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CAPITAL INFLOWS INTO THE TRANSITION ECONOMIES SINCE 1989

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(i) Introduction

The potential for foreign capital flows to raise economic growth is well recognized: among other things, they can supplement domestic savings, improve the allocation of resources and act as a conduit for new technology and know-how. For the transition economies, burdened by decades of economic backwardness, foreign capital can facilitate the ongoing process of economic reform and restructuring and help to improve international competitiveness. Success in these areas will improve their chances of narrowing the income gap between them and the western market economies.

In subsection (ii) financial conditions in 1990 and the ensuing financial turbulence in the region are discussed; subsection (iii) summarizes some of the key reforms and institutional arrangements which were essential for the development of sustainable, market-determined capital inflows; subsection (iv) overviews the growth and changing composition of financial inflows; and some observations and lessons are drawn in subsection (v).

(ii) Baptism by financial crisis

In 1990, the external financial situation of several eastern countries had become precarious. In the preceding years, external debt had risen and foreign exchange reserves had been drawn down as governments tried to prop up local economies with imports. Poland and Yugoslavia had a long history of excessive debt and had defaulted in the 1980s. However, highly indebted Bulgaria and Hungary were considered creditworthy (for some years Hungary had been rated by Moody's Investment Services)[1] as was Czechoslovakia. The debts of Albania and Romania were low, that of the latter because of the decision to liquidate all foreign debt after the default of 1981.[2] In Albania, the communist government had adhered to a long-standing policy of avoiding foreign loans.

Increasingly, however, the political upheavals in the region, the collapse of domestic output, and the demise of CMEA trading relationships resulted in a general downgrading of credit ratings (chart 1). By early 1990, commercial banks had curbed their lending to the area also in part because of reports of Soviet arrears in payments to western suppliers. Furthermore in:

- 1990: Bulgaria declared a moratorium on its foreign payments;
- 1991-1992: the SFR of Yugoslavia broke up and the successor states inherited $15 billion of foreign debt and the task of independently normalizing their relations with creditors. Over $5 billion in official reserves vanished leaving the successor states to find their own liquidity;
- 1991: the dissolution of the Soviet Union occurred late in this year. In October, the successor countries of the former Soviet Union effectively defaulted on Soviet debt obligations following the depletion of official reserves. Russia eventually assumed full responsibility for the entire external debt (receiving all assets in return). The successor states emerged from the deal largely debt free but lacking international reserves;
- 1992: Albania defaulted on large amounts of short-term debt obligations, most of which were accumulated as the result of speculation in foreign currencies;
- 1993: in January Czechoslovakia was dissolved, an event anticipated with some concern by investors. Eventually, the country's good credit rating was inherited by the Czech Republic, but Slovakia was marked down.

The financial distress of this period, accompanied by bouts of capital flight, triggered adjustments in current account balances (resulting in smaller deficits or higher surpluses), which exacerbated the fall in domestic output. Many of these problems would take years to resolve.

(iii) The path to normalcy

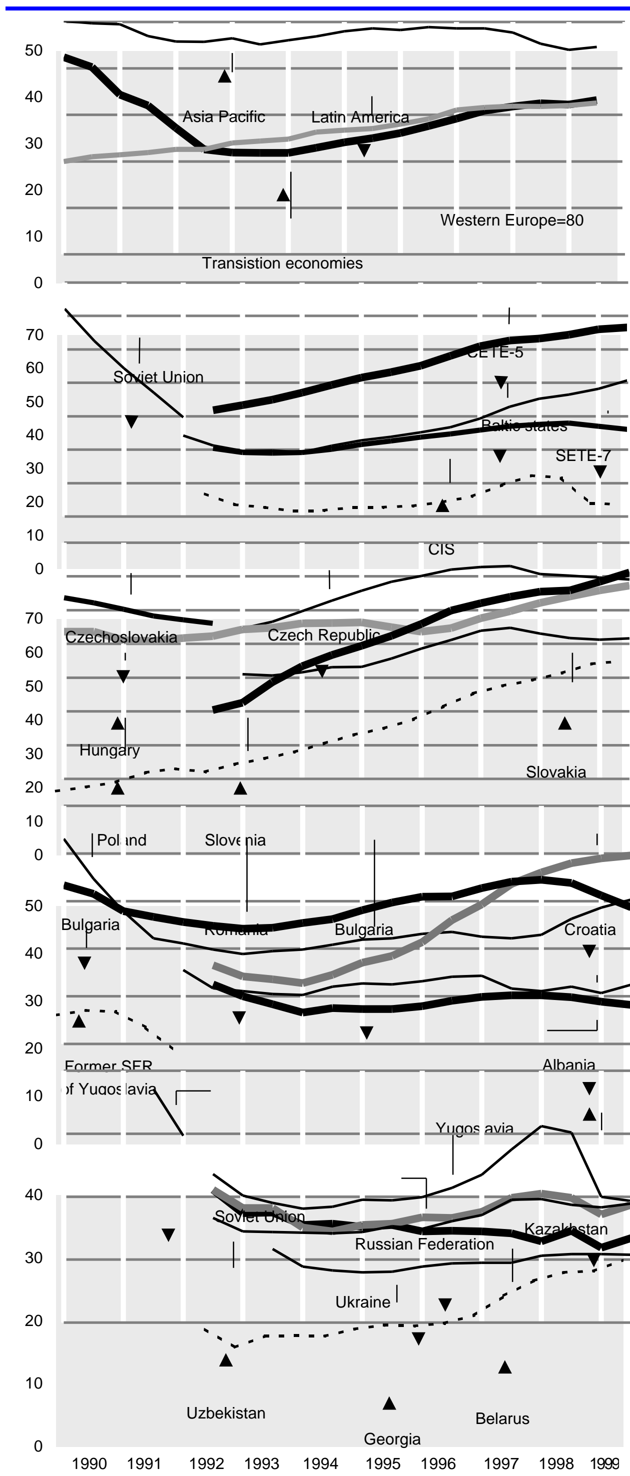
More fundamentally, the transition economies were faced with the task of implementing extensive economic and institutional reforms so as to establish the conditions for sustainable market-determined capital inflows and the efficient absorption of resources. Prior to the transition, the eastern economies were unable to attract the full range of market-based foreign capital. Under the centrally planned system, insulated from the international economy, there was no need to develop the necessary market-supporting legal and institutional frameworks.

