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EUROPEAN REGIONAL CONFERENCE ON FINANCING FOR DEVELOPMENT

An Issue Note prepared by the

ECE Secretariat

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INTRODUCTION

1. The General Assembly in its resolution A/54/196 decided to convene in 2001 a *High Level Intergovernmental Event on Financing for Development*. In accordance with this resolution, the UN Economic Commission for Europe, in cooperation with the EBRD and UNCTAD, has decided to convene a regional intergovernmental conference on 6-7 December 2000 in Geneva. The objective of the meeting is to exchange views and experiences in attracting public and private financial flows to the transition economies and in using them effectively for development; draw lessons from these experiences, particularly as they relate to institution building and governance, on the part of both governments and financial institutions in the region; highlight these lessons and conclusions that can be usefully taken up in the preparation of the *High Level Intergovernmental Event*; provide regional perspectives on issues related to governance in monetary an financial systems at the global level; and enable the ECE to improve its programmes and activities, particularly in the fields of economic analysis, trade and statistics, in light of the views expressed and the conclusions reached at this meeting.

2. National, international and systemic issues related to financing for development are of particular importance for countries going though an economic transformation. As table 1 shows, only a few countries have surpassed their output level of 1989. Enabling the domestic environment through institutional change and sound macroeconomic policies are essential if the transformation process is to be successful. Enhancing private capital flows, including foreign direct investment (FDI), will increase the likelihood of success provided there is a sound economic environment. Table 1 also shows that domestic investment has increased significantly in countries that are geographically near to the European Union, but this trend also reflects the development of the economic environment. In general those countries where

the domestic environment has improved have tended to attract capital from abroad including FDI.

3. This note briefly describes some of the trends and issues that are important for the member States of the Economic Commission for Europe. It reflects some key findings in the papers prepared for the meeting and raises some questions that might be taken up during the proceedings.

4. Some questions that the plenary session might raise include:

a. What are the basic approaches to development implicit (or explicit) in both national policies and the strategies of international financial institutions?

b. Are there reliable ways to assess the financing needs of the transition economies? Do the transition economies actually face a ‘financing gap’ between required and available resources and, if so, how large is it? How do the international financial institutions view this ‘financing gap’?

c. What is the role of investment in the transformation and development process? What has been and should be the role of foreign finance (official and private) in the process of economic transformation? Is there a risk that foreign finance may substitute for domestic resources rather than acting as a catalyst or a complement?

d. In light of the past decade’s experience with economic transformation, what should the international financial institutions (and the international community in general) do more, or differently, in the future to facilitate the process of economic transformation?

I. MOBILIZING DOMESTIC FINANCIAL RESOURCES FOR TRANSFORMATION AND DEVELOPMENT

5. The economic transformation in the former centrally planned economies involves a fundamental re-allocation of resources and deep economic structural change. The process of re-industrialization and modernization of these economies requires the mobilization of enormous resources and their channelling into efficient use. At present policy makers in the transition economies are looking for ways and means to accelerate the process of economic restructuring and reform but one of the important constraints they are facing is whether these economies can mobilize sufficient resources to undertake the needed reform-cum-restructuring effort.

6. It has often been argued that the transition economies, after several decades of economic mismanagement, are poorly endowed with domestic resources. Moreover, given the restricted access of many transition economies to the international financial markets and the limited amounts of official assistance they have been getting, claims have been made that some of these countries face severe resource constraints similar to those faced by many developing countries. These claims have hampered their economic recovery and, if unchecked, may continue to cause serious impediments to future development and growth.

7. However, judging from past experience, it has been domestic savings (and in the first place private savings) that have played the leading role as a source of investment and growth in most industrialized counties. Attracting external resources has been important for development and growth but for this to happen on a massive scale, it usually takes the form of

capital inflows, attracted by gainful investment opportunities. The questions is then whether one should expect that the transition economies will follow this traditional path or whether they are likely to deviate from it.

8. Past experience in some developing countries indicates that there may be numerous practical impediments to channelling external resources, including official assistance, into productive investment related to the institutional environment, the market infrastructure, the development of the financial system and the efficiency of its operation, etc. If such bottlenecks constraining the absorptive capacity of the economy are not eliminated, the effect of external resources may be counterproductive.

9. This issue raises three sets of questions that could be examined by participating delegates. The first set relates to the financial needs of the transition economies.

a. To what extent is financing a constraint for the process of economic transformation in the transition economies? Do (some of) the transition economies actually face a 'financing gap' between required and available resources and what is it?

b. What are the main financing bottlenecks (low domestic savings, or low amounts of official assistance, low amounts of private foreign capital) that the transition economies are facing?

