the resources needed to isolate themselves, but had to, at the same time, compensate for the loss of the former huge interior markets and diversify their suddenly vulnerable one-sided economies. Paradoxically that made them dependent instead on western capital and the fluctuations of the world market.

4.9 The lack of capital

In all successor states the role of the state in the economy expanded considerably. The state had to help in resolving the problems created by new territories, territorial integration, to reduce the vast regional differences, to unify the monetary system, to integrate the communications network, to bind its new territories with financial and economic ties to the new capital. All the new states needed capital and the state played a considerable role in attracting loans from the west (Teichova, 1988a).

The expanding role of the state was a legacy of the war economy and the regulation of the economy during the period immediately after the war. The chaotic currency conditions forced governments to maintain export and import controls until the middle of the 1920s. State intervention went beyond the solving of temporary difficulties, its purpose was to compel the nation to create a basis for autarchy. The tendency towards state direction of the economy was strengthened under the authoritarian regimes as well as through the effects of the depression.

Loans from abroad were a necessary source of capital for reconstruction and economic reorganization during the 1920s. Among the Habsburg successor states Czechoslovakia was the only one that exported capital during the 1920s. After the war Germany and Austria were eliminated as creditors and the financial markets were dominated by the United States and Britain (east central Europe) and France (Poland and the countries of the Little Entente); the conditions were, however, less advantageous for the debtors than before the war. More dangerous in the long run was that relatively little of the foreign loans was invested in production, communications or infrastructure, but instead in social investment or consumption. The rising burden of indebtedness was not matched by a corresponding improvement of the structural conditions of the economy. The share of foreign capital in government securities and shares in east central Europe was 50-70 per cent, but the successor states did not succeed in creating independent economies, even if the state played the role of entrepreneur, investor and consumer (Berend and Ránki, 1974; Teichova, 1985a, 1985b, 1988a; Radice, 1985).

4.10 Inflation and stabilization

During the years after the First World War almost all countries in central and East Europe went through a period of inflation that thoroughly shook their societies. The German inflation is the best known, but several other countries experienced hyperinflation. One of the consequences of inflation was that the middle-class was hard hit and experienced a loss of wealth and status that drove it in the direction of anti-capitalism, anti-socialism, anti-modernism and anti-Semitism.

In many countries stabilization programmes were undertaken, beginning in 1922 with the Austrian stabilization under the auspices of the League of Nations. The League gave stabilization legitimacy; the measures were not seen as infringements of the sovereignty of the country in the same way as if control had been in the hands of foreign central banks or private consortia. The League of Nations' programmes involved stabilization elaborated by outside experts and thus won the confidence of financiers. The debtor usually had to grant the government extraordinary powers for reconstruction, create an independent central bank, reach a balanced budget in two years, and reorganize and cut the civil service. The finances were under the control of a high commissioner appointed by the League—the Austrians made the joke that the League had made them a colony. Reconstruction schemes sponsored by the League of Nations were undertaken in Hungary in 1924, in Bulgaria in 1926 and 1928, in Danzig in 1925 and 1927), in Estonia in 1927, and in Greece in 1928 (Péteri, 1992; Berend and Ránki, 1974; Barber and Spencer, 1992; Teichova, 1988a).

Behind the stabilization programmes were the influential central banks of the United States, Britain and France. Their goal was a system of independent central banks upholding stability and economic rationality against politicians. Their goal was normality; that is the pre-war situation of stable currencies, balanced budgets and cooperation between strong, independent central banks. In general they had their way until the depression when the international cooperation between the central banks went the same way as the gold standard (Péteri, 1992; Mouré, 1992).

The results varied as between the successor states. Czechoslovakia was able to stabilize its currency in March 1919 and to avoid the hyperinflation that hit most countries. The creation of a new currency with a new name at a later stage had more of a psychological effect. Hand-in-hand with the austerity measures in many cases there went a stabilization crisis with rising unemployment (Dornbusch, 1992; Sargent, 1984; Winkler, 1986). Stabilization was slow and most parts of the former empires remained a semi-periphery in the international economy.

There are remarkable differences in the degree and kind of international participation in reconstruction after the two world wars and today. After World War I, the international community, or rather the victors expected a return to normal to occur more or less automatically, even if they feared 'contagion' from Soviet Russia. The League of Nations had to step in, however, when the crisis was prolonged and some countries were threatened by bankruptcy; only then were reconstruction programmes based on internationally guaranteed loans formulated. The Marshall Plan, with a large proportion of grants, was in part a response to these experiences and memories from the Depression. Today the degree of international involvement in the new states is higher than ever before—there even seems to be some overcrowding as a result of all the international organizations active in central and eastern

Europe. There is, however, no coordinated substantial plan for reconstruction; it seems as though faith in the invisible hand is almost as strong as in the early 1920s.

4.11 Trade and the reorientation of the 1930s

Several efforts were made, in the early 1920s and later, in Portorose 1921 and Genova 1922, to introduce economic unions or to lower customs between the successor states in central Europe. They met with little success, as was the case with corresponding efforts concerning the Romanov successor states (Ránki, 1983; Berend and Ránki, 1974; Pasvolsky, 1928; Drabek, 1985). The governor of the Bank of England saw the stabilization programmes for Austria and Hungary as a first step towards reconstruction and a revitalization of the whole European economy through 'an economic federation to include half a dozen countries on or near the Danube free of customs barriers' (Péteri, 1992).

The trend went, however, in quite another direction. Almost all countries introduced new customs tariffs in the 1920s and widened the sphere of products on which duties were levied. The end result was an increasing isolation, although a series of trade treaties in the mid 1920s normalized trade relations in other respects. This in many sectors benefited countries outside central Europe. The high tariffs constituted a kind of import substitution without significant real development of industry (Berend and Ránki, 1974; Pasvolsky, 1928; Drabek, 1985).

Trade policy thus broke old economic bonds; according to one estimate trade between the countries formerly belonging to the Habsburg Monarchy declined to 15.5 per cent of its value between 1911-13 and 1935. The striving towards autarchy was successful in that, for instance, Hungarian trade with Czechoslovakia and Austria sank from three-quarters to a quarter of total trade. Immediately after the war 52 per cent of Czech exports went to the Danubian countries, but in 1929 only 31 per cent. At that time Czechoslovakia imported over half of its grain from overseas; in 1930 a tariff war broke out between Czechoslovakia and Hungary, which drastically reduced trade (Berend and Ránki, 1974; Drabek, 1985).

Developments during the 1920s thus broke the pre-war pattern where the western parts of the Dual Monarchy and Germany were the main source of capital and the main recipients of grain from east central Europe, mainly Hungary. After the war the main creditors were the western powers but they had little use for East European grain and other food products. Britain and France, both debtors to the USA, turned increasingly to their colonial empires. The stabilization of the 1920s was based on loans but, in the long run, markets were needed. The depression lowered the prices of agrarian products, restricted the possibilities to raise new loans and limited exports. The countries of East central Europe had to export or perish and had to accept the conditions offered on the only possible market—Germany. Through clearing arrangements and in other ways they were in a few years part of the evolving German *Grossraumwirtschaft* (Ránki, 1983; Berend and Ránki, 1985; Teichova, 1988a).

4.12 Conclusion

The perspective of this chapter on the dissolution of the empires focuses on disruptions and things that went wrong. Revolutions and other major disruptions are the nearest the historian can get to the experiments of natural science. The historian cannot manipulate the conditions, and changes certainly do not occur in antiseptic surroundings, but can observe what happens when conditions suddenly and totally change.

One lesson from the great experiment of the dissolution of the empires in 1917-8 is that the imperial economies functioned reasonably well—at least compared to the chaos after their dissolution—and that something definitely was lost in this. The other side of the coin is that the new states were able to mobilize new resources and to make their economies work in rather difficult circumstances. There were, however, many weaknesses in the development during the first decade of independence as the Depression showed. In countries like Hungary, Austria and Poland growth was slower than the European average. Relatively, east central Europe fell behind as foreign loans were not enough to develop the economy as a whole. On the other hand the European balance between an industrialized west and agrarian east had been shattered, partly owing to transatlantic imports.

One question arises when one looks at the performance of the economies in the interwar period and that is; is there a normal period, and according to what measure? In most countries post-war instability continued into the middle of the 1920s, then the Depression and later the preparations for war disrupted the economies in the late 1930s. Only a few years at the end of the 1920s and in the middle of the 1930s can be seen as normal and reasonably stable periods.

Another lesson is that great changes produce losers, which can be dangerous. Obvious examples in the years after 1918 are the middle-class (through inflation) and the new minorities. The changes created political losers (for instance, Croats, Slovaks) deeply disappointed with the state where they lived and economic and social losers (for instance, members of formerly dominant groups losing their positions and land). It is worth remembering, however, that most losers accepted the situation during the relatively stable conditions of the 1920s. The Depression escalated latent conflicts.

The order established after the First World War only lasted two decades but it would be both wrong and unfair to judge it only on that score. On the other hand, today it might be wise to study the lessons of the interwar period. The Versailles Order fell due to its inability to solve, or to cope with, economic problems and minority questions. They are going to be just as crucial in the years to come.

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CHAPTER 5

EUROPE AND THE TRANSITION ECONOMIES

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Europe in the title, and most of the following text, refers to western Europe as it was before the Berlin Wall collapsed or, after 1990, as this plus the former GDR. But the term is also used to denote Europe as it is geographically defined. Transition economy, by contrast, is used in only one sense, its narrow sense,[1] to mean an economy going from central planning and state ownership of the means of production to the market and private ownership. The focus of the chapter is on transition economies in Europe and central Asia, but China and Vietnam are also touched upon. The term east, or eastern, refers to what, before 199l, was known as eastern Europe and the USSR, and which is now described as eastern Europe and the CIS. The Baltic states are included under the first term or listed separately.

In 1989, when transition can be said to have begun,[2] eastern Europe and the USSR accounted for over 3 per cent, China and Vietnam for less than l per cent, of total western European trade. But western Europe accounted for some 25 per cent[3] of the total trade of eastern Europe and the USSR, for 15 per cent of China's trade, and for some 5 per cent of Vietnam's. Both sides resorted to direct controls which limited exchange. In western Europe, quantitative restrictions reduced imports from the centrally planned economies and exports to them. In the centrally planned economies, the organization of the monopoly of foreign trade constituted a barrier to exchange and import substitution a policy of extreme protection.[4] These features were less in evidence in Hungary, whose introduction of market elements as from 1968 was accompanied by the decentralization and some liberalization of its western trade, and in China which began to open its economy to world trade in 1979.

Commercial relations between eastern and western Europe took place within the framework of sectoral as well as bilateral and multilateral trade agreements. The European Community resorted to the first, the competence for agricultural and then trade policy having been transferred to it from its member countries. Between 1964 and June 1988, it enforced over 40 export restraint arrangements with eastern European partners relating to agricultural products, steel and textiles. It also concluded a general trade agreement with Romania in October, 1980, and then, after the EEC-CMEA Declaration of June 25, 1988, which brought it the diplomatic

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[1] There is a broad definition of transition economy which is an economy undergoing change in an approved of direction, away from central planning, away from socialism, away from war and civil war. This is the definition which has been used by the World Bank which has designated as transition economies such disparate systems as Eritrea, Uganda, Estonia, Nicaragua and Cambodia.

[2] It actually started earlier in three countries, namely Hungary in 1968, China in 1979 and Poland in 1982.

[3] Given CMEA prices and exchange rates.

[4] Goods were imported only if they could not be produced domestically, or if they were in short supply. There was no competition between domestic and foreign production under central planning.

recognition of the Council and its member countries, a series of trade and cooperation agreements with all the CMEA's European members. The first was with Hungary in September 1988, the last with Romania in October 1990.[5]

Western European countries outside the community had bilateral trade agreements with the countries in the future transition area. In addition, all the western European countries, together with Czechoslovakia, Poland, Romania and Hungary, were contracting parties to the GATT which provided the multilateral frame of reference for their bilateral commitments. But, with the exception of Finland which, between 1974 and 1978, concluded free trade agreements with Bulgaria, first, Hungary, Czechoslovakia, the GDR, and then Poland, no western European country attempted regional integration with partners in the east.

The eastern European revolutions of 1989 changed all that. Barriers to trade fell and the CMEA collapsed. In western Europe, quotas were lifted or broadened and exports from the European transition economies benefited from the general system of preferences (GSP). In eastern Europe and, later , the USSR, the monopoly of foreign trade, which certain countries had abandoned in principle as from 1988,[6] was dismantled, private enterprises in their thousands began to trade, and imports from western Europe came in over the low tariffs which had remained, or been introduced, under central planning.[7] More essentially, regional integration in western Europe was extended to include the transition economies. EFTA, in June 1990, signed joint declarations of cooperation with Hungary, Czechoslovakia and Poland providing for the negotiation of free trade agreements between the signatories. The European Community, in August, proposed the conclusion of association agreements based on Article 238 of the Treaty of Rome. These promised free merchandise trade, freer trade in services and the liberalization of capital movements between the community and its partners in the east. These Europe Agreements, as they were alternatively called, became the chief instrument of transcontinental integration. The political, but also economic, division of Europe decided on at Yalta was over.