[1] This was a Ba1 sub-investment grade rating.

[2] The debt was repaid by draconian cuts of imports and investment, a policy which left the country with an obsolete capital stock and greatly impaired export capacity. This policy contributed to Romania's poor economic condition at the beginning of the transition.

CHART 1

Credit ratings of selected regions and ECE transition economies, 1990-1999
(Scale 0-100)



Source: *Institutional Investor* (London), various issues.

Note: SETE-7 excludes Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia. The CIS aggregate reflects only those countries in the lower panel. A country with a grade of 100 stands little chance of default.

Sovereign borrowing predominated, mainly in the form of syndicated and bilateral loans. Governments also decided the domestic allocation of funds, and foreign investment was prohibited or tightly controlled.[3] Very briefly, the necessary elements of systemic change involved: allowing resident economic agents to raise capital; the creation of domestic securities markets; privatization (a basis for equity markets); legalization of foreign direct investment; and the partial liberalization of other capital flows (table 1). These reforms were introduced in parallel with macroeconomic stabilization. Better initial conditions and an early launch of the reforms contributed to central Europe's lead in the creation of a positive investment climate.

Accession to the IMF and World Bank was a priority in order to gain access to financial resources and policy advice, and to reassure foreign investors. An approved IMF programme has been a condition for the release of certain World Bank and various other bilateral funds (below) and, if necessary, for the normalization of creditor relations. Recognizing the particular challenges of transition, the IMF introduced the Systemic Transformation Facility (STF) which provided additional funding under simplified conditions. By 1993, virtually all of the ECE transition economies were IMF members (table 1) and had drawn on its resources.

For countries in default, the normalization of relations with commercial (London Club) and official (Paris Club) creditors is generally a precondition for re-entering the international credit markets. It also tends to improve foreign assessments of the domestic investment climate. Certain types of investor are legally prohibited from investing in countries in default, if they are not already deterred by a country's balance of payments prospects. The restructuring of debt, which is central to Paris and London Club agreements (table 1), can provide breathing space for putting an economy in order and upgrading debt servicing capacity. By 1999, only Yugoslavia had failed to conclude such accords. If large debts have rendered a country insolvent, debt forgiveness can improve its chances of regaining creditworthiness. Albania, Bosnia and Herzegovina, Bulgaria and Poland all received debt relief from commercial banks, and Bosnia and Herzegovina and Poland from official creditors as well.[4]

In 1989 the international community launched a plan of official assistance intended to provide support for economic reform. Coordinated by the EU, the G-24 programmes pledged grants, emergency aid and new

[3] Yugoslavia was an exception as enterprises had substantial autonomy.

[4] Poland was accorded special treatment by the Paris Club which included a 50 per cent reduction in the net present value of the stock of eligible debt. The official debt of Bosnia and Herzegovina was reduced as part of the Dayton Accord.

bilateral loans.[5] They were eventually extended to most east European and Baltic countries. Later, similar programmes of assistance were introduced for the CIS, including a $24 billion financing package for Russia announced by the G-7 in April 1992. A new institution, the EBRD, was created to help support the transformation with equity investments and loans.

Since the early 1990s most transition economies have strived to improve their creditworthiness, in order to broaden their access to private capital and to obtain lower borrowing costs. Commitment to economic reform, better external financial positions and improved economic performance, as well as debt restructuring agreements (Bulgaria, Croatia, Poland, Slovenia and Russia), seem to explain much of the improvement in credit ratings (chart 1). The central European countries lead in this respect with a current average rating of 56, still far below the 80 of western Europe. Several countries were downgraded after the Asian and Russian financial crises, often as a consequence of their own policies, but others have improved (Hungary was the latest country to receive an upgrade in February 2000). Currently, six transition economies are rated investment grade risks (table 1).

