Globalization: Trends, Challenges and Opportunites for Countries in Transition

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Session I

GLOBALIZATION AND THE INTEGRATION OF INDUSTRY IN THE REGION

UNITED NATIONS
INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna, 2000

Preface

Globalization—the process of continuing integration of the countries in the world—is strongly underway in all parts of the globe. Supported by accelerating pace of technological change, by price and trade liberalization, and by growing importance of supranational rules, globalization has exposed national economies to much more intense competition than ever before. In countries in transition, the process of their integration into global economy has been characterized by at least two region specific features. First, this is the only region in the world that was practically de-linked from other parts of the world before the late 1980s. Second, the countries of the region have been faced with a highly challenging process of transition from centrally-planned socialist-type economy into a full-fledged market economy based on private ownership.

The combination of transition and globalization processes affects overall development of transition economies in most fundamental ways. Rapid advancement in the process of transition accompanied by full participation in the global economy enables countries in a region and their economic agents to seize the new opportunities and reap benefits of globalization. Without basic developmental capabilities and the appropriate policy framework, however, economic actors in countries in transition will find themselves unable both, to advance efficiently the process of transition and to compete successfully in the global environment.

This paper has two main objectives, first, to review globalization and to analyse to what extent have transition economies already become integrated into the global economy, and second, to provide an assessment of the transition process over the last decade and to discuss the prospects for the future of transition.

Executive summary

World as a global economy

Globalization, a highly complex and controversial concept, is not a new phenomenon but a continuation of developments that have been going on for some considerable time. The recent trend of globalization of economic activities is qualitatively different, however, as the world has definitely ceased to be a collection of relatively autonomous economic agents that are only marginally connected and are more or less immune to events in their neighbourhoods. Today, globalization involves numerous features, but the following three seem to be the main engine driving global economic integration: *(a)* internationalization of production accompanied by changes in the structure of production, *(b)* expansion of international trade in trade and services, and *(c)* widening and deepening of international capital flows.

Globalization is now a forceful process that is unlikely to be reversed. The future policy alternatives for countries and regions have thus to be analysed in the context of the global economy with free trade of goods and services, free movement of capital, technology and skills and with improvements in transportation and communication links. In spite of significant differences among regions of the world, there are convincing arguments that call each region to design its own strategy on how to cope with the challenges of globalization.

Integration of transition economies into the global economy

Economic transition of countries of Central and Eastern Europe and their integration into the global economy are, in fact, the two sides of the same coin. There is no economic transition of these countries to market economy without establishing participation of economic actors from this region in the international markets of good, services, capital and labour. And vice versa, competitiveness of products from ex-socialist countries on international markets cannot be effectively established without dismantling the centrally-planned economic system that had over several decades of its existence proved to be economically inefficient and thus inferior to the market-led type of economy.

Ample empirical studies demonstrate remarkable achievements of transition economies over the last decade in integrating themselves into the world economy and this conclusion applies for all segments of integration. Similarly, as in other regions of the world, there have been striking disparities among individual countries of the region in the speed of their integration into the global economy. Among the explanations for differences, the following three seem to be the most important:

- The achieved level of transition; Empirical evidence clearly supports the conclusion that countries that have performed well in the transition process are today also countries that have succeeded to largely integrate themselves into the global economy.

- The achieved level of institutional integration; Of particular importance for faster integration seem to be Association Agreement with the EU and especially the beginning of the EU accession negotiations.
- Differences in geographic location of countries; Proximity of countries to main trading partners has also contributed to uneven integration of individual transition economies into global markets.

A decade of transition: achievements so far

Over the first decade of transition, two broad macroeconomic patterns have emerged. In the more advanced countries of the region, rapid liberalization accompanied with sound fiscal policies has resulted in a sustained macroeconomic stabilization. In less advanced countries, however, progress in liberalization and privatization has been slow and uneven and macroeconomic stabilization has been jeopardized by the continuous soft budget constraints. Reversal of inflation, renewed growth of fiscal imbalances and reduced access to international capital market that we have been witnessing in many less advanced countries of the region over the last two years are only some of the indications indicating that macroeconomic stability in these economies is still very fragile.