In what follows, trade and investment, following the reduction in barriers between western Europe and the east, are considered first. The emerging pattern of transcontinental integration is analysed in Section II. Western European aid to support the transition in the east is examined in Section III. The conclusion discusses three issues. They are the future importance of western Europe in eastern trade, the course that the integration and accession of the economies associated to the EU will take, and the economic organization of the Eurasian continent. Western European exchanges with China and Vietnam are briefly mentioned in Section I.

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5 In the case of China, the community signed a trade and cooperation agreement as early as 1985.

6 This was true of Hungary and Poland following the adoption of laws on economic association or activity in 1988, but also, with restrictions, of the USSR following the Decree of December 2, the same year.

7 In 1989, the simple average tariff on industrial products was 5.9 per cent in Czechoslovakia, 11.7 per cent in Hungary and 18.4 per cent in Poland, as from which extensive tariff exemptions were granted under Poland's 1990 stabilization programme.

5.1 Trade and investment

The fall in the barriers between western Europe and the east after 1989, the dissolution of the CMEA with its preferential conditions of settlement,[8] and the collapse of the eastern economies, all led observers to expect not only an expansion of east-west European trade, but a major re-orientation of eastern exchanges towards western Europe. The entry into force of the Interim Agreements[9] between the community and Hungary, Poland and Czechoslovakia on March 1, 1992 reinforced this expectation. But available figures do not bear it out until 1994.

Table 5.1 shows trade between western Europe and the east from 1989 to 1997. There are two discontinuities in the statistics. The first is due to the unification of Germany in 1990 which shifted the GDR from east to west, and to the major foreign-trade price and exchange rate changes which preceded the dissolution of the CMEA in 1991. As is indicated in note 1 to the table, a series of comparable data from 1990 is therefore included following the recalculation of the statistics for that year at 1991 exchange rates and to reflect the changed geographic coverage. The second break occurs in l995 for the reasons indicated in note 2 to the table. A third series of comparable data is therefore included as from then.

TABLE 5.1
WESTERN EUROPEAN TRADE WITH THE EASTERN ECONOMIES, 1989-97
(billion dollars)

	1989	1990	(1)	1991	1992	1993	1994	1995	(2)	1996	1997
Exports	43.33	45.54		50.91	55.83	61.35	73.63	89.03		113.58	127.29
		57.59						97.30			
Imports	52.40	59.80		52.34	57.11	59.27	71.31	89.32		99.75	106.70
		55.89						93.49			

Source: *International Trade 91-92,* Table A2 for the 1989-90 figures; WTO (1996, 1997, 1998) *Annual Report*, vol. 2, appendix Table 2, and secretariat estimates for the 1990-97 figures.

Notes: (1) A break in the continuity of the series appears between 1990 and 1991 following the unification of Germany and the change in prices and exchange rates applied to CMEA trade as from the beginning of 1991. To provide approximate comparability between 1990 and 1991, a second set of 1990 figures is included in italics based on 1991 definitions and methods. (2) 1995 marks a second break in continuity: between 1994 and 1995, Lithuania changed from special to general trade, Latvia from f.o.b. to c.i.f., and Ukraine altered data collection, its exchange rate regime, and included processing trade; in 1995, the Czech and Slovak Republics included processing and long-term leasing. Note that in 1996 Hungary included shipments of industrial free zones.

On this basis, the value of western European exports to the eastern economies, that is the level of eastern imports from western Europe, increased by only 6.5 per cent from 1990 to 1993, but by 45 per cent from 1993 to 1995 and by a further 31 per cent between l995 and l997. The value of western European imports (that is eastern exports) increased by 6 per cent over the first four years, but rose by 51 per cent between l993 and l995, and then some 14 per cent to l997.

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[8] Prompt payment on delivery from bilateral clearing accounts was the CMEA rule. See, Economic Commission for Europe (1992: 56).

[9] These brought the commercial clauses of the corresponding Europe Agreements into force in advance of their ratification.

Trade turnover between the two regions thus increased by 6 per cent to 1993, but by some 48 per cent from 1993 to 1995, and again by 23 per cent between 1995 and 1997.

The evolution described is consistent with the extreme disorganization and steep fall in GDP which the eastern economies underwent from 1990 to 1993 and with the sharp recession in western Europe that year. But the evidence in Table 5.1 runs counter to the widely-held belief that western European exports immediately poured into eastern markets and that western Europe was flooded with eastern semi-fabricates. The puzzle resolves when the east is broken down into eastern Europe, on the one hand, and the former USSR on the other. Western Europe's trade turnover with the first rose by almost 40 per cent from 1990 to 1993. It was carried by the EU, which accounted for three-quarters to nine-tenths of western European trade with eastern Europe, and whose turnover with it, over the period, rose by 46 per cent if the first twelve members of the union are considered, and by 71 per cent if, as from 1993, fifteen members are taken into account. By contrast, western Europe's turnover with the former USSR reflected the steep fall in western European sales and fell by 19 per cent between 1990 and 1993. The impression of a trade surge with the eastern economies between 1990 and 1993 is thus attributable only to western Europe's, and particularly the EU's, trade with eastern Europe.

To explore the question of the reorientation of eastern trade to western Europe, eastern trade towards it has to be compared to the evolution of total eastern imports and exports shown in Table 5.2. As in Table 5.1, and for the same reasons, there are two breaks in the statistics. As in Table 5.1, two new series are shown which reflect, first, the recalculation of the figures in 1990 at 1991 exchange rates and given the change in geographic coverage, and, second, the changes entered in 1995.

TABLE 5.2
TOTAL TRADE OF THE EASTERN ECONOMIES, 1989-97(1)
(billion dollars)

	1989	1990	(2) 1991	1992	1993	1994	1995	(3) 1996	1997
Exports	195.60	181.60							
		105.19	92.80	99.98	105.96	121.51	154.40		
							159.58	172.79	178.81
Imports	174.58	159.04							
		113.34	97.09	94.28	104.08	115.94	149.24		
							151.25	173.46	190.65

Source: See Table 5.1.

Notes: (1) excludes trade between the Republics of the former USSR. (2) See note 1 in Table 5.1. (3) see note 2 in Table 5.1.

The figures show that total eastern exports, after a sharp fall in 1991, returned to their 1990 level in 1993, rose by 46 per cent between 1993 and 1995, and by a further 12 per cent to 1997. Total eastern imports fell by 8 per cent between 1990 and 1993, rose by 43 per cent between 1993 and 1995, and by a further 26 per cent to 1997. Total eastern trade turnover thus fell by 4 per cent between 1990 and 1993, rose 44 per cent between 1993 and 1995 and then again by 19 per cent to 1997.

The ratios of trade towards western Europe, as well as other areas, to the value of total eastern imports and exports are presented in Table 5.3. They refer to the period l990-5 for which comparable data are available. It is tempting to use these to measure the reorientation of trade. But they reflect both the variations of eastern exchanges with the various areas and of the level of total eastern trade and, for this reason, cannot be used for this purpose. To measure the reorientation of trade as from a given year, the level of total imports and exports that year has to be used as a constant, and the levels of trade with the different areas in subsequent years related to that yardstick. If this is done for eastern trade with western Europe as from 1990, the shares of exports to, and imports from, western Europe are shown to be 54 and 53 per cent in l993, and not 57 and 59 per cent as indicated in Table 5.3, to be 67 and 63 per cent in l994, instead of 59 and 63 per cent, and to be 85 and 78 per cent in 1995, and not 60 and 63 per cent as in Table 5.3.

TABLE 5.3
BREAKDOWN OF THE VALUE OF TOTAL EASTERN TRADE BY DIRECTION(1)
IN 1990, 1993, 1994, 1995
(percentage shares)

Direction	1990		1993		1994		1995	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
North America	2	5	4	7	5	5	5	5
Latin America	3	4	1	2	2	2	2	2
Western Europe	53	51	57	59	59	63	60	63
Eastern Economies	24	22	18	17	15	16	15	17
Africa	3	2	2	1	2	1	2	2
Middle East	3	3	2	2	2	2	3	1
Asia	12	13	15	12	14	11	13	10
World(2)	100	100	100	100	100	100	100	100

Source: WTO estimates.

Note: (1) Excludes trade between the Republics of the Former USSR, **and** trade between the Czech Republic and Slovakia. (2) Shares do not necessarily add up to 100 owing to trade to unspecified destinations and rounding.

In other words, the reorientation of eastern trade towards western Europe was barely perceptible in 1993 as compared to 1990, whereas in 1994, it was substantial. Moreover it turned western Europe, which was already the east's major partner in 1990, into an area accounting for close to two-thirds of the eastern economies total trade. By contrast, the share of the eastern economies in western Europe's total trade was 4 per cent.

As compared to its trade with the eastern area, western Europe's trade with China and Vietnam developed very rapidly. Western Europe's exports to China more than doubled from 1990 to 1993, while its imports from China rose by some 70 per cent. Western Europe's exports to Vietnam rose two and half times, and its imports from it sextupled over the same period. Between l994 and 1997, western Europe's exports to China rose by some 10 per cent and to Vietnam more than doubled, while its imports from China increased by 50 per cent and from Vietnam they more than quintupled. Nevertheless, the share of western Europe in either

country's total trade did not exceed 15 per cent in 1997. As for the share of China and Vietnam in total western European trade that year, it barely exceeded 1 per cent.

5.1.1 Investment

Although by 1989, all the eastern economies had joint venture legislation,[10] foreign direct investment began to flow into the east in appreciable amounts only once transition began. From 1990 to 1992, the rate of inflow was very rapid and greater than into the developing economies.[11] But in 1993, it fell back below this, and in 1994, it was negative. From then on, however, it rose fast, particularly in l995. In absolute terms, the net recorded inflow into the east rose from US$ 0.06 billion on a cash basis in 1990 to US$5.8 billion in 1993, decreased to US$5.6 billion in 1994 and then rose to US$21 billion in l997 (Economic Commission for Europe, 1998).

In 1990, eastern Europe recorded the only net inflow of foreign direct investment into the east. By 1992, the Baltic states and the CIS, especially Russia, had begun to attract investment. But 77 per cent of the inflow was still accounted for by eastern Europe, the Baltic states attracting 2.5 per cent and the CIS, 20 per cent. By 1997, the corresponding shares had changed to 44, 5 and 51 per cent, as, for the first time, total net foreign direct investment into the CIS, at US$10.8 billion, exceeded the inflow of US$9.1 billion into eastern Europe.

Gross cumulative inflows, which amounted to over US$65 billion for the period 1988 to 1997, show eastern Europe to be the chief destination of foreign direct investment (60 per cent), followed by the CIS (35 per cent) and the Baltic states (5 per cent). Taking the host countries individually, Hungary attracted US$15.5billion over this period, and hence the most, followed by Russia (US$ 14.8 billion) and Poland and the Czech Republic (some US$ 8.5 billion). From 1985 to 1997, FDI disbursements in China amounted to US$217 billion, of which US$45 billion occurred in 1997 alone (WTO, 1996: 47; UNCTAD, 1997: 78).

The investor countries are those of western Europe, the United States, to a much lesser degree Japan and, marginally, the eastern economies themselves (Meyer, 1994: 17-22). The share of western Europe in total investment cannot be measured with any precision for lack of information.[12] But available data show that western Europe is the leading investor in the east.[13] In China, by contrast, it has taken fourth place behind Hong-Kong, Japan and the United States.

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[10] The first joint-venture legislation was adopted in Romania in 1971, followed closely by Hungary in 1972. The last country to adopt such legislation was the USSR in 1987.

[11] In absolute terms, of course, inflows into the developing economies far exceeded those into the eastern transition economies. In 1992, net foreign direct investment into the first amounted to some US$47 billion, into the second to some US$4 billion. See, Economic Commission for Europe (1995), table 3.7.1 and Economic Commission for Europe (1998), appendix table B.16.

[12] The cash-flow data drawn from balance-of-payments statistics do not allow the country origin of investment to be established.

[13] Sheehy (1994), tables 8 and 9, assembles OECD and UN/ECE data to show that the EC + EFTA accounted for between 38 and 84 per cent of the number of FDI projects in the six east European countries between 1991 and 1993, and for between 55 and 80 per cent of the capital inflow associated with FDI into the same countries over the same period.

5.2 Regional integration

Western Europe offered the eastern economies regional integration almost as soon as the Berlin Wall went down. The free trade agreements concluded between the EFTA member states and Czechoslovakia, Poland and Romania in 1992, and Bulgaria and Hungary in 1993, went into force in 1992 in the case of Czechoslovakia, and in 1993 in the case of the other four countries. Following the division of Czechoslovakia, protocols of succession were signed between the EFTA member states and the Czech Republic and the Slovak Republic in April 1993. The accession of three EFTA countries, namely Austria, Finland and Sweden, to the European Union on 1 January 1995 meant that, on the EFTA side, the six free trade agreements were from then on implemented only by Iceland, Liechtenstein, Norway and Switzerland. These four countries then concluded free trade agreements with Slovenia and the Baltic states. The first went into force on 1 July l995, the second, with Latvia, on 1 June l996, the third, with Lithuania, on 1 January l997 and the fourth, with Estonia, on 1 October of the same year.