TABLE 1

Financial milestones in the transition economies

	IMF membership	Debt restructuring: Paris Club	Debt restructuring: London Club	Capital account liberalization[a]	Moody's/ Standard & Poor's credit ratings
Albania	Oct.-91	Dec.-93	**Jul.-95**	16.7	–
Bosnia and Herzegovina	Dec.-95	**Oct.-98**	**Dec-97**	17.6	–
Bulgaria	Sept.-90	Apr.-91 Apr.-94	**Jul.-94**	35.3	B2/B
Croatia	Dec.-92	Mar.-95	–	44.4	**Baa3/BBB-**
Czech Republic	Jan.-93			73.7	**Baa1/A-**
Hungary	May-82			59.5	**Baa1/BBB+**
Poland	Jun.-86	**Apr.-91**	**Oct.-94**	55.3	**Baa1/BBB**
Romania	Dec.-72			12.5	B3/B-
Slovakia	Jan.-93			23.7	Ba1/BB+
Slovenia	Dec.-92			40.5	**A3/A**
The former Yugoslav Republic of Macedonia	Dec.-92	Jul.-95	–	23.3	–
Yugoslavia	–			..	–
Estonia	May-92			..	**Baa1/BBB+**
Latvia	May-92			..	**Baa2/BBB**
Lithuania	Apr.-92			..	Ba1/**BBB-**
Armenia	May-92			..	–
Azerbaijan	Sept.-92			..	–
Belarus	Jul.-92			..	–
Georgia	May-92			..	–
Kazakhstan	Jul.-92			..	B1/B+
Kyrgyzstan	May-92			..	–
Republic of Moldova	Aug.-92			..	B2/
Russian Federation	Jun.-92	Apr.-93 Apr.-96	Dec.-92 Sept.-97	..	B3/CCC+
Tajikistan	Apr.-93			..	–
Turkmenistan	Sept.-92			..	B2/
Ukraine	Sept.-92			..	Caa3/
Uzbekistan	Sept.-92			..	–
Memorandum items:					
Czechoslovakia	Sept.-90			..	..
Soviet Union	Jul.-91 [b]			..	..

Source: IMF, *International Financial Statistics* and *Impact of EMU on Selected Non-European Countries*, Occasional Paper No. 174 (Washington, D.C.), 1998; World Bank, *Global Development Finance* (Washington, D.C.), 1999.

Note: Bold indicates that the debt restructuring agreement also involved debt reduction. In the case of credit ratings, bold indicates an investment grade rating.

[a] Index of capital account liberalization, ranging from 0-100 (fully liberalized capital account).

[b] Applied for membership.

(iv) The development of capital inflows since 1990

These economic and institutional changes have paved the way for capital flows into the eastern countries.[6] Early in the decade, net capital flows into *eastern Europe* were modest (chart 2), inflows of official funds being partially offset by capital flight. The capital surge in 1993 originated in Hungary and the Czech Republic. Hungary borrowed heavily to finance its emerging current account deficit and privatization-related FDI also rose sharply. In the Czech Republic portfolio investment responded to the opening of the securities markets to foreigners. In both countries, the outflow of short-term funds (capital flight) was reversed. In 1995 the flow of funds into eastern Europe peaked at 7.3 per cent of GDP (chart 2). This new surge reflected a greater diversity of countries and types of capital. The Czech Republic and Hungary again led the way, the latter reporting record privatization revenues. In Poland FDI, portfolio and other short-term investments increased as confidence rose following the normalization of credit relations and improving economic performance. Henceforth, Poland became the main destination of foreign capital entering the area. Starting in 1995, Croatia, Romania and Slovenia also experienced larger and sustained capital inflows.

In several cases capital inflows were responding to the large premia on domestic interest rates[7] stemming from tough anti-inflationary policies. These high yields attracted foreign investors and encouraged residents to seek cheaper credits abroad. This practice was perhaps

[5] Included were balance of payments loans (conditional on IMF approval) and, from the EU, European Investment Bank loans. UN/ECE, "International support for eastern transformation", *Economic Survey of Europe in 1991-1992*.

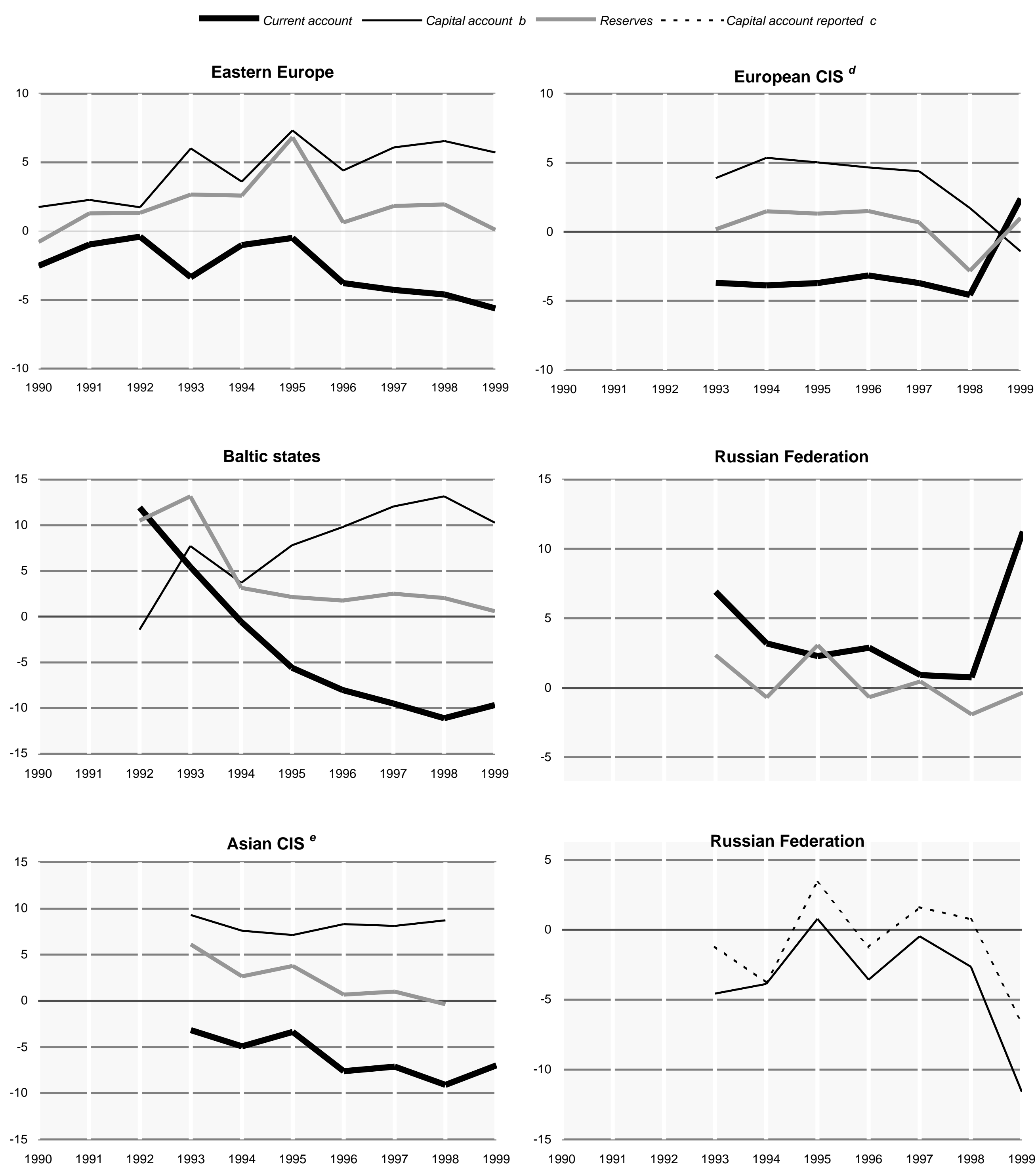
[6] This section is based on national balance of payments statistics. However, data through 1997 in World Bank, *Global Development Finance* (Washington, D.C.), 1999 has been used for the official and private flows in chart 6 (a breakdown which is generally not possible from available balance of payments statistics). The discussion of medium- and long-term debt below, based on balance of payments data, necessarily includes both official and private debt (although as shown below the former has declined in importance). Due to various recording problems, there is considerable uncertainty about the Russian balance of payments data.