The second set relate to the mobilizing domestic financial resources:

c. Do the transition economies raise sufficient amounts of domestic financial resources? What are their main components? What are the main recent tendencies?

d. What determines the level of private domestic savings in the transition economies? Which are the main factors that affect this level? What are the necessary conditions for increasing private savings in the transition economies? What is the role of government savings? Can FDI 'crowd in' domestic investment?

e. What can public policy do to stimulate domestic savings? What can the international community do to assist the governments in the transition economies in this area?

f. Can fiscal austerity sometimes be counterproductive from the perspective of long-run growth? How should the composition of government spending be structured so as to support transformation and development? Has the share in total spending of education, health and other social programmes been reduced to the point where the prospects for future growth and social cohesion are threatened?

A third set of questions relate to the issue of channelling financial resources into productive use:

g. What are the main conditions for the efficient channelling of financial resources in the transition economies into productive use? What are domestic institutional requirements (legislation, law enforcement, public institutions, market infrastructure, etc.) for the improvement of this process? After a decade of experience, and given that not everything can be done at once, what can be said about the priorities for institution building in the transition economies?

h. How does the financial system in the transition economies (prudential banking regulations, efficient banking supervision, depth and health of the financial system, development of capital markets) affect the process of mobilization and intermediation of financial resources? What should be done to accelerate and deepen the ongoing reforms in the financial system?

i. What can public policies do to improve the efficiency of allocation of financial resources and the efficiency of operation of the financial system? How can the international community assist the transition economies in the further improvement of their institutional and market environment?

II. ROLE OF OFFICIAL ASSISTANCE IN CREATING THE CONDITIONS FOR SUSTAINABLE DEVELOPMENT

10. In the past decade, the transition economies have received tens of billion dollars of official assistance from foreign governments, the EU (through the PHARE and TACIS programmes and the EIB), Bretton Woods institutions, EBRD, United Nations, NGO's and others. The broad objectives of this massive effort have been to provide support for macroeconomic stabilization, systemic and structural transformation (including the creation of market supporting institutions), private sector development, and to help create stable democracies. From time to time, emergency aid has been forthcoming as well. Funds have been provided in the form of grants, balance of payments assistance, debt relief, project and restructuring loans, technical assistance, and various facilities for SMEs.

11. The international assistance effort has had to grapple with tasks of unprecedented complexity, with no experience in the process of systemic transformation to draw on. The IFI's have had to extend operations to 27 new member states, more or less simultaneously. This was also the case for the EBRD that was created specifically to foster the transition. The involvement of a multitude of donors has raised many challenges: the coordination of programmes, resolution of conflicting objectives, decisions on the necessary scale and type of assistance, and agreement on burden sharing between donors. Governments and institutions which typically work with recipient countries on a bilateral basis have been confronted with regional problems requiring regional solutions.

12. The reliance of the most advanced transition economies on official assistance has diminished as certain objectives (stabilization) have been met and as access to private funds has increased. Even in these cases, however, there appears to be a continuing need for official support for various industrial projects, infrastructure improvement, environmental cleanup, preparation for accession to the EU, and so on. More generally, the potential demand for assistance in many transition economies remains substantial, including new situations requiring emergency aid. Several countries have yet to achieve macroeconomic stabilization, their external finances remain precarious, and the task of restructuring has barely begun. However, the availability of official funding is conditional on reforms and other policy measures, to which commitment does not always appear wholehearted.

13. This issue raises several questions concerning the role of official assistance:

a. Have official funds been available in adequate amounts and when most needed by the transition economies? And, have they compensated for shortfalls in private finance or have they discouraged mobilization of the latter? How effective has official assistance been in supporting structural adjustment?

b. Does official assistance complement or crowd out other financial flows?

c. The official sector, both the multilateral investment banks and bilateral donors, is engaged in upgrading infrastructure in the transition economies, but are the current plans sufficiently coherent and on a sufficient scale to encourage business investment?

d. Are concerns about 'aid addiction' exaggerated? What are the characteristics of those countries that have moved from dependence on official assistance to the ability to attract autonomous private flows?

e. Have the international institutions been successful in using their funds as a catalyst for business investment? How well is assistance coordinated, both among the international institutions and with domestic objectives? Have they also been successful in promoting public sector objects?

f. Have deficiencies in domestic absorptive capacities (including in public administration) been a constraint on the effective use of official assistance?