The first Europe Agreements were signed between the community and Czechoslovakia, Hungary and Poland on 16 December 1991, and went into force on 1 February 1994 in the case of Hungary and Poland. In 1993, Romania, Bulgaria, the Czech Republic and the Slovak Republic signed Europe Agreements, the last two countries having had to re-negotiate their association to the community following the division of Czechoslovakia. These four agreements went into force on 1 February 1995. The entry into force of all six treaties was preceded by that of the Interim Agreements which provided for the implementation of the commercial clauses of the Europe Agreements in advance of their ratification. Europe Agreements, preceded by free trade agreements as from 1 January l995, then went into force between the EU and Estonia, Latvia and Lithuania on 1 February l998. Finally, Slovenia signed an Europe Agreement with the EU on June l996 which, preceded by the corresponding Interim Agreement, went into force on 1 February l999.

The union is also prepared to consider free trade arrangements with a number of CIS members with which it has concluded non-preferential partnership and cooperation agreements. They are Russia, Belarus, Ukraine and Moldova whose agreements contain a clause providing for future negotiations concerning the creation of a free trade area. In sum, what is taking shape is a vast free trade area for industrial products, extending from EFTA and the fifteen-country union, through the ten associated eastern economies, to include, potentially, Moldova, Ukraine, Belarus, Russia and the Pacific rim.

The free trade agreements signed between EFTA and the transition economies provide for free trade in industrial goods between the signatories within a period of ten years. It is to be achieved asymmetrically, the EFTA countries offering their concessions first and their transition partners doing so second. The agreements do mention the parties' readiness to foster agricultural trade and gradually to liberalize investment flows and the service sector, but no more than that. They remain within the framework established by the Stockholm Convention.

The Europe Agreements are much more ambitious. First, in so far as trade and factor movements are concerned, they promise free trade in industrial goods, the liberalization of agricultural trade, liberalized trade in services, the improvement of labour movements and the gradual introduction of free capital flows. In short, the associated transition economies are to achieve, or tend towards, the four freedoms within a period of ten years. As in the case of the

EFTA agreements, industrial free trade is to be achieved asymmetrically with the EU offering concessions initially and the transition economies doing so later. But beyond trade, the Europe Agreements provide, second, for a political dialogue and, third, for extensive industrial, scientific, technological and cultural cooperation. The union, however, does not pledge given sums in favour of its partners but refers them to the PHARE[14] and other programmes. The treaties, as a whole, preceded by the corresponding Interim Agreements, may thus be considered as offering the associated economies improved market access in a first stage, a combination of expanded market access and transition support in a second and, in a third, when their market systems are functioning adequately and they are able to implement these, arrangements integrating their economies into the union's area of four freedoms.

The preamble of the Europe Agreements includes a sentence stating that association will help the eastern partner to achieve its objective of community or union membership. But it was initially stressed that association did not imply accession. This has changed. The European Council declared in Copenhagen in June 1993 that the eastern and central European associated countries could become members of the community provided they fulfilled a number of conditions amongst which were the existence of a functioning market economy, the capacity to survive the tumble of market forces and competitive pressure within the single market, and the ability to take on the obligations of economic and monetary union. The union's undertaking was confirmed at the meetings of the European Council in Corfu and Essen and a pre-accession strategy defined on the basis of the Europe Agreements, the White Paper on the Preparation of the Associated Countries for Integration into the Internal Market (Commission of the European Communities, 1995), a structured relationship with the institutions of the union, and PHARE.

In July l997, the commission submitted its opinions on the accession to the union of the ten associated states and published a reinforced pre-accession strategy which introduced the Accession Partnership. This establishes a negotiated programme of pre-accession measures for each candidate, the achievement of which is the condition for PHARE and other funding disbursed on the basis of annual financial conventions. Each Partnership is monitored within the framework of the corresponding Europe Agreement.

In December l997, the council, following the recommendations of the commission, decided to open accession negotiations with five of the ten associated countries, namely the Czech Republic, Estonia, Hungary, Poland and Slovenia. By the end of March l998, the union had concluded Accession Partnerships with all ten candidate countries. In December l998, accession negotiations actually began with the first five associated countries. In short, seven years after the conclusion of the first Europe Agreements in December 1991, the eastern enlargement of the union was under way. The potential extension eastwards of the union, as it expands to include the Czech Republic, Poland, Estonia, Hungary, Slovenia and then the other five countries with which Europe Agreements have been ratified, is shown in Figure 1.

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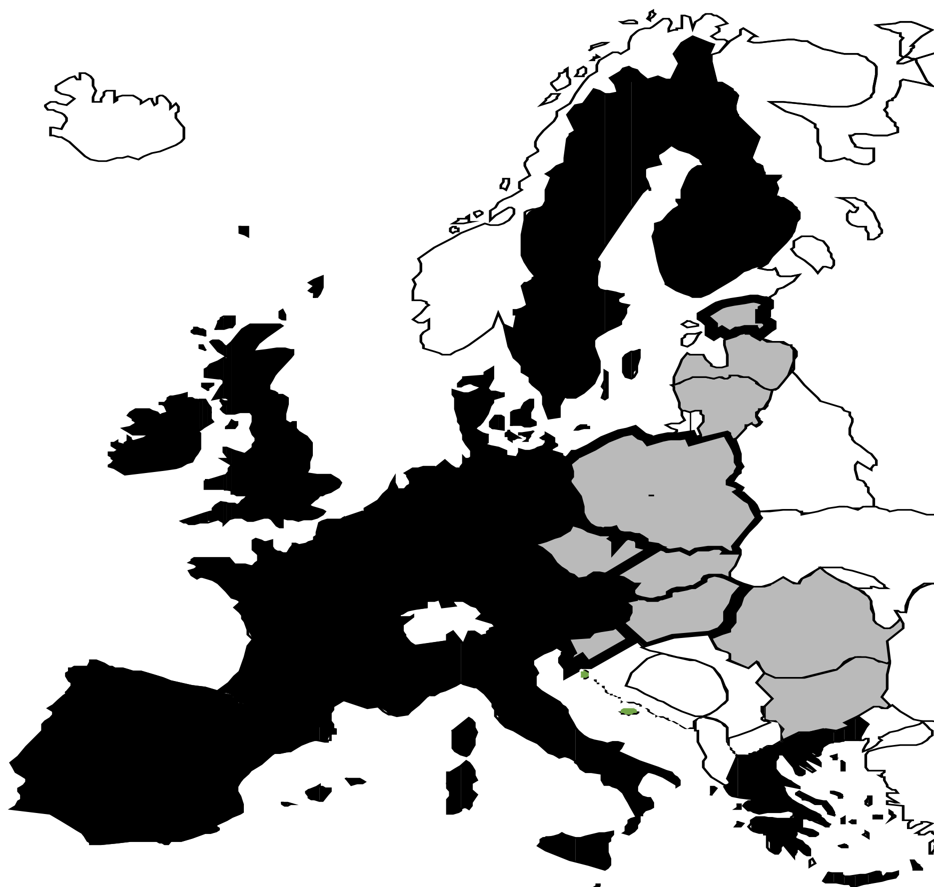
[14] Stands for 'Pologne/Hongrie: Assistance à la Restructuration Economique'; the programme was later extended to include the other European transition economies including the Baltic states, but excluding the CIS for which the TACIS programme was established.

FIGURE 5.1
THE EUROPEAN UNION'S EXPANSION EASTWARD



Key:
Grey: 10 countries whose Europe Agreements have been ratified
Black: outline: 5 countries negotiating accession to EU
Black: fifteen members of the European Union.

Despite these signal achievements, the European Community's, and now union's, policy towards the eastern economies has repeatedly been the butt of criticism. The union has been charged with not opening its market to the sensitive products which compose the greater part of the eastern economies' exports,[15] of segmenting the east into so many bilateral markets by means of the Europe Agreements and of exerting its bargaining power within this framework, of not setting a deadline for accession in relation to which the associated economies can mobilize their energies towards transition, and of not providing a fund to re-build the eastern economies comparable to the Marshall Plan.

15 Between 40 and 70 per cent of the six associated economies' exports to the EU in 1993. See, EBRD (1994).

However, in so far as the limitations, applied by means of price-mechanism devices or direct controls on imports of sensitive products are concerned, they were reduced or abolished at an accelerated rate after the Copenhagen Summit of 1993. 'The European Council', so ran its conclusion, 'recognizing the crucial importance of trade in the transition to a market economy, agreed to accelerate the community's efforts to open up its markets'.[16] Specifically, it speeded the abolition or reduction of union import duties on sensitive basic industrial products, on industrial products subject to GSP, on outward processing operations, on textile products, and on imports of steel. By January 1, l995, the union had thus dismantled almost all duties and quantitative restrictions on industrial imports from the associated countries. On 1 January l996, it removed the remaining duties and quotas on ECSC coal and steel products, and on 1 January l997, it abolished tariffs on the imports of textiles and clothing from the associated countries, excepting the Baltic states. On 1 January l998, it eliminated quantitative restrictions on these items. The union also accelerated the reduction of levies on agricultural imports and increased the quotas applied to them. As of the end of l997, consequently, more than 90 per cent of all imports from the associated countries entered the union without restriction and duty free (WTO, 1998a: 26). Tariffs and restrictions, as well as voluntary export restraint arrangements, continued to limit the union's imports from the CIS, however, and it is also with these countries that anti-dumping measures are most frequently used.[17]

The segmentation of the east introduced by the Europe Agreements is also being overcome by the regional integration of the transition economies themselves and by the preferential territory for origin created between the twenty-eight EU, EFTA and associated countries. The first is being achieved in three ways. On 1 March l993, the Central European Free Trade Area (CEFTA) entered into force. It includes the Czech Republic, Poland, Slovakia, Hungary, Slovenia, Romania and Bulgaria, established free trade in industrial products between the first four countries by 1 January l997, and has begun to dismantle mutual barriers to trade in agricultural products since 1 January l996. On 1 April l994, the Baltic free trade area entered into force, immediately establishing free trade in industrial products between Estonia, Latvia and Lithuania, and started to move towards free trade in agricultural products as of January 1, l997. The three Baltic countries, finally, have concluded, and are implementing, free trade agreements with the members of CEFTA. Free trade agreements are already in force between Lithuania and Poland, the Czech Republic, Slovakia and Slovenia, for instance.

The preferential territory for origin between the EU, EFTA and the associated countries was brought into being on 1 January l997 by the alignment of the rules of origin contained in the Europe Agreements with those applied in the preferential trade between the EU and EFTA, and by the linking of all countries through a system of diagonal cumulation. This means that a manufacturer in any one country can buy inputs in the rest of the territory and export the product throughout the EU/EFTA/central and eastern European area while keeping preferential origin (WTO, 1998: 60-1). In sum, the segmentation introduced by the Europe Agreements is giving way to a vast area of free trade in industrial goods, and of freer trade in agricultural products, extending from the eastern frontier of the EU to the western frontier of the CIS.

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[16] See, *Agence Europe* 24 June 1993: 6.

[17] In early l997, Russia was the second, and Ukraine the fifth, most frequent recipient of union anti-dumping measures; see WTO (1998a: 55).

No deadline has been set for accession to the union, it is true. This is in keeping with earlier practice, however, as no other country joining the community, and then the EU, was given one. The reason for this is that membership of the community and then the union did not, and does not, depend on a declaration at a given point in time, but depends on a series of conditions the fulfilment of which may be delayed by the overthrow of a government or by political or social obstacles. The associated countries' insistence on a deadline seems therefore essentially to reflect their governments' need, in a very unstable environment, for public recognition of their achievements, and the course they have chosen. Or it may even be a relic of the past when targets and dates were published and implementation left to the inspired improvization of the planners. Whatever the explanation, the Accession Partnerships, backed by the concentration of European aid on their implementation, meet the objective of mobilizing the associated economies behind the economic and political transition required for accession. Moreover, as compared to the publication of a date of entry which might have the contrary effect of relaxing the efforts of the associated countries towards transformation, the conditions set, and the framework imagined, by the reinforced pre-accession strategy provide an effective safeguard against chaos , or back-sliding into some form of authoritarian central planning.

Nor has the union pledged a sum to transition but, together with its member states, has already committed over thirteen times and, to the end of 1993, had paid out at least one and a half times as much aid to the east in nominal terms as the Marshall Plan offered western Europe.[18] And, as the Accession Partnerships alone show, assistance continues.

Overall, if one considers the integration strategies of both EFTA and the EU towards the transition economies, the economic re-organization of Europe, as it unfolds, appears to be three-tiered. The base is a vast free trade area in industrial products which, as indicated, could extend as far as the Pacific.[19] Superimposed within this is an area of countries having achieved the four freedoms, or in the process of doing so. It includes the present members of the union, the other members of the EEA, and will include Switzerland[20] as well as the associated economies whose accession process has not yet been completed. The third tier is composed of the members of the European Union. Whatever the relative importance of the three tiers in the future, the new arrangements amount to a transcontinental integration of Europe which would have been unimaginable in 1989.

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[18] Considering Marshall Plan Aid amounted to US$19.4 billion plus some US$300 million in productivity assistance. The lower figure used by the Economic Commission for Europe (1990: 11) makes the union's effort in favour of the east loom even larger.