[7] In Hungary and Poland, such premia were high even allowing for the pre-announced rates of currency depreciation. The fixed peg exchange rate policy in the Czech Republic was perceived by investors as removing exchange rate risk. UN/ECE, *Economic Bulletin for Europe*, Vol. 49, 1997.

CHART 2

Balance of payments of the transition economies, 1990-1999 [a]

(Per cent of GDP)



Source: UN/ECE secretariat, based on national balance of payments statistics.

a January-September.

b Including errors and omissions.

c Excluding errors and omissions for the Russian Federation.

d Belarus, Republic of Moldova and Ukraine.

e Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

TABLE 2

Net capital flows into the transition economies, by type of flow, 1993-1998

	Total flows (1993-1998)			*Private flows (Per GDP)* [a]	
	Dollars (billions)	*Per capita*	*Per GDP* [a]	*Total*	*Long-term*
Eastern Europe [b]	110.9	1 036	133	106	79
Albania	0.9	298	111	26	39
Bosnia and Herzegovina [c]	3.8	1 082	..	..	..
Bulgaria	2.5	292	62	47	-1
Croatia	7.6	1 686	250	159	137
Czech Republic	22.7	2 208	169	154	112
Hungary	20.5	2 017	204	207	160
Poland	32.4	837	112	80	61
Romania	12.4	550	87	44	42
Slovakia	8.3	1 547	163	148	73
Slovenia	2.2	1 094	78	108	108
The former Yugoslav Republic of Macedonia	1.5	748	175	20	5
Baltic states	9.0	1 181	188	92	79
Estonia	2.4	1 646	218	131	100
Latvia	1.5	595	106	109	103
Lithuania	5.1	1 389	223	63	55
CIS	-28.0	-131	-22	21	16
Armenia	1.7	473	229	14	12
Azerbaijan	4.0	528	256	99	99
Belarus	3.8	366	62	14	10
Georgia	1.8	348	105	6	6
Kazakhstan	6.1	372	77	76	71
Kyrgyzstan	1.5	325	141	26	23
Republic of Moldova	1.1	252	113	43	40
Russian Federation	-40.8	-277	-40	21	17
Tajikistan	0.8	129	136	29	23
Turkmenistan	1.7	392	148	156	110
Ukraine	8.0	156	47	23	17
Uzbekistan	2.9	124	59	39	30
Total above [b]	91.9	231	39	56	43
Memorandum items:					
CETE-5	86.1	1 295	143	125	92
SETE-7 [b]	24.8	612	108	58	46
Russian Federation [d]	2.6	18	3	21	17
Asian CIS	20.4	288	105	61	53
Three European CIS [e]	12.9	195	54	21	16

Source: UN/ECE secretariat estimates, based on national balance of payments statistics. Private flows in 1993-1997 are from the World Bank, *Global Development Finance* (Washington, D.C.), 1999.

Note: Total flows are the sum of the capital and financial accounts and errors and omissions as reported in the national balance of payments statistics. Total private flows includes FDI, long-term private guaranteed and non-guaranteed debt, short-term debt and portfolio equity flows.

a Per $1,000 GDP in 1997. These are purchasing power parity (PPP) estimates of GDP.

b Excluding Bosnia and Herzegovina and Yugoslavia.

c 1994-1998.

d Excluding errors and omission from total flows.

e Belarus, Republic of Moldova and Ukraine.

most pronounced in the Czech Republic between 1993 and early 1997 and in Poland which was swamped by short-term flows in 1995-1998.