III. FDI AND RESTRUCTURING OF TRANSITION AND EMERGING ECONOMIES

14. Foreign direct investment (FDI) can be an important catalyst for the financing of development in the transition and emerging market economies. Yet, its importance lies not only in providing finance for development, but also in the transfer and diffusion of new technology and organizational forms from relatively more technologically advanced economies. FDI is different from bank loans or portfolio investment because its importance lies in ownership change, control and management of enterprises, technology flows, skills development and knowledge, access to international markets and international networks, and speedy corporate restructuring and the structural change, etc. Evidence from western Europe and the developing countries suggests that FDI can help to spur economic growth, but the process is not automatic.

15. There is a large productivity gap between foreign investment enterprises (FIEs) and local enterprises in the more advanced countries of central and eastern Europe, but both are generally catching up with the average productivity of the European Union. However, evidence that FDI is generating enough inter-industry productivity spillovers to close the productivity gap between the FIEs and local enterprises is relatively weak. This evidence appears at both the industry-level and enterprise-level. Past experience in some developing countries confirm that there is little or no empirical support for positive net spillovers. In some instances negative spillovers can prevail.

16. It is often assumed that the net effect of FDI inflows on the balance of payments is positive. FDI is expected to finance capital goods that can increase export capacity without raising external debt. However, imports of goods and services by the FIEs and profit repatriation and earnings reinvestment by the parent firm can result in a negative net impact (an outcome observed in some developing countries).

17. The ability to attract FDI depends to a great extent on the characteristics and the location of the host country. This ability, and the prospect of economic development, will depend on the economic environment, including macroeconomic policy and the institutional framework, the national innovation system and the absorptive capacities of local enterprises. Even if all

these factors are present, FDI may still not come in large quantities if the location is remote from major world markets and transport routes. This has raised much concern in the CIS countries.

18. Several issues that might be explored include:

a. Is the view that FDI is essential for a country to move from the "economic periphery" into the group of economically advanced nations justified?

b. What are the domestic conditions required for FDI to have a marked impact on economic growth?

c. Has FDI been a catalyst of restructuring and development in the transition economies? What is the evidence and what are the lessons to be learned?

d. Is there evidence of inter-industry and intra-industry technology spillovers in the local economy? Are there negative spillovers from FDI? If so, what measures can be taken to ensure that FDI generates positive spillovers?

e. Should international mutual funds be required to maintain prudential capital charges in the form of liquid deposits?

f. What has been the impact of FDI on the balance of payments in the short run and in the long run? What measures can countries take to reduce the risks of FDI having a negative long-term impact on the balance of payments?

g. Does FDI through cross-border mergers and acquisitions (M&As) bring in capital faster than greenfield investment? Does greenfield FDI deliver better results than FDI through cross-border M&As, including privatization? What can government policy do to reduce the underpricing of privatized assets or asset stripping?

h. What are the key conditions for attracting FDI to an economy in transition? Should governments promote FDI? What can be learned from the experience of countries such as Ireland and Spain in attracting foreign investors?

i. Is competition for FDI a zero sum game as some countries appear to think? Are there convincing reasons for believing that countries which have lagged behind in the competition for FDI cannot catch up by pursuing investment friendly policies?

j. Have investment incentives actually produced net gains for the host economies? Given the international (and regional) competition for FDI, are there alternatives to investment incentives?

k. If countries are at a geographical disadvantage, entailing higher costs and risks, what policies might help to attract foreign investment?

l. So far, low income countries have received little FDI. Can investment incentives help to level the playing field? If so, can such countries bear the explicit or implicit costs of such policies?

IV. A REGIONAL PERSPECTIVE ON GLOBAL FINANCIAL ISSUES

19. The increased frequency and virulence of international currency and financial market crises, including in countries with records of good governance and macroeconomic stability, suggests that financial instability is systemic in nature and global in reach. A major reason for the growing vulnerability of developing countries and economies in transition to external shocks has been the dismantling of institutional checks and balances. This has appeared in the form of various official controls in this area at the national level and particularly the failure to redefine appropriate government policies as economies have become more integrated into the global economy. Given that a wholesale retreat from greater openness is neither likely nor desirable, national policy efforts are unlikely to be sufficient in them to deal with future financial crises. Moreover, there is a need to establish institutions and mechanisms at the international level in order to reduce the likelihood of such crises and to manage them better when they occur.

20. Acceptance of this position underpins all the recent discussions of reforming the global financial architecture. The debate has concentrated mainly on the following areas: standards and transparency; financial regulation and supervision; management of the capital account; exchange rate regimes; multilateral surveillance of national policies; provision of international liquidity; and orderly debt workouts. Clearly, reforms in these areas imply significant changes in the operating procedures and governance of the Bretton Woods institutions, notably the IMF. Indeed, these issues are often addressed in the context of the reform of these institutions, as in the case in the recent Meltzer Commission Report presented to the United States Congress.