[19] At the end of 1998, there was free trade in industrial products in an area encompassing the EU, the other EEA countries, Switzerland and Turkey. It was being established as between the EU and the ten associated countries, and as between the EFTA member states and the transition economies with which they had concluded free trade agreements. But there were still tariffs breaking up the area east of the single market in industrial goods constituted by the EU, the other EEA member countries, Switzerland and Turkey.

[20] Switzerland's bilateral agreements with the EU (which were signed in December l998) provide for the free movement of persons twelve years after entry into force and for the liberalization of agricultural trade. Switzerland already practises free trade in industrial products and services, and allows free capital flows.

5.3 Assistance

Official international assistance to the eastern transition economies was decided on in favour of Hungary and Poland in 1989. It was then extended to Albania, Bulgaria, Czechoslovakia, and then the Czech and Slovak Republics, to Estonia, the GDR, Latvia, Lithuania, Romania, Yugoslavia and later, to Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia, the former Yugoslav Republic of Macedonia and Slovenia in 1992. It was also extended to the USSR and then the CIS. The GDR remained a beneficiary only until the unification of Germany. Assistance to Yugoslavia was suspended as from November 1991. There are thus fifteen recipients of assistance in eastern Europe[21] and the Baltic states and, since the dissolution of the USSR, twelve in the CIS.

The countries donating assistance to eastern Europe and the Baltic states are the G-24, that is Australia, Canada, Japan, New Zealand, Turkey and the United States, the members of the EU, and the members of EFTA. To these must be added the EU in its own right together with the EIB and the ECSC, the EFTA Secretariat, and the international financial institutions (IFI), that is the EBRD, the IMF and the World Bank. Assistance is coordinated by the EU, and originally the community to which the task was entrusted by the leaders of the G-7 in 1989. The publication of disbursements, as opposed to commitments, was undertaken by the OECD.

TABLE 5.4
BREAKDOWN OF ASSISTANCE COMMITTED TO EASTERN EUROPE
AND THE BALTIC STATES BY MAJOR DONOR
(percentage shares calculated on cumulative commitments 1.1.90-31.12.96)

		Total assistance	of which grants
EU Members		37.5	29
(within which)	(France)	(7)	(35)
	(Germany)	(18)	(24)
EU		11.2	75
EIB		4.8	0
ECSC		0.2	0
European Union Total		53.7	36
EFTA Total		1.6	42
Other G-24		19.4	47
(within which)	(Japan)	(5.4)	(23)
	(United States)	(11.3)	(58)
IFI		25.1	0
Total		100	29

Source: European Commission (1996). G-24 Assistance Commitments, 1990-96 - Type of Donor.

Commitments to eastern Europe and the Baltic states reached a cumulative total of 98 billion ECU from 1 January 1990 to 31 December 1996. Of this total, as Table 5.4 shows, over 55 per

[21] Note that the definition of eastern Europe has changed slightly as between section I and section III. In the first, it excluded Yugoslavia and its successor states. In the second, it included Slovenia. In the third, it includes Yugoslavia and then, in its stead, as of l992, Bosnia and Hercegovina, Croatia, the Federal Republic of Yugoslavia, the former Yugoslav Republic of Macedonia, and Slovenia.

cent was pledged by western Europe, and 54 per cent by the EU and its member countries alone. Moreover, the single largest donor country was Germany, which accounted for 18 per cent of the total, followed by the United States (11 per cent) and France (7 per cent). Assistance in the form of grants amounted to 29 billion ECU, of which the EU alone accounted for 66 per cent and western Europe for 69 per cent. In this case, the single largest donor country was the United States with 22 per cent of the total, but followed by Germany with 14 per cent and France with 8 per cent.

The form of assistance has evolved over the years. From 1990 to 1992, in response to urgent or exceptional needs, the emphasis was on emergency aid, macroeconomic financing and debt reorganization. By 1992, it was on technical assistance in education in particular, but also in the environmental, agricultural and industrial sectors. Moreover, support to transition, notably in banking and privatization, was intensified. In 1993, there was a shift from technical assistance to investment projects, particularly to build up the infrastructure, and grants as a share of assistance began to decline. The outlook, at the end of 1996, was for a continued emphasis on investment projects, the IFI's pursued provision of macroeconomic financing, and the EU's concentration of its resources on the implementation of its pre-accession strategy.

In the case of the USSR and then the CIS, the donors have been those listed for eastern Europe and the Baltic states to which must be added South Korea and the countries of the Persian Gulf. But the IMF and the World Bank only joined the other donors in 1992, as the USSR was never a member of the Fund, and its successor states only became so in the middle of that year. No overall coordinator of assistance has been appointed for assistance to the USSR/CIS region so that information on assistance there is less comprehensive than in the case of eastern Europe and the Baltic states. The EU has nevertheless been active in compiling and providing data. Moreover, as in the case of eastern Europe and the Baltic states, the OECD was given the task of recording disbursements.

TABLE 5.5
BREAKDOWN OF ASSISTANCE COMMITTED TO THE USSR AND THE CIS BY MAJOR DONOR
(percentage shares calculated on cumulative commitments 30.9.90-1.1.96)

	Total assistance
EU Members	54.9
EU	4.1
European Union Total	59.0
Japan	5.1
United States	13.9
IFI	22.0
Total	100.0

Source: Commission Européenne (1997: 17).

The cumulative commitments of the international community to the USSR and the CIS from September 30, 1990 to January 1, l996 amounted to 123.2 billion ECU and have therefore been larger over a shorter period than to eastern Europe and the Baltic states. Moreover, as Table 5.5 shows, the preponderance of the EU and its member countries with 59 per cent of the total is even greater than in the case of the former. So, although it is not shown, is the share of

Germany, the importance of which is accounted for by export credits and strategic aid granted in relation to unification. The chief forms of assistance have been export credits and public assistance to private investment, the EU member countries accounting for the lion's share of both, and particularly of the second with almost 80 per cent of the total amount committed.

The recording of disbursements has lagged well behind commitments and, in 1995, the last year in which total disbursements were published, did not reach beyond 1993. It is on the low side because it does not include assistance to Yugoslavia and its successor states or, generally, contributions to multilateral organizations, and because the disbursement data of certain donors are incomplete (OECD, 1995). It shows that total net official assistance, including multilateral disbursements, amounted to US$54.6 billion, or 43 billion ECU[22], from 1990 to 1993. The breakdown by donor is published only for total net bilateral official and private flows taken together and shows, on this basis, that western Europe accounted for 84 per cent of total disbursements, the EU for 77 per cent and Germany alone for 62 per cent. Deducting the private flows, and making the extreme assumption that they were all attributable to the EU, which was not the case, western Europe's share of total net official bilateral assistance would have been some 75 per cent, and the EU's over 60 per cent. Deducting private flows and making the same assumption about them as before, and supposing further that no multilateral assistance was European—which again was by no means the case—western Europe's and the EU's share of total net multilateral and bilateral assistance would have been 61 and over 52 per cent. In sum, it can safely be concluded that western Europe was the largest donor of assistance to the eastern transition economies.

5.4 Conclusion

Western Europe, since 1989, has restored relations with the other half of the continent to which, between the second half of the 1940s and until then, it had only restricted access. In the wake of the overturn of the centrally planned economies, the implosion of the CMEA and, very little later, of the USSR, it has become the largest trading partner of eastern Europe, the Baltic states and the CIS, the essential investor in the region, and by far the largest donor of assistance to finance the disequilibria of the formerly planned economies and transform them into market systems. Despite the rapid expansion of its economic relations with the Chinese and Vietnamese transition economies since 1990, these have remained peripheral partners for western Europe.

With the change of system, the division of the European continent decided on at Yalta has disappeared. The economic horizon of western Europe has rolled back to the Pacific and the western European nations, traditionally traders, have celebrated by offering free trade. Free trade for the ten eastern European and Baltic states that have concluded agreements with the member countries of EFTA. Free trade and an area of the four freedoms for the same ten states associated to the EU. Potential free trade for Belarus, Ukraine, Russia and Moldova, parties to the union partnership and cooperation agreements. What is taking shape, at the initiative of

[22] Total net official and private multilateral and bilateral assistance is shown to be US$83 billion and private flows to be US$29 billion; OECD (1995: 9). The difference between the two is US$54 billion, or 43 billion ECU at the rate of 0.80 ECU/US$.

western Europe, is thus a transcontinental area of liberalized exchanges extending from Lisbon to Vladivostok.

This alone is a major integration prospect. But over and above it, the EU, which is the powerhouse of western Europe, has offered accession to the associated countries, that is Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania and Bulgaria . This promises the closest degree of integration for the countries concerned. Thus, on the western edge of the Eurasian continent, a vast economic union is arising which, given its endowments and free trade with the countries of the CIS, will become one of the centres of world activity in the twenty-first century. The bi-polar system vanished with the USSR. The unipolar system which many believed would follow to create one world is already giving way to an emerging system of very great entities, of which the European Union is one.

Many questions have arisen as a result of the change which has swept the European continent. One is whether western Europe will retain its preponderant position in the trade of the transition economies in the east. Taking their cue from calculations drawn from gravity modelling, certain authors (Drabek and Smith, 1995) have concluded that there will be a swing back to intra-eastern trade. But without relying on these calculations which are meaningless as has been argued elsewhere,[23] a number of reasons can be given for expecting a revival of intra-eastern trade. First, progressive stabilization in the east will, quite naturally, lead the transition economies there to envisage re-establishing or developing commercial relations with each other. In particular, the gradual stabilization of Russia and other CIS economies will enable trade to revive with them, but will also prompt them to continue to trade not only with the economies extending aid in western Europe, as they have essentially been doing, but also with their rapidly developing neighbouring economies. Thus, it may be that after their reliance on western Europe, the eastern transition economies will develop their exchanges more rapidly amongst themselves or with their other neighbours. This notwithstanding, the share of western Europe in total eastern trade is likely to remain the highest for some time to come.

A second question to be raised as the EU begins to apply its reinforced pre-accession strategy, is the course that the integration and accession of the associated economies will take.[24] Integration areas between the transition economies are emerging which seem destined to disappear as the member countries accede to the EU. But, as accession may only begin for the

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[23] Matejka (1994). Gravity modelling has been used, in the case of the transition economies, to estimate the level and direction of trade that they should achieve as market economies. The procedure has been to calculate coefficients for a group of 'comparable' developed market economies, and to insert their values into equations containing the GDPs' of the eastern economies before, or at the outset, of transition. But these GDP's are fabrications based on net material product (NMP), the socialist measure of aggregate production, which excludes most services. They have been turned into 'GDP' estimates by correcting for the inclusion of services and, sometimes, for the distorted prices at which production was valued. The estimates in national currency have then been converted into dollars at calculated exchange rates, as no market exchange rates existed. Multiplying these dollar 'GDP' values by the coefficients for developed market economies consequently does not produce estimates of the level and direction of trade which the transition economies should achieve once they are market economies. For, if they were, the structure of their production and the relative prices at which it was valued would be completely different, so would the level of their GDP's and so would their exchange rates. Nor *a fortiori* do these calculations provide estimates of the level and direction of trade of the transition economies once they have become market economies and their production has returned to 1989 levels as is advanced by Baldwin (1994: 88-96).

[24] Inotai (1995) for a Hungarian analysis of eastern enlargement and the issues it raises.

first signatories of the Europe Agreements at the end of the ten-year transition periods provided for in their agreements, that is as from 2004, it has also been proposed that a more elaborate preparatory strategy be offered the transition economies (Brabant, 1996), or that new organizations bringing together both the union and the associated countries be established to manage the interim (Baldwin, 1994). This would be a novelty since such intermediate structures were never set up for other associated economies. At the same time, to the extent that the introduction of a further preparatory course or the creation of new institutions suggest that accession is being put off or may never occur, it is the wrong signal to emit to such fragile states and unstable market economies as those of eastern Europe. The EU's reinforced pre-accession strategy, which signposts the path to union and offers technical assistance and PHARE funding to that end, renders the proposals obsolete and is the more direct route to membership.

A final question which the emerging transcontinental integration poses is the ultimate economic organization of the Eurasian continent from west to east. As has been argued, the outer envelope is a free trade area, within which lies an area of the four freedoms, within which again is the European Union. But how far east will the EU extend? The simple answer is that it will do so to the frontier between the ten countries that have concluded Europe Agreements, and are candidates for accession to the union, and the countries that have concluded partnership and cooperation agreements and are excluded from union membership. In other words, the eastern frontier of the EU will be its border with the CIS. One consequence of this expansion eastwards will be that the union's border with Russia will grow longer and run down Finland, then Estonia, Latvia and, with an interruption, Lithuania, on one side of Kaliningrad and Poland, on the other. But the EU's expansion eastwards will also turn Belarus, Ukraine and Moldova into buffer states between Russia and the EU. As Russia revives, they will be torn between the two. They may play one giant market off against the other and so strengthen their own positions. Or they may be tempted, or obliged, to integrate more closely with one rather than the other. In short, the issue of the eastern frontier of the EU remains an open question the peaceful answer to which would seem to be assured only by transcontinental security arrangements.