In the countries of the former Soviet Union, capital imports generally picked up only in 1992 or later. Inflows into the Baltic states increased rapidly (to nearly 13 per cent of GDP), until the downturn in 1999 (chart 2). In the Asian CIS, capital imports doubled in six years. However, the stable ratio of inflows to GDP conceals uneven developments between countries. In the *European CIS*, however, the ratio declined slowly until foreign financial crises and domestic problems caused inflows to plunge in 1998-1999. Although the exact size of *Russia's* capital flows is uncertain, all measures indicate substantial volatility. Chart 2 shows reported financial inflows and, separately, the sum of recorded flows and "errors and omissions". This latter item, generally considered to reflect unrecorded capital flows (i.e. largely capital flight), has typically been large and negative (as is common in the developing countries, but not recently in eastern Europe). Net capital outflows (including unrecorded capital) averaged about 3 per cent of GDP in 1993-1998. This has been made possible by a large current account surplus and foreign borrowing.

The early reforming countries – the Czech Republic, Hungary and Poland – have attracted most of the foreign capital (table 2), about 60 per cent of the regional total. On a per capita basis, the Czech Republic and Hungary also rank high as do some of the south European and Baltic countries (chart 3). The top five countries attracted nearly nine times more capital per capita than the bottom five. Several low income countries (Azerbaijan, Armenia and The former Yugoslav Republic of Macedonia) are near the top of a ranking based on the ratio of inflows to GDP (table 2).

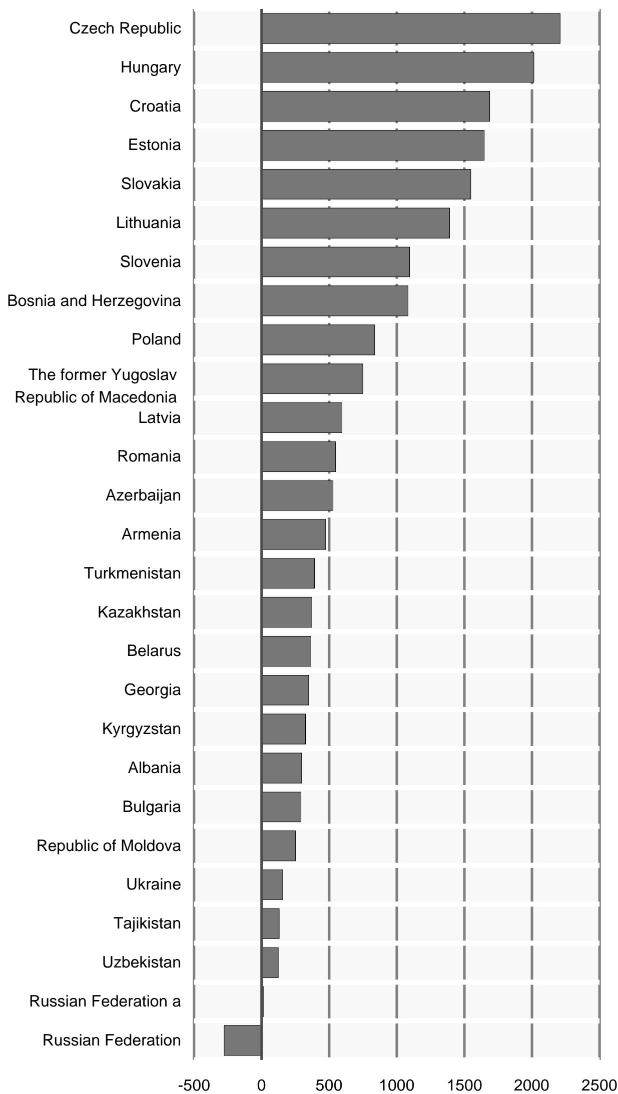
Much of the intercountry differences in total capital inflows reflects their degree of economic reform (chart 4). This is not surprising, as access to even official funds is often conditional on the implementation of structural reforms and sound macroeconomic policies. Private capital is unlikely to be attracted to countries where the protection of property rights is weak and the institutional framework for market-based activity is deficient.

The geographical distribution of net capital flows into the transition economies has gradually become more diversified (chart 5). Since the first half of the decade, the dominance of central Europe has diminished while the shares of the other groups (but not the European CIS) have risen.

Financial inflows (often including IMF funds) have allowed for the rebuilding of official reserves (chart 2). In eastern Europe, reserves increased markedly as a result of the surge in capital inflows in 1993-1995. However, the rate of accumulation slowed as current accounts deficits rose (which was also true in the Baltic states). In three European CIS countries official reserves were drawn down in response to the tightening of financial constraints in 1997-1998 (the upturn in reserves in 1999 stems from their shift to current account surplus. Capital and current accounts have been roughly balanced in the Asian CIS and

CHART 3

Capital flows into the transition economies, 1993-1998
(Dollars per capita)



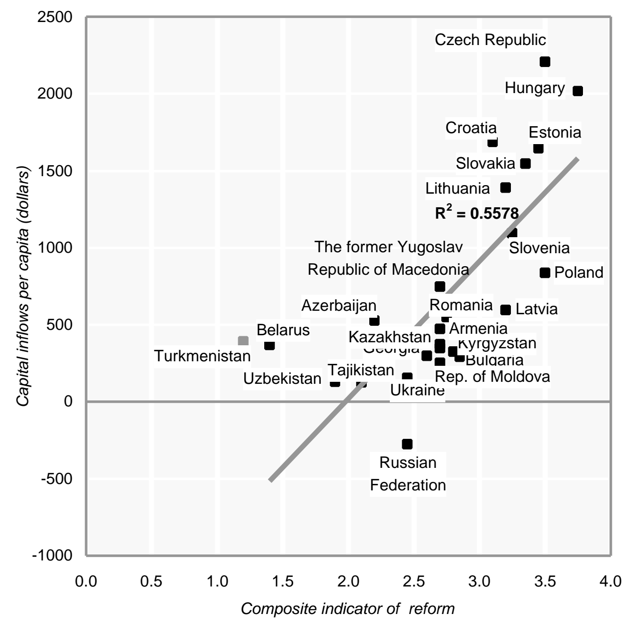
Source: UN/ECE secretariat, based on national balance of payments statistics.