Macroeconomic reforms alone, although necessary, do not lead automatically to supply responses needed for a comprehensive transformation to a market economy. These reforms, namely, do not deal systematically with structural weaknesses of the country's economy. To address these weaknesses, a clearly defined set of microeconomic policies and structural reforms is needed. Similarly as in areas of macroeconomic stabilization, there are huge differences among individual transition economies in terms of the progress achieved in the structural transformation of their economies. Countries that have already carried out a comprehensive macroeconomic stabilization programme, primarily the CEECs and the Baltic states, are typically also countries that are now in a more advanced stage of transition. In contrast, countries that have been late with the introduction of macroeconomic measures are lagging behind also with structural transformation processes.

Major components of structural reforms that have been carried out by transition economies over the first decade of transition include:

- Adjustment of the legal and regulatory system; By now, a large majority of countries in the region have adopted laws in all areas fundamental for economic transformation. Although passing the legislation is an important step forward, experiences gathered over the recent years increasingly show that this is of limited relevance if not accompanied by all necessary by-laws as well as with effective implementation and enforcement.
- Financial sector reform; Countries in transition have gone a long way in transforming their financial system, and especially their banking systems. The transformation has been implemented through a combination of policy measures. In addition to the replacement of the original mono-bank system, government policies in this area have typically included reforms in prudential regulation and supervision, recapitalization and privatization of State owned banks and new entrance of new private banks. There are, however, big differences across the region both in terms of the design of these policies as well as in terms of their implementation.
- Enterprise sector reform; This segment of structural transformation is clearly at the very heart of the transition process and, in general, involves

processes associated with the transition from a public dominated to a private dominated economy. Progress of transition reforms in this segment has varied significantly among individual countries of the region. One general pattern has, however, emerged. Areas of reforms in which transition requires redistribution of assets, such as privatization, have on average moved steadily over the period, with small-scale privatization moving much faster than privatization of large companies. On the other hand, in areas of reforms that involve institution building, the progress has been the slowest.

Prospects for the future of transition

There seems to be a growing consensus that the region is now approaching the end of the first phase of transition. Although the process of change in this phase of transition has been remarkable, the tasks here have been in many respects more straightforward than those that follow. Main challenges of the new, second phase of transition are to make these new market economies function more efficiently and to build on the foundations established in the first phase of transition.

In order to respond effectively to challenges of the next phase of transition, countries of the region must continue with their structural reforms. Institutional strengthening and improved governance are expected to constitute the key elements of the next phase of transition. At a more operational level, six segments of structural reforms have been identified as being of particular importance for the second phase and therefore for the future of transition. They include:

- Changed role of the government; the process of transition does not simply mean withdrawal of the state from directing economic activity. What transition means is to transform the role of the state so that it will become supportive to markets and to private sector development.
- Continuation of enterprise sector reforms; Reform of the enterprise sector will continue to be at the heart of the next phase of transition and this relates to both, to the entry and growth of new private firms as well as for the restructuring of privatized and state-owned companies.
- Enforcing of financial sector reforms; In spite of significant achievements in this area over the last decade, the financial sector in transition economies, even in some of the more advanced countries, is still far below the efficiency level of financial institutions in industrialized countries. Major improvements are needed in the areas of competition enhancement, improvement of the regulatory environment and strengthening of the supervision.
- Human resource development; if countries in transition would like to increase international competitiveness of their economies, they will have to significantly strengthen their human resource capabilities. This implies that education and especially rehabilitation of R&D capacities in the region will have to get a much more prominent place in the next phase of transition.
- Improvement of physical infrastructure; In order to address the problem of distorted physical infrastructure, transition economies have been faced with large needs of building new infrastructure networks and replacing the existing old technology. Response to these needs have been strongly influenced by the severe pressure on government finance.
- Reducing poverty and income inequality; In order to address an increasing poverty and income inequality—they are becoming a serious obstacle

for public confidence in, and acceptance of, the reforms required in the next phase of transition—governments throughout the region will have to play in the future a much more active role in controlling poverty and income distribution.

Challenges for UNIDO

The process of globalization and its impact on development issues of countries in transition necessitates the international organizations, including UNIDO, to critically re-evaluate their technical cooperation strategies and policies and re-design the areas of intervention and programmes of assistance in the countries of this region along the lines of the new development paradigms, UNIDO business plan and service modules.