21. A number of proposals have been made since the Asian and Russian crises by governments, international organizations, NGOs, private researchers and market participants. Some of these proposals have already been discussed in international institutions such as the IMF, BIS and the newly-established Financial Stability Forum. According to US Secretary of the Treasury Larry Summers, a consensus has emerged on the ‘desire’ for a clearer delineation of the respective roles of the World Bank and the IMF and for strong and well-targeted support for successful development in the poorest countries. However, a close look at a recent IMF report reviewing the progress so far made shows that many of the proposals and actions considered in these fora have concentrated on marginal reform and incremental change rather than on the more ambitious ideas that emerged in the wake of the East Asian financial crisis

22. If financial instability is global and systemic, national policies will be insufficient to cope with the problem. Specific proposals for reform are being discussed in a number of international institutions such as the IMF, the BIS, and the Financial Stability Forum. As the Asian and Russian crises recede in time the emphasis of reform has shifted more towards national regulatory measures and tighter financial discipline. After the Asian and Russian crises there was much discussion of the pros and cons of controls on flows of short-term capital.

23. **These issues raise three sets of questions that could be examined by participating delegates. The first set relates to the prevention of financial crisis**:

a. Is there any general agreement on the nature and causes of the many financial crises – not only those in Asia and Russia – that have occurred over the last two decades?

Where does the debate on the reform of the IMF now stand? Is the IMF now in a better position to act as a crisis manager than before the Asian and Russian crises?

b. How important is transparency of markets and institutions for an effective financial system? Is there a case for more global standards? How can increased financial regulation and supervision be organized effectively and applied fairly? Are the various proposals for stronger prudential norms and regulations appropriate or feasible (or too costly) for many transition economies at their present stage of economic and institutional development?

c. Why is so much importance placed on liberalization of capital accounts? Can short-term capital volatility undermine the prospects for growth – and FDI? How can transition economies attract the foreign capital needed to boost fixed investment while avoiding or reducing the destabilizing effects of short-term capital flows? Would a Tobin tax be feasible and desirable?

Most informed commentators dismiss the idea that financial crises can ever be completely avoided, so the demand for effective mechanisms for managing them remains. This raises a number of important issues related to managing the financial crisis:

d. How can the timely provision of liquidity to countries facing speculative attacks be arranged? Are the proposals for "pre-qualification" for liquidity desirable and feasible, particularly from the perspective of transition economies?

e. How can the need to act speedily and effectively in a crisis be balanced against dangers of moral hazard?

f. Should the influence of foreign creditors in a financial crisis be reduced by arrangements for orderly debt workouts, perhaps along the lines suggested by Chapter II of the US Bankruptcy Code?

Given the slow pace and uncertain prospects of reform of the international financial architecture many governments, especially those with emerging market economies, have shown increased interest in regional arrangements to protect themselves from speculative attacks and financial crises. The outstanding achievement in this respect is the EMU that has eliminated fluctuations in the exchange rates of its members while providing for considerable mobility of capital. This raises a number of important issues related to managing the financial crisis:

g. Do such regional arrangements conflict with the aims of reform of the international financial system, especially in a global economy?

h. If exchange rates are irrevocably fixed in a monetary union, what are the policy implications for maintaining national competitiveness? Can the EMU provide a haven and anchor for the transition economies of central and eastern Europe? What are the costs and benefits for transition economies of tying their currencies to the euro? Could "euroization" slow down the processes of transition and adjustment in these economies?