Note: Flows include errors and omissions.

a Excludes errors and omissions.

CHART 4

Progress in transition and total capital inflows per capita, 1993-1998



Source: UN/ECE secretariat, based on national statistics. Transition indicators are from EBRD, *Transition Report 1999* (London).

Note: The regression excludes Turkmenistan.

official reserve positions of most of these countries have been consequently weak.

The growth of capital inflows into the transition economies has been associated with major changes in their composition. In the early stages of the transition, official funds, initially mostly IMF credits and grant aid, accounted for the bulk of financial inflows (chart 6). In central Europe, IMF loans peaked already in 1991, their subsequent rapid repayment[8] offsetting the growth of other multilateral loans and grants. The pattern was similar in the Baltic states, although net repayments of IMF credits started later. By contrast south-east Europe has continued to rely heavily on official sources.[9] In the three European and Asian CIS the use of official resources rose until 1995. Russia received large grants in the first half of the decade, but bilateral loans (used extensively by the Soviet Union) have diminished. However, borrowing from the IMF has been heavy, especially in 1995-1996. By 1997, the net flows of private funds into the transition economies were generally several times larger than official flows (chart 6 and table 2). This was most pronounced in central Europe, which accounted for 57 per cent of total private flows during 1993-1997. Relative to GDP, the central European countries, Croatia, Estonia, Latvia, Azerbaijan and Turkmenistan, have been the leading recipients (table 2).

The growing importance of private capital has been associated with an increasing share of funds of a long-term nature (FDI and long-term debt, table 3). The emergence of FDI as the principal source of external finance is generally viewed favourably since such funds are often accompanied by new

[8] The Czech Republic, Hungary and Poland were free of IMF debt by 1996.

[9] Croatia is an exception. Bosnia and Herzegovina, which is not included in the chart for lack of data, has drawn on an official aid package of $5 billion included in the Dayton Accord.

TABLE 3

Net capital flows into the transition economies, by type of finance, 1993-1998

(Per cent of GDP)

	CETE-5		*SETE-7* [a]		*Baltic states*		*Russian Federation*		*European CIS*		*Asian CIS*	
	1993-1995	*1996-1998*	*1993-1995*	*1996-1998*	*1993-1995*	*1996-1998*	*1993-1995*	*1996-1998*	*1993-1995*	*1996-1998*	*1993-1995*	*1996-1998*
Capital transfers [b]	1.8	0.1	0.8	0.2	-0.1	0.1	0.2	-0.1	0.1	0.2	-0.4	-0.6
Foreign direct investment	2.3	2.6	0.9	2.9	4.2	5.7	0.4	0.7	0.6	1.3	3.4	5.3
Long-term debt	0.9	0.3	1.5	3.4	4.8	4.3	-0.7	-0.3	4.8	2.5	4.8[c]	3.7[c]
External bonds	1.4	0.4	-0.1	0.8	0.1	0.7	-0.1	1.5	-0.2	0.4	–	0.4
IMF	-0.5	-0.1	0.1	–	1.4	-0.2	1.1	0.9	1.6	0.6	1.0	0.9
Short-term funds	1.3	2.3	1.1	1.0	-2.4	1.7	-2.0	-2.4	-0.7	-0.5	..	..
Portfolio investment [d]	0.6	0.6	–	0.7	-0.4	-0.9	-0.2	4.0	0.1	0.7	..	..
Short-tem flows	0.3	0.9	0.7	-0.1	1.3	1.5	0.1	-3.9	-0.6	-0.5	..	..
Errors and omissions	0.4	0.8	0.4	0.4	-3.4	1.2	-1.9	-2.5	-0.2	-0.7	..	..
Total net flows	6.2	5.2	4.2	7.4	6.5	11.8	-2.1	-2.1	4.8	3.6	7.8	8.4
Memorandum item:												
Total flows (billions)	40.5	45.3	7.8	16.7	2.0	7.0	-16.5	-24.3	6.3	6.6	7.4	13.0

Source: National balance of payments statistics; World Bank, *Global Development Finance* (Washington, D.C.), 1999 (for net bonds and portfolio equity flows).

a Excludes Bosnia and Herzegovina and Yugoslavia.

b Includes debt write-offs under debt restructuring agreements, especially important for Poland (in CETE-5) during 1993-1995 (see text).

c Includes portfolio investment, short-term investment and errors and omissions.

d Excludes external bonds.

technologies, improved corporate governance and marketing, and so on. FDI has tended to be linked for most of the period with the privatization of state assets, which also helps to explain why slowly reforming countries have received little FDI. However, reinvested profits and greenfield investments are becoming more important. On average, the share of FDI in total net inflows is higher in transition economies than in developing economies.[10]

South-east Europe and the Baltic states have increased their use of long-term, mainly private, debt (table 3). Typically this mode of financing is only open to creditworthy countries. In southern Europe, Croatia and Romania have resorted to private debt financing to cover large current account deficits since FDI inflows have been small. By contrast, long-term debt inflows into central Europe diminished in 1996-1998, when sovereign borrowing was largely obviated by foreign private investment. In Slovenia the current account was in surplus and Hungary was actually paying off foreign debt (with privatization revenues), having brought the current account under control. However, Slovakia's growing current account deficits were financed by foreign debt. In the CIS, low credit ratings generally constrained access to financial markets, although Kazakhstan, and for a limited period, the Republic of Moldova, Russia and Ukraine, were able to issue bonds. Borrowing became considerably more difficult for virtually all the transition economies after the Asian and Russian financial crises.