The above structural reforms that the countries in transition need to vigorously pursue, constitute at the same time the challenge for possible intervention by UNIDO, especially in such field as sustainable industrial policies and strategies including a conducive institutional support, private sector development with emphasis on small and medium scale enterprises, microeconomic improvement of the industrial enterprise performance including environmental norms, clean and energy efficient technologies, investment and technology promotion and human capacity building.

Contents

1 Introduction

Globalization—the process of continuing integration of the countries in the world—is strongly underway in all parts of the globe. While the movement of goods, services, ideas, capital and technology across national borders is not a new phenomenon, its process in the past decade marks a qualitative break with the past. Supported by accelerating pace of technological change, by price and trade liberalization, and by growing importance of supranational rules, globalization has exposed national economies to much more intense competition than ever before.

In countries in transition,[1] the process of their integration into global economy has been characterized by at least two region specific features. First, this is the only region in the world that was practically de-linked from other parts of the world before the late 1980s. Second, the countries of the region have been faced with a highly challenging process of transition from a centrally-planned socialist-type economy into a full-fledged market economy based on private ownership. As a consequence of political changes in the region, a number of newly independent States have been faced with an additional challenge of transition from a regional to national economy.

A combination of transition and globalization processes affects overall development of transition economies in most fundamental ways. Rapid advancement in the process of transition accompanied by full participation in the global economy enables countries in a region and their economic agents to seize the new opportunities and reap benefits of globalization. Without basic developmental capabilities and the appropriate policy framework, however, economic actors in countries in transition will find themselves unable both, to advance efficiently the process of transition and to compete successfully in the global environment.

This paper is aimed at providing a general framework for the analysis of how globalization trends interact with the process of transition. The paper is, however, not intended to address specific industrial sector issues of globalization and transition, as they represent the core of the second paper prepared for this Session.[2] There are two main objectives of this paper. The first one is to review globalization and to analyse to what extent transition economies already become integrated into the global economy. The second objective of the paper is to provide an assessment of the transition process over the last decade and to discuss the prospects for the future of transition.

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[1]The paper uses classification of countries in transition as determined in the EBRD's *Transition Report 1999*. Therefore, the countries of the region are divided in the following three groups:

(i) Central and Eastern European Countries (CEECs) the group includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Slovakia, Slovenia and the former Yugoslav Republic of Macedonia.

(ii) Commonwealth of Independent States (CIS) which includes as full or associate members all countries of the former Soviet Union, except the Baltic States; The group includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhzstan, Kyrgyzstan, Republic of Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

(iii) Baltic States; The group includes Estonia, Latvia and Lithuania.

[2]See, Kaczurba, Janusz. Industries of New Market Economies of Central and Eastern Europe and Newly Independent States in the Age of Globalization: Major Policy Issues, 2000.

In addition to this Introduction, the paper consists of four chapters. Chapter 2 addresses the global trend of globalization and describes its main features and implications. Chapter 3 puts transition economies into the globalization perspective and discusses what has been achieved in terms of their integration into the global economy over the last decade. In chapter 4, an overview of how far CEEC have come in their transition from centrally-planned to market economies, while chapter 5 outlines the challenges for the next phase of transition and consequently also the challenges associated with further international economic integration of transition economies into a global economy.

2 The world as a global economy

Globalization is a highly complex and controversial concept. The term, it has come into fashion in 1980s and 1990s, lacks universally accepted definition as well as a broad consensus on the appropriate empirical measures. Experiences show that the term "globalization" is used in both a descriptive and a normative sense. In a descriptive sense, globalization can be explained as a process where national markets are becoming increasingly interlinked, where the interdependence of production is intensified and where the mechanism deciding about the allocation in goods and factor markets is increasingly operating at a global level. In its normative sense, however, globalization is seen as a process of opening trade and foreign investment regimes of national economies (Berthelot, p. 1).

2.1 Main features of globalization

Globalization is not a new phenomenon but continuation of developments that have been going on for some considerable time. The recent trend of liberalization of economic activities is qualitatively different, however, as the world has definitely ceased to be a collection of relatively autonomous economic agents that are only marginally connected and are more or less immune to events in their neighbourhoods.