TABLE 1

Selected economic indicators for in the ECE transition economies, 1999-2000

	GDP			*Industrial output*			*Investment*			*Capital flows/GDP*		*FDI/GDP*	
	Indices, 1989=100	*Growth rates*		*Indices, 1989=100*	*Growth rates*		*Indices, 1989=100*	*Annual percentage change*		*Per cent*		*Per cent*	
	1999	*1999*	*2000* [a]	*1999*	*1999*	*2000* [a]	*1999*	*1999*	*2000* [a]	*1999*	*2000* [b]	*1999*	*2000* [b]
Eastern Europe	95.1	1.4	4.6	78.0	-0.6	9.9	..	..	..	7.1	6.4	3.3	4.0
Albania	95.0	7.3	..	26.3	16.0	18.4	..	..	..	7.6	9.8	0.8	1.6
Bosnia and Herzegovina	..	..	..	9.6	10.6	15.3	..	..	..	8.2	..	1.4	1.7
Bulgaria	70.6	2.4	5.2	43.1	-12.3	3.2	71.7	25.3	..	9.8	9.1	5.2	4.7
Croatia	77.9	-0.3	3.8	56.0	-1.4	2.8	177.9	-5.9	-5.5	9.7	10.7	3.0	6.3
Czech Republic	95.3	-0.2	3.1	76.9	-3.1	5.0	103.4	-5.5	3.8	5.0	6.0	5.5	8.4
Hungary	99.4	4.5	6.2	114.0	10.7	21.0	125.0	6.6	6.1	9.1	4.3	3.1	4.0
Poland	121.9	4.1	5.6	122.3	4.3	10.2	171.1	6.9	4.0	7.5	6.4	3.0[c]	3.6[c]
Romania	75.8	-3.2	2.1	42.7	-11.2	5.0	62.1	-10.8	..	4.3	5.4	4.9	1.7
Slovakia	100.5	1.9	1.7	76.4	-3.4	8.3	90.6	-18.8	-4.4	9.1	9.7	1.3	1.3
Slovenia	105.3	5.0	4.9	75.6	-0.5	8.4	180.1	17.0	..	3.5	3.6	0.5	0.4
The former Yugoslav Republic of Macedonia	76.8	2.7	10.4	45.8	-2.6	10.7	77.6	1.2	..	8.0	11.1	1.1	1.7
Yugoslavia	41.6	-19.3	..	35.2	-23.1	19.9	..	..	..	..	..	..	..
Baltic states	65.1	-2.3	3.9	41.3	-7.4	3.5	..	..	..	10.1	6.6	5.9	4.1
Estonia	79.1	-1.1	6.4	56.7	-3.9	12.0	136.5	-15.2	1.7	8.5	5.4	8.2	5.8
Latvia	59.5	0.1	5.2	45.3	-5.4	3.8	45.1	-10.4	24.1	12.7	5.7	5.3	5.4
Lithuania	63.4	-4.2	1.9	35.3	-9.9	-0.8	149.0	-5.6	..	9.4	7.8	5.1	2.6
CIS	55.5	2.9	7.0	52.2	7.2	10.0	..	..	..	-7.8	..	2.6	1.7
Armenia	60.5	3.3	2.6	44.5	5.2	2.9	12.1	0.5	..	17.8	..	9.4	9.1
Azerbaijan	46.8	7.4	8.5	28.0	3.6	4.7	..	..	..	20.7	-0.2	23.7	4.2
Belarus	81.4	3.4	4.0	95.6	10.3	5.6	59.1	-5.4	..	2.1	5.3	4.1	1.2
Georgia	31.3	2.9	-1.8	16.1	7.4	9.1	..	..	..	6.0	..	3.5	2.9
Kazakhstan	62.0	1.7	10.5	49.8	2.7	16.3	19.2	-0.5	..	1.6	..	9.6	8.3
Kyrgyzstan	66.2	3.6	7.4	40.2	-1.7	3.3	33.5	-11.9	..	20.3	..	0.9	-0.4
Republic of Moldova	32.7	-4.4	1.7	33.7	-9.0	3.6	53.2	-19.5	..	6.5	13.5	1.1	12.9
Russian Federation	57.6	3.2	7.5	49.7	8.1	10.3	17.4	-1.7	..	-12.7	-13.2	1.8	1.0
Tajikistan	33.1	3.7	6.5	37.4	5.6	9.0	..	..	..	-5.1	..	2.2	2.7
Turkmenistan	74.0	16.0	14.0	62.0	15.0	14.0	..	..	..	23.4[d]	..	1.9	1.5
Ukraine	39.3	-0.4	5.0	51.0	4.0	10.8	15.9	–	..	-1.9	3.0[e]	1.1	2.6
Uzbekistan	93.9	4.4	3.8	119.2	6.1	6.2	..	..	..	0.5	..	1.0	1.0
Total above	66.1	2.2	6.0	60.6	3.4	9.9	..	..	..	1.1	..	3.1	3.0
Memorandum items:													
CETE-5	109.0	3.1	4.8	100.4	2.8	10.8	..	..	..	7.2	6.0	3.2	4.1
SETE-7	70.7	-3.0	4.2	42.5	-11.5	6.9	..	..	..	7.0	8.0	4.0	3.5
Former Soviet Union	55.8	..	..	51.8	..	..	..	..	..	-8.7	-8.8	..	..
Former GDR	..	..	..	55.3	4.8	..	..	..	..	..	..	..	..

Source: UN/ECE Common Database, derived from national and CIS statistics.

a January-June.

b Data for 2000 are preliminary.

c Cash basis.

d Estimate.

e January-March.