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CHAPTER 6

THE RESPONSE OF THE UNITED NATIONS TO THE CHALLENGE OF ECONOMIC TRANSITION

Norman Scott[1]

When the extent of the revolutionary changes sweeping through the central and eastern European countries (CEEC) and the former Soviet Union (FSU) was grasped by the 'outside' world towards the end of 1989, the United Nations and its secretariat were as much taken by surprise as the governments and populations of the countries concerned. Time was needed to digest the implications for the work of the United Nations system of the momentous political and economic transformation under way and to determine what form and scale of support it could provide. Fears were voiced immediately by developing countries that support for economies in transition to a market system would not only place new claims on the limited funds available for development assistance, but would also lead to a diversion of resources from the programmes of which the former were already beneficiaries. This anxiety was expressed repeatedly in the General Assembly, at ECOSOC, in UNCTAD and in the governing bodies of the UNDP, ILO, WHO, UNICEF and the other UN agencies. While recognizing, with some reservations, the justification for multilateral support for the countries in process of transition, the developing countries pleaded for an increase in total funding to meet the new needs and opposed any deflection or reduction in the resources attributed to development assistance.

Unprepared for the dramatic collapse of what had seemed an unassailable monopoly of political power by one party, with social ownership of the productive assets and economic organization based on planning, the UN system had nonetheless considerable experience, acquired over some forty years, in the management of programmes of development assistance and technical cooperation. How much of that experience could be mobilized rapidly to support the transition process? On what scale could funds be raised for that purpose? What new methods or structures, particularly for coordination of a concerted programme, needed to be put in place by member governments and by the secretariats of the organizations involved? What should be the relations between bilateral and multilateral assistance? What criteria could be used to assure the effectiveness of the aid delivered? How did recipient governments perceive the usefulness, relevance and, sometimes, conditionality of the outside support they received from the UN system in the transformation of their economies? What capacity did they have to manage and absorb inflows of financial and technical assistance of which they had no earlier experience? These and many other questions need to be addressed in any thoroughgoing assessment of the United Nations' response to the challenge of radical change posed by the collapse of the communist system in eastern Europe on the threshold of the 1990s. This essay attempts only to sketch in some elements of the answers to these questions.

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6.1 The intergovernmental response of the United Nations

Within a few weeks of the disappearance of the Berlin Wall as a symbol of the division of Europe into two competing 'economic and social systems' discussions were taking place in the UN General Assembly on the potential scale and use for international aid for development of the 'peace dividend'—the resources released from competitive military expenditure. No formal decisions were adopted, however, before the summer session of ECOSOC in 1990. On 21 December 1990 the General Assembly adopted a resolution convening a special high-level meeting of ECOSOC at ministerial level, to be held in July 1991, in order to examine the impact of the evolution of east-west relations on international economic cooperation. That meeting was preceded by a colloquium convened in Algiers jointly by the UNDP and the UN secretariat's Department for International Economic and Social Affairs (DIESA) in May 1991 to engage in a preliminary discussion of the same issues to be taken up at the ECOSOC ministerial meeting. A major concern expressed at these meetings was the risk of disruptive consequences for the economies of developing countries of the collapse of CEEC markets and CMEA trading ties, which had deepened the existing recession in the CEEC region. This concern presumably explains the considerable emphasis placed on 'the impact of the recent evolution of east-west relations... on the economic growth and development of developing countries' and on 'the integration of the countries in transition into the world economy'—the terms used in the titles of several resolutions and in secretariat reports dealing with their implementation. As a result, ECOSOC has consistently devoted more attention to the external or 'integration' aspects of the transition than to the equally important issues of transforming domestic structures and institutions.

As a follow-up to the ECOSOC high-level meeting the General Assembly adopted a resolution in which it called on the international community to provide additional assistance to those developing countries which had been adversely affected by the transformation in central and eastern Europe. Several subsequent General Assembly resolutions dealing with the problems of, and support for, the economies in transition were adopted—notably 47/171 and 47/187, 48/181 and 49/106. This last-mentioned resolution 'calls upon the United Nations system to continue to conduct analytical activities and to provide policy advice and technical assistance to the economies in transition, tailored to each country's respective stage of economic transformation'. It further 'calls on the United Nations system to continue studying ... possible ways of enhancing economic and technical cooperation among countries with economies in transition, as well as with developing countries, identifying how the United Nations system can strengthen cooperation, while avoiding duplication...'

6.2 Coordination of support within the UN system

The repeated call for stronger cooperation, and avoidance of duplication, reflected a concern about the effectiveness of United Nations' development assistance which had been widely felt before new claims for support had emerged as a result of the transition process. The large number of agencies and programmes involved in the new aid effort heightened the urgency of improving methods and mechanisms of coordination. The Administrative Coordination Committee (ACC), bringing together the executive heads of all agencies in the system under the Secretary General, already existed. Its mandate, however, was too broad to permit a steady focus on the coordination of UN system support for the countries in transition. It was therefore decided to set up a Joint Consultative Group on Policy (JCGP) to foster interagency cooperation in the transition countries,

with subgroups dealing with joint programming at the technical level in groups of countries such as the Baltic states.

Increased use was also been made for coordination of the established mechanism of the Consultative Committee on Programme and Operational Questions (CCPOQ). At the fifth meeting of the CCPOQ it was decided, as part of its triennial review of operational activities, to undertake in-depth country studies, based on detailed questionnaires, in 14 countries, two of which—Belarus and Uzbekistan—being countries in transition. In addition, the UNDP already had in place a series of annual meetings of its Interagency Consultative Meeting at which all United Nations bodies acting as UNDP executing agencies participate. This forum was also used to review the status of coordination of UN system activities in the countries in transition.

A wider circle of coordination of international assistance to countries in transition was inaugurated by the Washington-Lisbon-Tokyo series of international conferences convened in 1992 on the initiative of the United States of America. Within the United Nations delegation to these conferences the UNDP was assigned the role of lead agency for technical cooperation. The conferences vested overall responsibility for general coordination of aid in the World Bank, which convened the first four Consultative Group meetings in December 1992. Given UNDP's previous experience with both the consultative group and the roundtable mechanisms for aid coordination, UNDP was accorded the status of statutory member of the Consultative Groups, charged with responsibilities for in-country follow-up of consultative group meetings. This set of activities was linked to UNDP efforts to foster national capacity-building for foreign aid management, co-financed with the World Bank.

6.3 The response of the United Nations Economic Commission for Europe

The ECE Secretariat was the first branch of the UN system to put forward a reasoned analysis of requirements, and a set of proposals for what it described as a 'framework for western support for the process of transition'. Published in April 1990 (in the 'Economic Survey of Europe in 1989/90') the contribution of the ECE secretariat influenced the policy debate more by its analysis than by its prescriptions, although some of these were taken up and put into practice, as shown later. (It may be added that the ECE secretariat, in its regular reports on economic developments in the CEEC, also engaged in the policy debate over the relative merits of rapid and radical reforms—so-called 'shock therapy'—as opposed to a gradualist approach, for which it argued persuasively.)

A central theme of the ECE study was that of the possible relevance of United States assistance for post-war reconstruction in western Europe for the new challenge of reform and transformation in the east. As the secretariat put it 'Commentators, both in the west and the east, have suggested that some kind of new "Marshall Plan" might be an appropriate way to support the process of economic and political reform in eastern Europe. Since "Marshall Plan" is in danger of becoming a hackneyed synonym for throwing large amounts of money at larger problems, it will be useful to take a closer look at the original Marshall Plan and the problems to which it was addressed before suggesting the outlines of a programme of western support for eastern reform...'

Starting from recognition of the similarity of the constellation of problems facing western Europe in the post-war period and those of eastern Europe at the threshold of the 1990s, the ECE study also stressed the very important differences in the two situations. The resemblances may be

recalled briefly. A collection of highly regulated economies faced considerable problems of reconstruction and restructuring. Attempts to find solutions to their problems were hampered by large current-account deficits, the correction of which was impeded by overvalued and inconvertible currencies and by a network of bilateral trading relationships which restricted the growth of trade and of international specialization based on comparative advantage. There was a threat of open inflation, and many countries carried a heavy burden of foreign debt. Moreover, there were fears that the expectations of the population for a rapid recovery in their fortunes were rising more rapidly than the economic capacity to satisfy them, thereby creating risks of social unrest and political instability.

In the visionary policy initiative—launched in his famous speech at Harvard University on 5 June 1947—the US Secretary of State, George C. Marshall, proposed American assistance to Europe as a means for breaking out of the vicious circle in which long-run structural adjustment was frustrated by intractable short-term problems such as the widespread shortage of raw materials and essential commodities, compounded by an acute scarcity of dollars. Marshall emphasized that American assistance was intended as a cure, not a palliative.

The secretariat analysis singled out the salient features of the Marshall Plan with a view to determining their possible relevance to an analogous programme of aid for the former CMEA economies. These are summarized in the following paragraphs. The secretariat also discussed the merits of opposing arguments deployed in the controversy which emerged in the 1980s regarding the importance of Marshall aid for post-war European conversion and recovery; one school of thought taking the view that recovery was already well established before American assistance came on stream, and arguing that such recovery would have continued even if Marshall aid had not been forthcoming. The opposing view was that the Marshall Plan, while not deserving exclusive credit for post-war recovery and reconstruction, nonetheless provided the 'crucial margin' that made European self-help possible. Far from being an academic debate of interest only to economic historians, this issue was judged by the secretariat to be central to deciding what might be expected from any large-scale programme of aid similar to the Marshall Plan: 'there is clearly a difference between easing constraints on a growing and dynamic economy and restoring a broken-down and non-functioning system to working order'. After reviewing the evidence it drew the conclusion that post-war Europe fell into the former rather than the latter category. But while fairly rapid progress was being made in solving the problems mentioned above by domestic initiatives, Marshall aid helped to sustain the recovery by easing balance-of-payments constraints. Moreover, by reducing the risk of widespread materials shortages and bottlenecks of supplies it helped to maintain business confidence and, thereby, the growth of fixed investment. This was also supported by an imaginative, though modest, programme of technical assistance which consisted in demonstrating to west European businessmen American policies at the enterprise level for fostering innovation in new technologies and improving productivity.

6.4 The essential features of the Marshall Plan

6.4.1 Scale of assistance

The European Recovery Programme—to give the Marshall Plan its official name—provided west European countries with some US$12.4 billion over four years, or some US$3.1 billion a year. At 1989 prices (the year the ECE secretariat study was written), this was equivalent to US$65.4

billion (or US$16) a year. Based on the same scale of population, the US$42 per head provided by the Marshall Plan would have amounted, if applied to the six countries of eastern Europe in 1989, to around US$4.8 billion a year. If the then Soviet Union were included, the total would have been nearly US$16.7 billion a year. Adjusted for price changes, this sum was not much higher than the original Marshall Plan was. It would have been the equivalent of some 0.3 per cent of the GDP of either the United States or the European Community.

6.4.2 Time-frame for restructuring and recovery

The Marshall Plan set 1952, some six years after the end of the war, as the date by which internal and external balance should be re-established. Thus, the span of the programme was set at four years, with emphasis on intra-regional cooperation within a context of multilateralism and a liberal trading system.

6.4.3 Procedures and coordination

Each recipient country had to draw up a four-year plan for recovery, including estimates of output, imports and exports and the methods by which economic balance would be achieved at the end of the period. To coordinate these plans and the allocation of aid, the recipient countries had to set up a mechanism, the Organization for European Economic Cooperation (OEEC), through which they cooperated amongst themselves and with the USA in assessing requirements and initiating proposals for action.

6.4.4 Grant aid and technical assistance

The lion's share (90 per cent) of the US$12.4 billion of financial aid distributed under the Marshall Plan was in the form of non-repayable grants, and there was also a large grant element in the loans accorded, which were usually for 35 years at 2-1/2 per cent interest, with repayment starting only at the end of the active aid period in 1952. Technical assistance, as mentioned above, was concentrated on demonstrating to Europeans the value of American production techniques, innovative strategies and labour-management relations. It was, in monetary terms, a relatively small component of the total Marshall Aid programme, but one whose benefits were very large in relation to the quite modest outlays involved.

6.4.5 Living standards and political stability

By providing the means of overcoming the critical European balance of payments deficit, most of which was with the dollar area, the Marshall Plan played a vital role in allowing recipient countries to achieve rates of growth of output and investment which could only otherwise have been attained at the expense of a drop in living standards, with attendant problems of social unrest and political instability.

6.5 Post-war western Europe and post-communist eastern Europe compared

The striking similarities between the economic problems facing central and east European countries after the collapse of the Berlin Wall in 1989 with those of western Europe after the capture of Berlin in 1945 did not blind the ECE secretariat to the equally important, if less conspicuous, differences in the two situations. Crucial amongst the latter was that western Europe

in the late 1940s did not have to reconstruct market economies from first principles. Although the exigencies of war economies had entailed the suspension or regulation of market mechanisms in many sectors, a clear system of property rights remained in place and the basic incentive structure of the market continued to exist alongside wartime planning and rationing. Entrepreneurs still had incentives to raise efficiency and to save with a view to subsequent investment. The resultant savings overhang contributed decisively to the rapid response of investment in western Europe to the shortages and bottlenecks encountered in the immediate post-war years.