In the immediate post-World War-II period, globalization was mainly driven by rapid growth in foreign trade while in the 1950s and 1960s, direct foreign investment (FDI) started to play an increasingly important role in this process. Over the last two decade and based on a global trend of trade and investment liberalization, the world economy has evolved into a highly integrated system. Today, globalization involves numerous features, but the following three seem to be the main engine driving global economic integration: *(a)* internationalization of production accompanied by changes in the structure of production, *(b)* expansion of international trade in trade and services, and *(c)* widening and deepening of international capital flows.

Technological change and globalization of production

Technological changes we are witnessing today affect the parameters of technology and product flows across countries. Improvements in transportation networks and technology are reducing the costs of transportation while improvements in information technology have made an increasing volume of information available at close to zero costs. Lower transportation and communication costs have important implications for the nature of production activities, the flow of knowledge it relies on and the marketing of products that it makes. Reduction of transportation and telecommunication cost, for example, raise the intensity of competition and stimulate identification of most economic sites for both manufacturing of products and components as well as for their marketing.

New technologies have led to another aspect of globalization, i.e., to introduction of flexible production forms. By turning away from vertically integrated forms of production which have traditionally been organized in one location and by turning towards specialized production sequences which can be spread across national borders, global production has achieved further geographical dispersion and further extension of its networks. In this way, companies become independent from concrete location, and consequently, the competition for business establishment becomes much more intense than before.

Large multinational companies are best suited to optimize their network of locations at an international level. They now rely on production chains that involve many countries, as raw materials and components may be supplied by two different countries, the inputs may be assembled in the third country, while the marketing and distribution of the product may take place in still another country. The technology that multinationals deploy in each location depends on local abilities to absorb and use that knowledge. As a consequence, those with low capabilities receive the simplest know-how, while those with high capabilities receive more advanced forms of know-how, and in some case the R&D process itself (Lall, p. 5).

New flexible production systems and the imperative of competitiveness it introduces have led many firms to concentrate on their core competencies. The outsourcing of non-core activities has led to the opening of new business opportunities for small-scale industries. With their flexibility to react promptly to market signals, these industries may take advantage of their company-specific competitive advantage within the high growing intra-industry trading. On the other hand, however, new patterns of global production expose small-scale industries to new risks challenges, as production flexibility means the possibility to change the combination of subcontractors. Though legally independent, these component producers need to be in close functional relationship with their partners, domestic and foreign, within global production networks. Quality and reliability of production together with input and delivery schedule flexibility are becoming imperatives for their successful operation.

Expansion of trade in goods and services

The intensified globalization of production is closely interlinked with the second dimension of globalization, i.e., with rapid expansion of international trade of goods and services. International trade data clearly show the rise in global production networks. About one-third of world trade in the mid-1990s took place within these networks. In certain industries, the trend is even more impressive (World Bank, 1999a, p. 65). In 1995, for example, only parts and components accounted for more than one quarter of total transportation and machinery exports in many countries, including several transition economies, such as Czech Republic, Croatia and Slovenia (see table 1).

In addition to its interlinkages with the globalization of production, trade in goods and services is important from the globalization point of view for several other reasons. First, it is frequently the primary means of realising the benefits of globalization. Countries win when they gain market access for their exports and technology through international transfers. The rising share of imports and exports in GDP clearly indicates the growing exposure of national economies to international trade. Second, the continuing reallocation of manufacturing activities from industrialized to developing countries and countries in transition opens new opportunity to expand trade. This does not relate only to trade in goods, but more and more also to trade in services as it has become by far the most dynamic compo-

Table 1. Share of parts and components in exports, 1995

Economy	Percentage of parts and components in: Total exports	Exports of manufacturers	Exports of transportation and machinery
Barbados	10.9	18.5	61.6
Brazil	6.4	12.1	33.9
China	6.0	7.2	28.8
Croatia	5.4	7.3	32.1
Czech Republic	10.6	13.0	36.2
Hong Kong SAR	13.6	14.5	46.2
Malaysia	14.3	19.1	25.9
Mexico	13.0	16.8	24.9
Nicaragua	5.0	24.6	81.6
Philippines	6.6	16.0	29.7
Republic of Korea	10.0	11.0	19.1
Singapore	18.2	21.7	27.8
Slovenia	7.7	8.6	24.5
Taiwan Province	17.4	18.8	36.3
Thailand	10.9	15.0	32.5

Source: World Development Report, 1999, p. 66.

nent of the overall global trade. Third, growth of trade has been firmly supported by international institutions, first GATT and later on WTO. They have served as the means of securing continuous process of trade liberalization and have thus contributed substantially to the creation of a commercial environment conducive to the multilateral exchange of goods and services (World Bank, 1999a, p. 51).