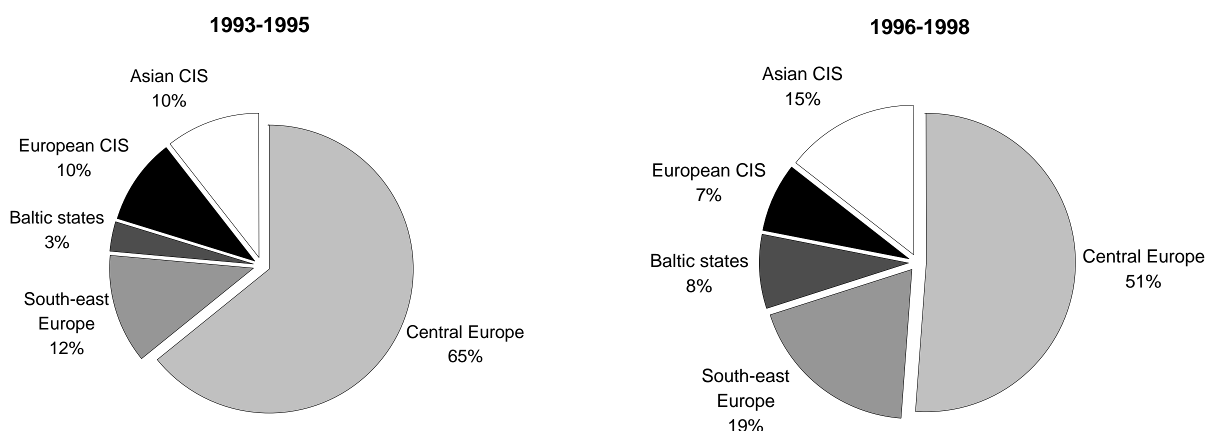
Short-term funds are defined here as short-term debt, portfolio equity investment and errors and omissions as reported in the balance of payments. The latter item is generally taken to represent unrecorded capital flows, which in the transition economies have been generally positive (the exceptions are Kazakhstan, Russia and recently, Ukraine). Virtually all the transition economies have received large short-term inflows (often associated with tight macroeconomic policies and high interest rates), but in central Europe their importance grew, from 20 per cent of total inflows in 1993-1995 to 44 per cent in 1996-1998. In general these short-term funds have not been necessary for current account financing, a risky practice because of their volatility. However, they have posed challenges for macroeconomic policy, large inflows causing exchange rate appreciation and necessitating sterilization operations.[11] On the other hand, outflows triggered during the past two years by contagion or unsustainable domestic policies have sometimes led to currency crises.

[10] In 1990-1998, FDI accounted for 34 per cent of capital inflows into the developing economies (up from 18 per cent in 1983-1989). UNCTAD, op.cit., chart 5.3.

[11] UN/ECE, *Economic Bulletin for Europe*, Vol. 49, 1997 and *Economic Survey of Europe, 1999 No. 1*, sect. 4.3.

CHART 5

Share of regions in total net inflow of finance in transition economies, 1993-1998
(Per cent)



Source: UN/ECE secretariat, based on national balance of payments statistics.

Note: The chart excludes the Russian Federation because its average net inflows were negative during these periods. Southern Europe excludes Bosnia and Herzegovina and Yugoslavia. Net inflows include errors and omissions.

(v) Concluding observations

Despite the difficult financial situation in the early 1990s and the various obstacles to be overcome (in some countries key problems were not sorted out until the middle of the decade), many transition economies have attracted capital inflows of the order of 5 per cent of GDP or more, similar to that received by the developing economies in the 1990s.[12] However, a significant number have still failed to create the conditions for attracting private capital inflows and recently several have suffered new setbacks (e.g. Russia in 1998).

It is likely that IMF programmes and other official funds provided vital support early in the transition in helping to build credibility, boosting foreign exchange reserves and paving the way for credit ratings (although Slovenia accomplished this without any IMF funds at all). IMF resources appear to have been particularly important in 1991 when western banks withdrew new credits. In most central European and Baltic countries, resort to IMF facilities was temporary (as in fact it was intended to be), but in general recidivism has prevailed in the region.