The transformation of the centrally planned economies of the east into market-oriented, decentralized economies of the OECD variety called, in contrast, for sweeping changes in existing economic institutions and the creation of the whole institutional infrastructure without which a market economy cannot function efficiently. Institution-building requirements range from legislation governing property rights to company and contract law, financial institutions, regulations and regulatory bodies, a capital market and stock-exchange, labour law, dispute settlement procedures and a banking and fiscal system. No experience existed of creating so diversified a set of institutions in a short space of time. Nor is there any uniformity in the institutional mix of the OECD economies. Many economic institutions embody customs, practices and preferences specific to individual societies... 'Beyond a number of core elements, there is no single, homogenous model of a market economy'.

Awareness of the radical difference between the two situations, and of the fact that the process of transition was uncharted territory for both economic analysis and policy, led the ECE to propose a modified Marshall Plan as a framework for western aid to the new challenge faced by the international community. Its proposal for a modified approached also rested on recognition of one of the lessons of the experience of western lending to the CEEC in the 1970s, and 1980s—namely that the absorptive capacity for new capital and technology of the east had been shown to be very limited.

6.6 The ECE secretariat proposal

The proposed modification of the Marshall Plan model was both simple and bold. It consisted in suggesting that the appropriate approach would be to turn the Marshall Plan model upside down. Whereas the Marshall Plan had been long on grant aid and short on technical assistance, western aid to eastern Europe, at least initially, should reverse their relative importance. Following the Marshall Plan example, recipient countries could be left to draw up their own programmes of transition to a market economy and to indicate the types of technical assistance required. Western experts or international institutions could provide help in formulating their programmes and requests for technical assistance and financial aid. By establishing some links between absorptive capacity, technical assistance and financial aid, it might be possible to avoid one of the weaknesses of the Marshall aid programme, namely, that it did not do enough to strengthen incentives to better performance.

The types of technical assistance recommended would give priority, at least initially, to creating the legal, financial and institutional infrastructure of market behaviour. This would encompass advice on how to avoid market failure (in relation to monopolistic firms, externalities and public goods), to conduct privatization, to carry out deregulation, to generate reliable statistics. More specific proposals were for both technical and financial assistance to remedy the environmental

problems in the east caused by 'planning failures' in the past and for a Central European Payments Union (CEPU) as an intermediate stage in the transition towards a fully multilateral system of trade payments. This latter proposal was based on the successful experience of the European Payments Union (EPU) which was operative from 1950 to 1958 (with Marshall Plan financial backing) and contributed significantly to the successful liberalization of west European trade and payments.

In short, the ECE proposal, recognizing the limited absorptive capacity of the CEEC because of the lack of many complementary factors such as market-supporting institutional infrastructures, argued for effective technical assistance to enlarge their absorptive capacity. 'The more successful the assistance, the less would be the need for grant aid and the greater the attraction for private capital'. Nonetheless, financial assistance (especially grant aid which would not add to indebtedness) would be needed for such objects as the radical improvement of transport and telecommunication systems and the reduction of environmental pollution.

Finally, the proposal, inspired by the role of the OEEC in administering the Marshall Plan, recommended that the needs of recipient countries should be coordinated by a technically qualified international institution which would help to identify and clarify those needs as well as monitoring progress and providing a forum for exchanging ideas on and knowledge of the national programmes. Pointing out that at least six or seven major international institutions were already involved in various forms of international aid and cooperation at the end of 1989 'only one international economic institution... includes all the eastern countries and the western market economies in its membership', the secretariat accompanied this thinly-veiled plea for a coordinating role for the UNECE by a reference to the task of 'overall review and coordination' being conducted 'within the framework of the Conference of Security and Cooperation in Europe (CSCE)'.

This plea, even though couched in the measured and dispassionate prose which the research staff of the ECE had been obliged to cultivate during the long decades of the Cold War, was destined to fall on deaf ears. The response of member governments at the forty-fifth session of the ECE in April 1990 was muted. Far from rising to the challenge of adapting the concept of the Marshall Plan to the dramatic and epoch-making revolution in political and economic systems occurring in eastern Europe, and possibly assigning to the ECE the crucial role in reconstructing east-west economic relations for which it had been briefly destined at its creation in 1947, member governments confined themselves to 'restructuring' the organization itself. The broader framework for western support for the transition proposed by the secretariat was brushed aside. Instead, procedures were set in place to identify the 'priority tasks' of the ECE, and to adapt the allocation of staff resources and the *modus operandi* of intergovernmental cooperation accordingly.

At first sight the decision not to enhance the role of the ECE to that of a central player in the new configuration of east-west relations, freed at last from the constraints inspired by the deep divide created by the Cold War, may seem surprising. The organization's experience of, and expertise in, the difficulties and possibilities of economic and technical cooperation might have seemed to predestine it for a lead role as the only pan-European organization active in this field. As it happened, a combination of factors frustrated any such ambition. There was to be no question of the ECE becoming a powerhouse of ideas, initiatives, programmes or coordination of a concerted western effort in support of the transition. Instead, a limited programme of technical assistance, to be financed from the current operational budget, in narrowly defined fields such as the

environment, statistics, transport and trade procedures, was assigned as a set of priority or 'core' tasks to the ECE.

The reasons which led member governments (comprising all of the states of eastern and western Europe plus the United States and Canada) to relegate the ECE to a secondary, if not marginal, role in supporting the process of transition merit some consideration here for the light they shed on how the potential contribution of the United Nations was conceived in western, and also CEEC, capitals.[2] Those reasons may be summarized as follows; the order in which they appear does not necessarily correspond to their relative importance:

1. Other international organizations staked a claim to be the main architects of the shape of things to come. Chief amongst them was the European Communities (EC) and, in particular, its Commission. Brussels had long awaited (witness its protracted shadowboxing negotiations with the CMEA and its member states in the late 1970s and 1980s) the 'penitence of Canossa' of the centrally planned economies. Sooner or later they would, Brussels (correctly) anticipated, acknowledge the immense trading might of the communities and sue for terms—and assistance. With the *dénouement* of 1989 there was no disposition on the part of Brussels to dilute its bilateral bargaining power by enlarging alternative, multilateral channels of cooperation in Geneva.

2. The EC, at the time of decision-making about the future role of the UNECE in 1990, comprised only twelve members of the 34-country membership of the ECE. Nonetheless, their weight (trading, and otherwise) was such that the positions they took in discussions and negotiations counted for far more. It was the EC commission which persuaded its member states to dismiss any suggestion of attributing even a modified Marshall Plan role for the ECE and to propose, instead, a distinctly modest programme of technical assistance workshops. This exercise in persuasion was facilitated by the competing, if not conflicting, claims for a share of the action emanating from numerous other international organizations, some fully institutionalized—e.g. the OECD, the World Bank, the International Monetary Fund and the UNDP—others, at that time, less so—the G-24, the CSCE (later to be renamed the OSCE) and the EBRD. In the circumstances, it was easy, and to a certain extent justifiable, to argue that the responsibility for designing and conducting western programmes of support for the systemic transformation of the east should be distributed amongst these organizations according to their mandates, experience and comparative advantage. Given the diversity of these numerous organizations, and their (typically) broad terms of reference, it would have been difficult indeed to determine, using criteria such as comparative advantage, which tasks should be assigned to each in order to ensure the maximum effectiveness of their combined and several contributions to western support for the transition. Students of international organizations might well find it profitable to conduct research into, for example, the reasoning behind the recommendation of the Bonn Conference on International Economic Cooperation of the CSCE, held in early 1990, to the effect that the UNECE should concentrate its assistance efforts on non-specified 'priority tasks'.

3. The perception of the efficiency of the UN (of which, as a Regional Commission, the ECE is an integral part) as an aid-providing agency was, to put it mildly, open to

[2] For a fuller account see, Norman Scott, 'La Commission Economique pour l'Europe des Nations Unies et le processus de transition', *Relations Internationales*, No. 76, 1994: 439-51.

question. Leaving aside the UNDP, which had a justifiably high rating, other UN agencies were regarded with some suspicion as being bureaucratic, or weakly managed, or possessing expertise narrowly focused on developing countries. This last point weighed heavily, since developing countries, as noted earlier, had been vociferous in arguing, from the earliest days of the collapse of the ancient regime in the east, that no aid resources should be deflected from their needs to provide support for the transition. Moreover, UN budgetary procedures were rightly judged to be laborious and slow, so that the UN system's fast-reaction capacity was viewed with misgiving.

4. The above arguments, deployed to limit any potential enhancement of the role of the UN-ECE, met with only feeble opposition from the CEEC, who were *demandeurs* in the debate about western support for their transformation. Insistence on their part on an enlarged field of action for the ECE would have run the risk of antagonizing the EC whose coordinating role for G-24 assistance had been consecrated by the Houston summit in July 1989. Moreover, most of the countries in transition were striving for closer association with, and eventual membership of, the European Communities, whose aid-giving capacity (including commercial policy measures giving, it was hoped, improved access to its markets) was incomparably greater than the resources available to the ECE.

5. Thus, the ECE secretariat was the only strong advocate of entrusting aid-coordination to a single agency, while at the same time arguing for an enhanced role for the ECE in the 'new institutional architecture of Europe'—one which would have been closer to the vision expressed by its first Executive Secretary, Gunnar Myrdal. This was not enough to tilt the scales. The final outcome was from then on (April 1990) almost predictable. A modest number of priority sectors of activity would be assigned to a restructured ECE. Its contribution to technical assistance for the countries in transition would take form of workshops, whose purpose would be essentially to provide training for officials and technicians in the countries in transition, mainly in the priority sectors mentioned earlier.

The debates of the forty-fifth session of the Commission April 1990 reflected many of the arguments summarized above and culminated in two decisions which were to govern the response of the ECE to the new situation in Europe for the following years. Decision A(45) entitled 'the activities of the Economic Commission for Europe' contained directives for restructuring the commission and, by implication, its secretariat. It stated that, in view of the profound and rapid changes taking place in countries members of the ECE and wishing to maintain the valuable momentum built up at the CSCE Conference on Economic Cooperation in Europe, held in Bonn from 19 March to 11 April 1990, and considering that the process of economic reform and structural adjustment, with increased reliance on market forces, will enhance economic performance, improve the conditions for closer cooperation and contribute to a more open world trade system, while conscious of the need for coordination among the different existing international economic institutions to avoid duplication and to ensure the maximum effectiveness of this work. The commission then decided, having noted the limited resources available for ECE work within the regular UN budget, to define priority areas for future action by the ECE and to develop practical measures in these priority areas, as recommended by the Document of the CSCE Bonn Conference.

The second relevant Decision, D(45), entitled 'The work of the Commission concerning economies in transition in eastern and central Europe', pursuing the idea of workshops as a main form of ECE

activities in support of the transition, requested the secretariat to present a number of practical workshop themes after consulting member states and other international institutions, with special attention to be given to close collaboration with the European Community.

The next stage, at the intergovernmental level, was the resumed meeting of the forty-fifth session, held in December 1990, when the UNECE adopted its Decision O(45) in which it adopted the priorities originally proposed by the EC—namely, transport, environment, statistics, trade facilitation and economic analysis—and streamlined its methods of work and structures. The commission observed that economies in transition would benefit from technical and policy advice and that ECE transition-related activities, if they were to serve a real purpose, should be topical, timely, useful, economical and non-duplicative of work undertaken by other organizations.

The outcome of these decisions most relevant to the present discussion was a shift in the focus of regular ECE activities towards problems of the transition and the launching of a programme of technical assistance-oriented workshops, some one hundred and fifty of which were organized in the four years after the programme was launched in May 1990. At the same time there was a redeployment of secretariat resources towards the new priority sectors and, much later in 1994, some ten posts of regional advisers, whose mandate was specifically concerned with providing technical and policy advice to the countries in transition, were reallocated to the ECE secretariat from UN headquarters.

The reorientation of regular ECE activities took place through its ramified structure of intergovernmental committees, working parties and groups of experts and in the context of a great expansion of membership (from 34 member countries in 1990, to 55 in 1995). It consisted in identifying the needs of the transition countries in infrastructure (e.g. promoting the construction and interlinkage of trans-European motorways and railways, the interconnection of electric power grids) and included the preparation of guides on important aspects of the reform process such as privatization and property rights, environmental conventions and other legal instruments promoting the integration of the region as a whole. The Conference of European Statisticians reached agreement on a special transition policy in 1992 designed to assist economies in transition to introduce a statistical system adapted to the needs of a market economy. The economic analysis of the secretariat, and of the principal subsidiary body of the commission (named Senior Economic Advisors to ECE Governments) devoted increasing attention to the nature of and difficulties experienced in the transition process and monitored policy developments as well as assistance needs and the financial support provided by western countries and international organizations.

The programme of ECE workshops grew rapidly in numbers and themes. Nine were held in 1990, 27 in 1991, 35 in 1992, 39 in 1993, and 43 during the period April 1994-March 1995. The themes of the workshops were intended to be demand-driven, in the sense that the transition countries, where most of the workshops take place, have the main say in their choice. They have dealt with such subjects as privatization, restructuring of state enterprises, the promotion of small and medium-sized enterprises, the promotion of foreign-direct investment, management of new technologies, efficient use of energy and the development of housing markets. On average the workshops, usually not lasting for more than two days, have attracted some 100 participants, usually chosen by governments in consultation with the secretariat and bringing other participants from several transition countries. The aim has been to achieve an active dialogue between western experts (many of whom are designated by other western international economic organizations) and eastern experts, rather than a passive transfer of information.