Liberalization of international trade is a process that has been going on for most of the post-war period, but the key changes came in the mid-1980s with the launching of the Uruguay round and in the early 1990s with its successful completion and with the creation of the WTO. The Uruguay Round was by far the most comprehensive of all the eight GATT rounds of trade liberalization and it included new issues, such as services, intellectual property rights and investment measures. It also extended its rule in the area of agriculture. Equally important is the post-Uruguay Round agenda with pressures from industrialized countries to broaden the scope of WTO's activity on "non-border" issues, such as investment policy, competition policy, labour standards and environmental regulation. With increasing openness, more and more policies that had been considered as policies of domestic domain in the past are seen today as policies that have trade effects and are therefore of an international character. It is for this reason, it is argued, that these issues should be addressed by WTO that is the guardian of the international trade system (Berthelot, p. 2).

The growing involvement of WTO into areas formerly regarded as within the domain of domestic policy is driven hard by most powerful players in the international economy, especially by the United States. The process is, however, leading to increasingly open resistance not only in many developing countries but, less explicitly, in some countries in transition, as many of them are still negotiating their accession to the institutions. In addition, resistance is also growing in some segments of the population in most advanced countries, as shown on the occasion of the last trade summit in Seattle.

"New rules of the game" embodied in international trade and investment agreements, procedures and norms, strengthen market forces and expose economies to greater international competition and globalization. They open foreign markets further and therefore provide a stronger and more predictable and transparent framework for private enterprises. At the same time, they further reduce the ability of governments to implement independent strategies to promote national development by intervening in trade and investment flows (Lall, p. 6).

Widening and deepening of international capital flows

Financial flows across national borders have risen far more quickly than trade in recent years and are therefore another distinctive feature of globalization. Since 1990, there has been a huge upsurge in international capital flows and a growing integration of international capital markets. In this period, total FDI inflows in the world increased for almost three times (inflows to developing countries for four times and to transition economies for more than 10 times) (World Investment Report 1999, p. 477-480). Firms from all parts of the world are raising funds from both, debt and equity segments of international securities markets. Since 1993, the amount of outstanding international corporate debt issued on these markets has risen for 75 per cent, reaching US$3.5 billion in early 1998. At the same time, many multinational firms registered in more than country's stock exchange raising funds from markets in different countries (World Bank, 1999a, p. 70).

The rising number and volume of international capital transactions accompanied by growing international trade has increased the daily turnover on foreign exchange markets to more than US$1.5 trillion in 1998. New financial instruments, such as futures, options and swaps, increasingly traded on international capital markets are yet another evidence of the integration of national markets. There are also new important players in the world of international finance. By easing of restrictions on international portfolio diversification in many industrialized countries, has stimulated institutional investors, like mutual funds, pension funds and insurance companies, to start investing one part of their portfolio abroad. In 1995, these investors controlled a pool of capital amounting to as much as US$20 trillions, 20 per cent of this amount was invested abroad. This figure represents a 10 times increase in the volume of funds and 40 times increase in investment abroad since 1980 (World Bank, 1999a, p. 70).

There are several factors behind this fascinating pace of international financial integration and increase of international capital flows. They include rapid improvements in technologies for collecting, processing and disseminating, and increased volume of private savings for retirement, but the most important among them is capital account liberalization which involves changes in policies toward different types of capital flows. The big push for the liberalization of international capital flows came in the early 1970s with the introduction of a flexible exchange rate regime. Under this exchange-rate regime, foreign exchange risk previously carried out by central banks has been system transferred to private sector actors and this led to the demands for the removal of capital movement controls. By the end of the 1980s, industrialized countries had, by and large, completely abolished exchange controls while in developing countries and transition economies the trend for exchange regulations and capital controls liberalization is underway. Its speed and depth, however, varies significantly across countries. Recent financial crises have brought the issue of measured, sequential approach to capital account liberalization to the attention of both policy makers and researchers.