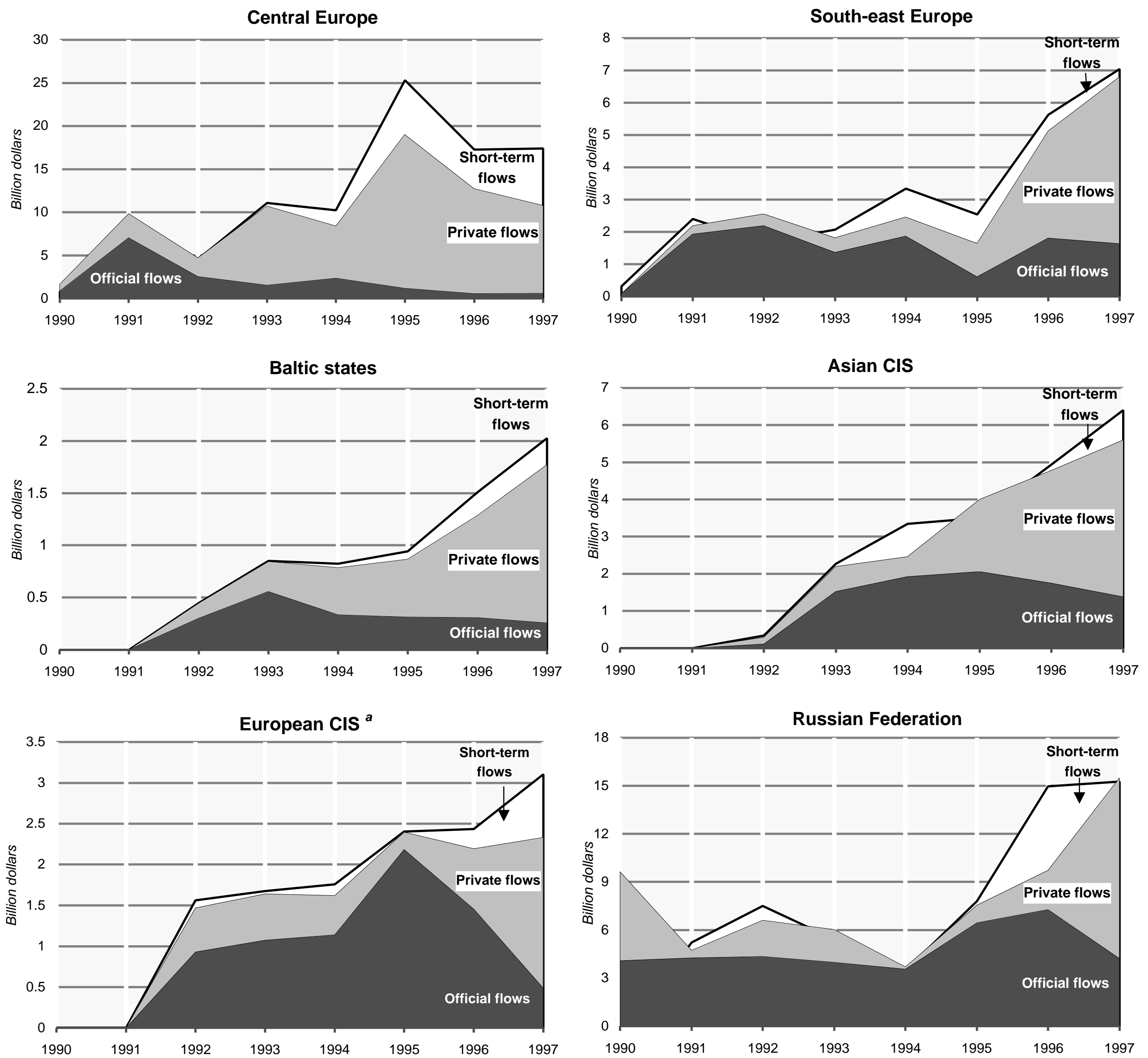
The developments described above have implications for the sustainability of financial inflows and current account deficits. The shift toward private long-term capital is desirable since the global supply is relatively elastic (unlike official funds). Provided that these countries remain creditworthy, financing through long-term debt should not be a problem. However, the risk of market instabilities and of interruptions to the flow of long-term funds persists (as occurred in 1997 and 1998). Although most creditworthy transition economies have been able to tap the international fund markets again, corporate borrowing is still below the levels prevailing before the Asian financial crisis. The growth of FDI has been viewed positively since it does not add to foreign debt (although it eventually gives rise to profit repatriation) and appears to be more stable than other funds. Moreover, FDI proved to be resilient in the wake of the Asian and Russian crises. With policy makers increasingly relying on FDI for current account financing, assuring future flows takes on additional importance.

Despite their particularly difficult initial financial conditions, Poland, Croatia, Slovenia and the Baltic states currently enjoy some of the highest credit ratings and have attracted the largest amounts of foreign capital among the transition economies. In doing this they have demonstrated that dire financial straits are not necessarily a permanent impediment to market entry. They have benefited from the increasing willingness of investors to differentiate between countries on the basis of economic fundamentals (although in crises they are still likely to suffer from contagion). Other countries, including some considered creditworthy in 1990, have not fared as well in the ratings. It is also true, however, that some of these have still been able to attract funds temporarily. Plenty of lenders were prepared to extend cash (at high yields) in the absence of fundamental reform as long as debt levels did not seem to be excessive, although financial crises have generally followed. Experience also shows that debt restructuring is a necessary but not a sufficient condition for regaining long-lasting access to the capital markets. Even debt reduction has not guaranteed success in this regard as reflected in the lone positive example of Poland.

[12] UNCTAD, op. cit., table 5.1.

CHART 6

Total, official and private net resource flows to the transition economies, 1990-1997
(Billion dollars)



Source: UN/ECE secretariat, based on World Bank, *Global Development Finance* (Washington, D.C.), 1999.

Note: Official flows include official loans and grants; private flows include FDI, long-term debt and short-term flows (short-term funds and portfolio equity flows).

[a] Excluding Russian Federation.