Workshops are not particularly expensive to run and could to that extent be described as cost-effective. However, since the commission decided not to use ECE regular budgetary resources to fund the programme, much of the costs of holding workshops has had to be borne by the countries in transition themselves. Only a few bilateral contributions in cash or in kind have been made by western governments or private western sponsors. Part of the problem of financing has been due to the fact that the technical assistance funds of other aid-giving international organizations are as a rule earmarked for specific projects and therefore not available to support ECE activities. That, nonetheless, does not account for the very weak response of ECE member governments to the secretariat's appeal for contributions to the Trust Fund for Assistance to Countries in Transition established in 1993. Such donations as were received in the following two years were on a small scale (typically US$20,000) and earmarked for specific subjects. The EC Commission pledged only 20,000 ecus and imposed very slow disbursement procedures.

Testimony to the usefulness of the ECE programme of technical assistance workshops is provided, indirectly at least, by the satisfaction expressed with them by governments of countries in transition and by the number of requests the latter have made for new workshops to be organized.[3] Most workshops have had a strong training component and were designed to enhance national capacity-building. A regular system of evaluation of their relevance and effectiveness (principally by means of questionnaires to participants) was instituted at an early stage. Proposals for improvements from countries in transition have included the suggestion that specific subjects should be chosen which could attract partners able to provide funding for follow-up projects and activities. The availability of funds to ease the burden of financing now borne mainly by the recipient countries themselves has remained a problem, however. This is indicated by *inter alia*, the small number of workshops organized in the newly independent states (notably in the Central Asian region). As a result, the regional advisors deployed since 1994 have had to devote much of their efforts to fund-raising from donor countries and other sources. More active or substantial contributions from other international, regional and subregional institutions were sought, in line with the recommendations of Commission Decision B(49)1994, which also called for efforts to diversify forms and methods of operational technical assistance. These efforts at fund-raising yielded modest results. By 1997 some thirty member governments had contributed (relatively small sums) to the device of' trust funds which enabled these resources to be earmarked for projects of interest to the donor countries.

The dilemma for the ECE secretariat was the familiar one of being assigned more tasks than the wherewithal to carry them out. Since member governments were unwilling—for the reasons mentioned earlier—to allocate a larger budget to the ECE, the alternative was to reduce the scope of activities of the organization thereby releasing resources for priority or core tasks, most of which related to the needs of the economies in transition. This process of streamlining and redefining the priorities of the ECE took place within the context of the parallel effort to restructure the United Nations and extended over a period of four years. By the time of the celebration of the fiftieth anniversary of the founding of the ECE, in April 1997, a plan of action had been drawn up and was adopted on that occasion by the commission, together with an anniversary declaration. Some key elements of these texts deserve to be recorded here, since they

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[3] In 1994-5, revealed preferences may be inferred from the following distribution by country: Hungary was host to 10 workshops, the Russian Federation to 5; Belarus, 4; the Czech Republic, Romania and Ukraine 3 workshops each; and Poland, Slovakia, Estonia and Slovenia hosted 1 each.

illustrate how the perception of the role of the ECE in facilitating the process of transition had evolved in the light of several years' experience.

The declaration, to which all member governments subscribed, states that

> the Commission has successfully carried out vital tasks of cooperation and integration... By drawing up guides for legal reforms and international transaction practices, it has helped the countries in transition to promote trade and investment within the institutional framework of a market economy. By publishing extensive economic analysis and statistics it has encouraged the exchange of views and the sharing of experience, leading to greater mutual understanding and contributing to policy convergence...The Commission's work now takes place in an unprecedented historical context, when all its members subscribe to the principles of democracy and the market economy... Cupertino within the ECE region contributes to bridging gaps between its subregions... in defining activities which need to be dealt with in a multilateral framework and for which the ECE is the appropriate forum... we have paid particular attention to the countries in transition and their economic relations with the Commission's other member countries.
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> The reform of the Commission, which is outlined in the Plan of Action (document E/ECE/1347) reduces the number of programme elements by 60 % and the intergovernmental structure from fourteen Principal Bodies to seven. The following current areas of work of the Commission have been identified: environment; transport; statistics; trade, industry and enterprise development; economic analysis; energy; timber; and human settlements.' ... We have also agreed on a structure for organizing activities to meet specific requests from subgroups of member countries, in particular the countries in transition ...

Two projects were launched in 1997 and 1998 which reflect the readiness of the ECE to respond to such specific requests from subgroups of member countries. The first of these was the Southeast European Cooperative Initiative (SECI), set up in December 1996 with the aim of encouraging cooperation among the countries of the region and facilitating the access of southeast Europe to European integration processes. The participating countries are Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Greece, Hungary, Moldova, Romania, Slovenia and Turkey. The ECE was requested to provide SECI with technical assistance in helping it to discharge its tasks. Early projects selected for cooperation included trade facilitation, with actions to overcome border-crossing difficulties; transport infrastructure, with the identification of bottlenecks along main international corridors in the SECI region and short-term measures to remove them; financial measures to promote SMEs through microcredit and guarantee schemes; energy efficient demonstration zones; interconnection of natural gas networks, diversification of gas supply and improvement of security of supply in southeast Europe; and Danube recovery programme.

The second subregional project is the Special Programme for Economies of Central Asia (SPECA). This programme was initiated by the President of Kazakhstan and supported by the UN Secretary General who asked the Executive Secretaries of ECE and ESCAP to combine their efforts in developing and implementing a regional programme. Participating countries—Kazakhstan, Kyrgyzstan, Tadjikistan, Turkmenistan and Uzbekistan—have adopted a series of projects of national and regional importance with the aim of establishing a favourable economic environment with a focus on regional policies in such fields as the development of transport

infrastructure, the rational use of energy and water resources, a joint strategy for regional development and attracting foreign investment, and regional cooperation in the development of multiple routes for pipeline transportation of hydrocarbons to global markets. SPECA represents a systematic development n the part of the two Regional Commissions and the recipient countries in close collaboration with UNDP.

6.7 Interagency coordination and the UNDP

The provision of technical assistance, and the establishment of a field presence by United Nations agencies in a large number of new recipient states constituted a severe test of the system's ability to manage assistance in a coordinated manner. The multiplicity of national and unilateral programmes and projects of assistance meant that recipient countries (where aid-management capacity was virtually non-existent) were confronted by highly fragmented offers of support as well as a plethora of policy advice amongst which it was difficult to choose.

Thus, the need for coordination and an integrated approach were recognized at an early stage in the resolutions adopted by the General Assembly and ECOSOC, referred to earlier, as well as the Governing Council of the UNDP. The UNDP, as the largest channel of United Nations aid for development (expenditure on field operations of US$1 billion in 1990, rising to US$1.4 billion in 1991), and the agency with the greatest experience of disbursing technical assistance and enhancing national absorptive capacity, was predestined to play a lead role.

On the basis of the advice received in consultation with the ACC and the Joint Consultative Group on Policy (JCGP), the UNDP Administrator proposed a strategy believed to be conducive to integrated UN system assistance to the transition countries. In consisted in taking new approached to the presence of the UN system and these countries and in attempting to integrate their assistance activities. Assuring a UN presence consisted in setting up temporary UNDP offices, also referred to as United Nations Interim Offices, four of which had been established by the end 1992, the number rising to 13 by the end of 1993. The U and the UNDP agreed to share the operating costs of these offices. (Note that, given the nature of past associations between the recipient countries, it was decided—with their explicit approval—not to take a regional approach to the provision of assistance but to concentrate on country offices and programmes). As for coordination of activities, the mechanism of the JCGP has been used actively to foster interagency coordination. By this means, joint missions from several agencies were sent to recipient countries in the early stages of the programme in order to assess needs for assistance. In addition, a JCGP subgroup was set up late 1993 to deal specifically with joint interagency programming in the Baltic States and the CIS at the technical level.

Although the resources made available for the UN/UNDP Interim Offices were meagre in relation to those provided in regard to UN/UNDP offices in developing countries, coordination has been facilitated by means of a wide area network (WAN), a computer-driven and statistics-based communications system. The equipment for this system and its installation was provided by a group of telecommunications enterprises in the Netherlands and Sweden. The aim of the network is to assure an effective flow of information between field offices and their counterparts in the recipient countries, the UN and UNDP headquarters and, through a central European point, agency headquarters.

It has to be recognized, however, that the UN Interim Offices and temporary UNDP offices were not given staffing and other resources on a scale permitting them to provide the broad range of services normally expected from established UNDP field offices. From the outset, it was envisaged that these offices would be required to have a much more specific and narrow focus and would have to develop new and innovative methods of making a significant impact on several key areas.

One such method, contributing to capacity-building in selected areas linked to the most pressing needs of the transition process was initiated in Poland in 1991. Known as the 'Umbrella Project' it consisted in a cost-effective facility through which high-level expertise is made available in a quick-response mode for short-term assignments. Increasing (though still limited) use was also made of expertise from within the region, e.g. from Hungary, to help other countries of the region.

Essentially, UNDP has also aimed at using its limited resources as seed money to develop sound proposals that are attractive to other donors. At a seminar in Poland in September 1992, country officials from 14 newly-independent states identified one aspect of capacity-building—aid management and aid resource utilization—as high amongst their priorities. The concrete purposes identified were to increase their absorptive capacity to shift from a supply-driven to a demand-driven mode of cooperation; and to minimize the accumulation of debt-creating assistance while reducing the recurrent costs associated with cooperative forms of assistance.

6.8 The International Labour Organization (ILO)

The ILO launched its programme of multilateral assistance to the countries in transition from a position of some weakness, compared to many other UN agencies, because of the conflictual relationship which had characterized its relations with the authorities of those countries during the communist era. The struggle of the Solidarity movement in Poland against the policies of the government of that country throughout the 1980s had brought long-simmering disputes over trade union rights to a head. As a result, while the ILO had endeavoured to monitor labour standards and social protection in those countries, most of which had been members of the Organization since its inception, it had limited experience of running technical cooperation projects in the region and had no local infrastructure on which to build a new programme of assistance.

This initial disadvantage did not, however, delay the start-up of a broadly-based programme of technical cooperation in the early stages of the transformation process. The Organization took the view that economic and social reforms were two sides of the same coin and should go hand in hand. Unless market mechanisms could be combined with effective measures of social protection and labour market policies, there was a perceived risk that social discord, strife and widening income inequalities would result in disillusionment with the process of transition which could endanger the continuation of democratic change.

The needs of technical cooperation in the labour and social fields were grouped in the following broad categories:

- effective labour market policies and employment promotion;
- development of industrial relations systems based on tripartite collective bargaining and mechanisms for resolving industrial conflicts;
- reform of social security systems, especially the development of unemployment insurance and the reform of pension schemes;

- improvement of the working environment and occupational health and safety.

Reform of labour legislation, reflecting international labour standards, was a first requirement, for which the ILO could draw on its vast experience of comparative national legislation. At the same time, assistance was, and continues to be, provided in institution-building in the labour field in such forms as labour administration, independent employers' and workers' organizations, employment services, centres for training and re-training, labour inspection services, social security systems and statistical services. Policy advice was also given high priority, particularly in respect of integrating active labour market policies, social protection and the restructuring related to privatization.

It was recognized early on that effective technical cooperation in the fields mentioned above would have to be buttressed by sound analytical work in the evolving—*de facto*, deteriorating— labour market situation in the economies in transition. To that end, numerous specialist meetings, at the expert and policy-making level, were organized by the ILO and the International Institute for Labour Studies. Moreover, a multidisciplinary team (CEET) was assembled and established in Budapest in late 1992 with the object of gathering information, undertaking analysis and providing policy advice. Reports prepared by the team on labour market developments in Russia, Hungary, Bulgaria and Ukraine included the findings of surveys of unemployment associated with the transition process in those countries. Their numerous and detailed recommendations for governmental policy and attracted wide attention in the countries to which they were addressed. The Budapest CEET has also organized many technical workshops on specific policy issues on its agenda such as local labour market adjustment strategies, the social dimension of privatization and unemployment benefits.

Training has been an important component of the ILO's technical cooperative programme, much of it being undertaken by the ILO International Training Centre in Turin. Pursuant to General Assembly resolution 48/181, that Centre was entrusted by the CCPOQ with responsibility for developing a 'training of trainers' programme for the management of development, with the aim of achieving a cost-effective multiplier effect and of establishing a network of training institutions in the region.