In addition to moves toward capital account convertibility, other policies have made many developing countries and countries in transition a more attractive destination for foreign capital. Among other "push factors" (i.e. factors in industrialized countries that have stimulated outflow of capital), low interest rates in industrialized countries have to be emphasised while among the “pull factors” (i.e. policy measures introduced by emerging markets in order to attract capital inflow), macroeconomic stabilization and structural reforms, especially those in the financial sector and those aimed at attracting foreign direct investment seem to be more important than others.

2.2 Globalization versus regionalization

Globalization is now a forceful process that is unlikely to be reversed. The future policy alternatives for countries and regions have thus to be analysed in the context of the global economy with free trade of goods and services, free movement of capital, technology and skills and with improvements in transportation and communication links. The solution to current problems at the global level depends to a great extent on the decisions taken within a rather narrow group of industrialized countries, primarily within the G-7 countries. Other countries and regions, and particularly developing countries and countries in transition, are de facto second league players and their ability to influence prevailing world trends is rather limited. The challenge for these countries and regions therefore is to find their own responses to the overall trend of globalization.

Are globalization and regionalization processes that substitute or complement each other? Should countries enter immediately into the global economy or should they opt for regional integration as a first step that will later on be followed by more complete global integration. Responses to these questions are country specific and depend on geography, history and culture of the particular country as well as on the level and structural patterns of its economy. In spite of the differences, there are convincing arguments that call each region of the world to be involved in a broad and deep debate on the behaviour of the present globalizing world and to design a strategy on how to cope with the challenges of globalization.

This strategy has two components, a national one and a regional one. A prerequisite for a region to be effective in this globalization debate is that each country of the region puts its own house in order. Macroeconomic balance (effective monetary and fiscal policy and sustainable balance of payments position) together with effective resource utilization are necessary conditions for both, broadening the margin of manoeuvre for governments and for achieving sustainable development. The second element of this strategy at the national level is that the role of governments should be redefined (Emmerij, p. 12)). The policy objective is not to dismantle or shrink government, but to strengthen those public policy instruments that promote development and equity as the market itself does not solve these problems. As will be discussed later (see chapter 2.3.), left to its own mechanism, market actually worsens social imbalances and tensions.

At a regional level, this strategy calls for a regionalism, at least for developing countries and countries in transition, to take precedence over globalization. Globalization and regionalization are two processes that are driven by two very different forces. Globalization, either in the form of the internationalization of production or in the form of international trade and capital flows, is being realized primarily by private firms operating increasingly worldwide. In contrast, regionalization implemented in arrangements, such as EU, NAFTA or MERCOSUR, is being clearly guided by governments of individual countries and is therefore a public-sector driven process. There are strong arguments in favour of so-called “pragmatic liberalism”, i.e., to combine selective and temporary protectionist measures with a general policy of overall liberalization. This policy, it is in fact being carried out by industrialized countries for years and even decades, advocates an approach whereby countries of a region should first increase their international competitiveness within regional schemes before exposing themselves to the full-fledged globalization (Emmerij, p. 12).

2.3 Benefits, risks and challenges of globalization

Globalization is a controversial process

It is generally claimed that globalization underpinned by liberalization of economic policies and by technological advancement carries important benefits, such as improved resource allocation, increased competition and therefore wider options for consumers, the ability to tap international capital markets, and the exposure to new ideas, technologies and products. For the private sector, globalization means that economic agents are faced with many more opportunities and much more intense competition than ever before. On the other hand, globalization also demand a drastically changed role of national governments. Private sectors operating in the highly competitive environment need clear rules of operation, stable macroeconomic environment, unrestricted access to imports, efficient economic and social infrastructure, and all these are requested from national governments.

Globalization is also far from being uncontroversial. The central claim of those who argue for case of globalization is that under open trade and capital regimes, investment and growth will be stronger. There is, however, little evidence supporting this claim. On the contrary, the world GDP growth rates in the 1980s and 1990s have declined since the 1970s when financial liberalization started. Moreover, the share of investment in GDP in the world has in general fallen suggesting less willingness to undertake long-term investment (Berthelot, p. 3).

Another controversial issue being advanced by promoters of globalization is the claim that the increased liberalization of trade and capital markets has been associated with greater efficiency in resource allocation. As far as trade liberalization is concerned, numerous studies provide strong empirical evidence supporting this assertion and the many benefits of this process. On the other hand, the evidence on capital account liberalization is much more mixed. Studies on this subject do not provide systemic evidence that capital liberalization *per se* brings significant benefits. In addition, experiences of many emerging countries that have experienced financial crises in recent years clearly indicate that capital account liberalization is a far more complex process than liberalization of trade flows. It is today well recognized that capital movement liberalization, if not accompanied by appropriate corporate governance, banking regulations, capital market development and macroeconomic conditions, may have many negative consequences, including a depressed long-term growth rate.

A traditional argument of neo-liberals in the area of investment is that capital always invests in the most profitable opportunities. At the international level, this argument says that capital account liberalization will bring about a more optimal global allocation of resources. This argument is based upon the assumption that investment in one country depends only on the profitability of investment there and not on the supply of domestic savings. According to this assumption, there is zero correlation between domestic savings and total investment. In real life, however, the situation is very different. Total investment in a country is still strongly correlated with domestic saving, and thus foreign savings represents typically a rather small portion of total fixed capital formation. This correlation clearly indicates that capital is still far from being entirely mobile, although restrictions on capital flows, at least in industrialized countries, have in fact been eliminated (Berthelot, p. 3).

"Winners" and "losers" of globalization

Globalization is a highly uneven process and numerous facts can prove this. For example, growing trade is not leading to more equitable distribution of underlying comparative advantages. DFI are very concentrated, with 10 developing countries accounting for over three-quarters of total FDI inflows to this part of the world. Similar inequalities exist in the generation of "new knowledge" where a small number of countries continues to dominate innovation.

There are "winners" and "losers" of globalization and this applies both, to different countries in the world as well as to different groups of populations within each individual country. There appears to be a growing inequality among countries resulting from the globalization process. The Gini coefficient[3] of the world per capita GDP increased from 0.44 in 1960 to 0.55 in 1989 (UNIDO, 1996, p. 6). In roughly the same period, between 1960 and 1990, the gap between per capita incomes of the richest and poorest countries doubled from a ratio of 30 : 1 to a ratio of 60 : 1. In the following seven years it further increased to a ratio of 74 : 1 (UNIDO, 1999, p. 2). At the country level, measures of the degree of income inequality are on the increase almost everywhere. This applies both to industrialized countries as well as to developing countries and countries in transition. In the United States, for example, an average CEO made 41 times the wage of the average manufacturing worker in 1970. By 1997, the ratio increased to 326 : 1 (Magarinos, p. 9).

The fact of some countries being "winners" and others being "losers" in the globalization process indicates that there are significant differences among individual countries in their ability to cope efficiently with the challenges of globalization. For developing countries and countries in transition, their globalization performance can be measured with the level and the speed of their integration into the global economy. There are two factors that seem to be of crucial importance. The first one is economic growth. The quarter of developing countries that have integrated most quickly over the 1984-1993 period grew nearly 3 percentage points than the slowest integrating quarter. The second factor is the quality of the policies. Three types of policies have been identified as those ones that affect the speed of integration relatively quickly: those affecting macroeconomic policies, trade and FDI regimes and economic infrastructure. Policy reforms designed to increase an economy's growth and stability are likely to influence a country's speed of integration both directly and through their effect on growth (World Bank, 1996b, chapter 2).

[3]The Gini coefficient is a measure of the relative degree of inequality. The coefficient ranges from 0 to 1. Zero is total equality, 1 is total inequality.

3 Integration of transition economies into the global economy

The pre-1989 socialist countries of Central and Eastern Europe were largely characterized by a deliberate isolation from other parts of the world economy. All segments of their international economic cooperation, including trade, investment and technology flows, were predominantly occupied with intra-Soviet bloc transactions while economic ties with countries outside the region were rather weak.