The major part of the ILO's activities in support of the transition process—over 90 per cent—has been financed by, and often executed in cooperation with, third parties (notably the World Bank and the UNDP) and by bilateral agencies. Contributions from multi-bilateral donors from 1990 to 1994 amounted to some US$18 million, while the ILO's own regional budget for technical assistance amounted to an estimated US$3 million during the same period. The share of Europe, mainly the CEEC, in total ILO technical cooperation outlays rose from 1.2 per cent in 1988 to 5.5 per cent in 1994. With a view to assuring coordination, and avoiding duplication, the ILO took the lead in setting up in 1990 a regular series of biannual Information and Coordination Meetings on assistance to central and eastern Europe in the social and labour fields. Fifteen such meetings had been held by March 1995, attended by multilateral and bilateral donors as well as recipient countries. The latter have been consistently positive in their assessments of the usefulness of the technical assistance thus provided.[4]

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[4] Report of the Director General to the Fifth European Regional Conference of the ILO, Warsaw, September 1995: 99.

6.9 The World Health Organization (WHO)

If the extent of the failures of economic planning surprised even informed observers when a fuller and more truthful statistical picture became available from 1990 onwards, the woeful state of public health came as a still greater surprise. Over the years official statements had laid claim, with supporting statistics, to higher standards of health services (e.g. numbers of hospital beds, ratios of physicians to population, etc.) than those provided in market economies. The WHO, through its Regional Committee for Europe, was quick to recognize the gravity of the situation and launched in mid 1990 'Eurohealth', a five-year programme of intensified cooperation with, and technical assistance for the central and east European countries.

The point of departure of Eurohealth was the perceived existence, in terms of health standards, of two Europes. In central and eastern Europe life expectancy at the beginning of the 1990s was on average 6.4 years less than in the EC or the Nordic countries; infant mortality was double that of western Europe (and in some Central Asian republics it was 10 times as great); the incidence of diseases preventable by immunization was high, as was chronic disease caused by alcoholism, poor nutrition and unsatisfactory living conditions The health care systems were, in general, poorly equipped and underfinanced.

On the basis of this diagnosis the Eurohealth programme focused initially on mobilizing international support for the emergency provision of life-saving drugs, vaccines and medical equipment. It also engaged in careful assessments of needs for medical assistance and for the types of reforms envisaged in the WHO's broader programme of policy measures known as Health for All.

The addition of 19 countries to the WHO's register of members, and the scale of requirements indicated above, called for a redirection of resources to the Eurohealth programme, which has nonetheless been underfunded (the shortfall in discretionary funding being put at US$10 million annually in the 1994-7 period). In 1990 the Regional Director for Europe was requested, as an emergency measure, to reallocate US$1 million from the regular budget to meet the most pressing needs of the CEEC. In fact, the sum released amounted to US$2 million, supplemented by US$10.2 million in extrabudgetary contributions in cash and kind. In 1992-3 the regular budget provided US$2.5 million, with extrabudgetary contributions amounting to US$6 million—augmented by US$3 million contributed to joint projects by the UNDP and the UNFPA. By 1994-5 the regular budget had risen to a modest US$3.3 million, but member governments contributed only US$340,300 towards the target total of US$11 million for extrabudgetary contributions.

This lack of support for the WHO aid programme for the transition in the health sector is the more difficult to understand in view of the highly positive conclusions reached about the value of the Eurohealth programme by independent external evaluators. In-depth country case studies were undertaken for Bulgaria, Kyrgyzstan, Latvia and Lithuania by the external evaluators in 1993-4, and the work of the 16 liaison offices in the economies in transition was also appraised. The evaluation methods used for assessing performance and the needs for changes in strategies were useful and thorough and might well be applied with benefit to technical cooperation programmes provided by other branches of the UN system.

6.10 United Nations Children's Fund (UNICEF)

After an absence of about four decades, since the early 1950s, UNICEF was quick to undertake a programme of support for the economies in transition. Already in April 1990 the Executive Board adopted a decision on central and eastern Europe entrusting the Executive Director with a mandate to provide technical support in the traditional fields of UNICEF competence (health, nutrition, early childhood education, etc.) drawing on UNICEF's experience in utilizing low-cost technologies. The programme authorized was described as being one of transitional support over the transitional period 1990-2, a modest and temporary response, and was prefaced by the recognition of the UNICEF commitment to concentrate its financial support in developing countries. The initial funding authorized was 'additional spending of up to US$1 million per year, without any diversion of support from developing countries... The sum to be replenished to the extent possible by special contributions ... with costs to be covered, as far as possible, through the utilization of non-convertible currencies from the CEEC'.[5] This decision signalled the return to the CEEC of UNICEF. Acting on this mandate the secretariat organized, with the Polish government, a roundtable in Warsaw in October 1990 on safety nets for children in the countries in transition. This served both to identify needs and as point of departure for monitoring changes in child welfare. The aim was also to arrive at recommendations for desirable, affordable and realistic changes in social policies. In common with the WHO, with which UNICEF engaged in closer cooperation (joint programmes, joint fact-finding and advisory missions) at an early stage, UNICEF rapidly came to the conclusion that the situation—in terms of health, nutrition, infant mortality, child care, etc—was grave and much worse than anticipated.

UNICEF assessments also called attention to the generalized crisis reflected in the spread of poverty, mortality (particularly for males in the 40-59 age group) and crime. In a series of reports tracking welfare indicators for all social groups (and thus going beyond the plight of children and other vulnerable groups usually targeted) the secretariat documented the alarming decline in standards of welfare and pleaded for a reversal of the policy of neglect of social costs during the process of transition. 'These costs are not only the cause of unnecessary suffering and waste of human lives, but also represent a source of considerable instability and social conflict that could threaten the entire reform process'.[6]

In the hope that more systematic statistical monitoring and documentation and analysis of welfare changes would help in formulating improved economic and social policies and in strengthening social safety nets, a special project was launched in late 1992 by the Florence-based UNICEF International Child Development Centre. Entitled 'Public Policies and Social Conditions: Monitoring the Transition to the Market Economy in Central and Eastern Europe' (MONEE) its principal aim has been to fill the information and policy analysis gap in the debate on the transition. The project has also helped to monitor the implementation of the National Programmes of Action with which the CEEC, with the support of UNICEF, strive to achieve a number of child-related health, education and social protection goals.

In addition to the regular series of biannual Regional Monitoring reports, a major MONEE study published in October 1994 under the title 'Crisis in Mortality, Health and Nutrition' made a

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[5] Report of the UNICEF Executive Board, ECOSOC Official Records 1990, Supplement 8, Document E/1990/28.

[6] *Public Policy and Social Conditions*, UNICEF, International Child Development Centre, Florence, Report No. 1, November 1993.

valuable contribution to the policy debate on the social costs of the transition by warning, on the basis of detailed statistics, that a health and mortality crisis in the CEEC was eroding social stability and posed a threat to the continuation of the process of political and economic reform. The extensive and detailed comparative statistics which that report assembled brought out clearly the disturbing extent of the phenomenon of impoverishment which has accompanied the transition.

The resources put at the disposal of UNICEF for its programme of support for the countries in transition were modest in relation to the scale of the needs which its analytical and statistical work had revealed. This was partly due to the claims placed on supplementary financing by specific emergency needs such as the much publicized plight of orphans in post-Ceausescu Romania and the tragic conflict in the ex-Yugoslavia. Thus, emergency support expenditures in the CEEC including ex-Yugoslavia totalled US$13.7 million in 1991-2 (of which US$8.2 million for ex-Yugoslavia). This total amount represented less than 2 per cent of all UNICEF expenditure. In the same period US$4 million were expended on analytical and advisory work and on the support staff at headquarters and the field. In 1993 UNICEF expenditure for emergency operations in the region rose to US$12.2 million, with a further US$19.4 million expended in ex-Yugoslavia. Funding for general support continued at some US$2 million each year in 1993 and 1994.

6.11 United Nations Industrial Development Organization (UNIDO)

The reaction of UNIDO to the new agenda written by the needs of the transition process was, first, to try to match the needs, expressed through mechanisms such as joint committees, with the services UNIDO was equipped to provide in the sphere of its competence, namely, the industrial sector; and second, to adapt services which had been developed for other regions to the requirements of the CEEC. Three central priority areas were chosen for the provision of technical cooperation support to the region: industrial restructuring, environment and energy; and enterprise development. The services provided have consisted in an integrated package of policy advice, institution-building, human resource development and investment promotion services—an activity in which UNIDO had already been engaged in Poland since the beginning of the transition.

The adaptation of technical cooperation methods used in other regions included placing special emphasis on the development of programmes and projects that (a) are replicable within the region, with a view to meeting the demand for UNIDO services in a cost-effective manner and (b) help create new regional industrial linkages. In addition, UNIDO country support strategies were formulated for Azerbaijan, Kazakhstan, Kyrgyzstan and Uzbekistan by teams of national and international experts and UNIDO staff in close cooperation with the governments. Further country support strategies for Croatia, Slovenia and Slovakia were in preparation at the end of 1994.

In terms of funding, the finance available has been spread rather thinly over the 15 countries of central and southeastern Europe as well as the 15 newly independent states of the FSU which together constitute the Europe and NIS component of UNIDO's global programmes. Technical cooperation expenditure reached US$4.8 in 1994 (with a 53 per cent increase in project approvals, in value terms, over 1993). As much as 41 per cent of these funds were provided by UNDP, followed by 25 per cent from IDF and 19 per cent from trust funds created specifically to assist the region for which UNIDO succeeded in attracting additional contributions. Almost one-half of total expenditure went on project personnel, US$1.1 million on equipment and US$1 million on

subcontracted projects.[7] A rising share of projects undertaken is concerned with enterprise restructuring—about one-third in terms of dollar expenditure.

6.12 Food and Agriculture Organization (FAO)

The FAO embarked on a programme of technical support for the economies in transition from a very narrow base, because of its limited membership in the central and east European region in earlier years. By the end of 1993 it had mounted 43 projects with a combined budget of US$11.5 million, equivalent to only 2 per cent of total FAO project expenditure. The main recipients of this support were Albania (US$3.5 million), Bulgaria (US$2.8 million), Poland (US$1.1 million) and Hungary (US$1.1 million). There were no national projects in the FSU but a modest (US$70,000) regional project on agricultural restructuring in central and eastern Europe was carried out in 1992/1993. Most of the financing for the programme of support for the CEEC came from trust funds, as is normally the case with FAO expenditures, and some 20 per cent was funded by UNDP. The types of assistance provided range from technical advice on raising productivity in farming, forestry and fisheries, pest control and similar typical FAO aid activities to programmes designed to enhance national farming management capacity at the ministerial and local level. Training for trainers schemes have also been funded and organized by the FAO.

6.13 Summary assessment

International aid for the process of transition has taken many forms and has been channelled to recipient countries through a whole array of institutions, public and private, bilateral and multilateral. Compared to the flow of credit and technical assistance provided by the G24, by the European Communities' PHARE and TACIS programmes and by the Bretton Woods' institutions, the contribution of the United Nations system has been relatively modest in financial terms and widely dispersed over a large number of agencies.[8] Notwithstanding the many mechanisms put in place to reduce, by coordination of programmes, the risk of duplication of activities, there has inevitably been some overlap because agencies often pursue their own agenda; are not exempt from cultivating their own constituencies in recipient countries and the quality of overall management (in respect of budgeting, priorities, and programme delivery) of some of them has come in for harsh criticism from member governments, although this has been directed more at global programmes than at those specifically concerned with countries in transition. Even in the absence of overlapping mandates and institutional rivalries, the task of coordinating within and between multilateral and bilateral assistance programmes is immense—as can be seen from the register (or database) of requests for, and assistance to, the transition countries which is maintained by the OECD.

With these qualifications, the assessment of the assistance provided by the UN system is nonetheless positive. In general, it has concentrated its efforts on capacity-building and institution-

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[7] UNIDO, Industrial Development Board, Programme and Budget Committee, Eleventh session 1995, Document IDB 14/10. From January 1994 a process of restructuring UNIDO itself was started, in which its priorities, structures and procedures have been redesigned with a view to making it more cost-effective, quality-oriented, and responsive to the changing needs of member states.

[8] A full review of the response of the UN system to the aid needs of the countries in transition would have to include many not covered here, such as the UNHCR, ITU, WMO, ITC, UNCTAD, GATT/WTO, WIPO, etc.

building—prerequisites of a successful transition—and, after the emergency relief operations undertaken at the start of the transition, has placed emphasis on long-term technical cooperation. Moreover, the programmes designed to mitigate the social costs of transformation have been a valuable complement to the more narrowly focused economic assistance provided by the larger bilateral and regional aid donors. Both the institution-building and social-cost concerns of UN system aid, with the priority it gives to technical cooperation, are consonant with the prescriptions advanced by the UN secretariat based on its analytical work on the problems and requirements of the transition. Whether this is the correct policy approach will only be verifiable when fuller evaluations of the aid projects become available. The willingness of the UN system to undertake such evaluations, often entrusted to outside, impartial experts, and in consultation with the governments of recipient countries, must also be counted as a positive response to a challenge without historical precedent.

LIST OF PROJECT PARTICIPANTS

The UNU/WIDER project on The Evolving New Market Economies in Europe and Asia: Integration into the World Economy, the Changing Internal and External Factors and the Global Implications was conducted at UNU/WIDER in 1993-96. The project comprised two components. The book *Going Global: Transition from Plan to Market in the World Economy* (ed. Padma Desai, MIT Press, 1997) is the output of the first component of the project, directed by Professor Padma Desai. This publication is the output of the second component, directed by Professors Harriet Matejka and Mihály Simai.

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