The change of political regime and beginning of the transition process from centrally-planned to market economy was a starting point on the region's path towards global economic integration. Economic transition of countries of Central and Eastern Europe and their integration into the global economy are, in fact, two sides of the same coin. There is no economic transition of these countries to a market economy without establishing participation of economic actors from this region in the international markets of goods, services, capital and labour. And vice versa, competitiveness of products from ex-socialist countries on international markets cannot be effectively established without dismantling the centrally-planned economic system that had over several decades of its existence proved to be economically inefficient and thus inferior to the market-led type of economy.

Ample empirical studies demonstrate remarkable achievements of transition economies over the last decade in integrating themselves into the world economy and this conclusion applies for all segments of integration. While participation of economic actors from transition economies in global production networks is discussed in detail (see the other paper to be presented at this Session, Kaczurba, 2000), this paper addresses another two important aspects of the region's economic internationalization, namely its trade expansion and reorientation, and its international financial integration.

3.1 Trade integration

Expansion of trade

Before the beginning of transition, international trade was almost exclusively an intra-CMEA affair. The share of trade with other countries of this regional integration accounted for more than 80 per cent in the former Soviet Union's trade while for CEECs countries this share was lower and amounted to around 50 per cent (Brenton and Gros, p. 67-68). Trade within the CMEA region was distorted in several other ways. For example, trade flows were handled exclusively by the State-owned trading organizations. This means that a handful of State-owned firms had a monopoly over the whole segment of international cooperation while all other economic agents had practically no contacts with the outside business community.

Since the start of transition, trade has become an increasingly important part of transition country economies. The ratio of foreign trade (average of exports and imports) to GDP increased throughout the region as a result of both, strong growth of foreign trade and the decline of the GDP in the early transition period. In 1995, the combined trade to output of the five CEFTA countries at that year was already at an almost 40 per cent level. For advanced and developing countries, this ratio was almost around half of that in the same year (World Economic Outlook, 1997, p. 96-97).

Geographical reorientation of trade

The liberalization of external trade in the early 1990s led to another important foreign trade pattern of transition economies, namely to a sizeable change in the geographic composition of the trade. Most of this reorientation consisted of geographical reorientation of trade flows from the CMEA towards the Western market economies, especially the EU. The biggest change in the geographical structure of trade happened early in transition and has remained more or less unchanged since then.

The CEECs and the Baltic States have achieved by far the most in shifting away from their trade from the former CMEA countries and in integrating themselves into the global trading system. They roughly doubled the share of advanced countries in their total exports and imports in the 10-year period between 1986 and 1995; each from 35 per cent to almost 70 per cent (World Economic Outlook, 1997, p. 98). This way, the CEECs succeeded in increasing their portion in overall imports of the OECD countries. Between 1990 and 1993, this share increased to 55 per cent, as shown in table 2. The penetration was even more successful in the area of manufactured goods where CEECs more than doubled their share in the same period. Within this group, the SITC category 78 (finished cars, parts and components) needs special mentioning, as the market share of these countries increased more than four times between 1990 and 1993. This figure clearly confirms growing integration of countries from this part of the world in the global automobile industry achieved through growing exports of automobiles and automotive parts from plants constructed with foreign capital and technology in countries such as Czech Republic, Hungary, Poland, Slovakia, Slovenia and more recently also in Uzbekistan.

Several factors contributed to the success of the CEECs and the Baltic States in reorienting their trade. These countries benefited from their geographical proximity to EU markets and had better initial conditions. They also more rapidly stabilized their economies and started the process of industrial restructuring. In addition these countries have made significant steps towards institutionalizing their access to export markets in advanced countries. A number of the CEECs and the

Table 2. Import shares of transition economies in OECD markets, 1987, 1990 and 1993

(percentages)

Economic grouping, region or country	*Year*	*Total trade (SITC 0-9)*	*All manufactures (SITC 5-8)*[a]	*Clothing (SITC 84)*	*Chemicals*	*Vehicles*
Central and Eastern	1987	0.94	0.67	2.24	0.94	0.19
European Countries	1990	0.91	0.71	2.21	1.02	0.19
	1993[b]	1.46	1.43	4.42	1.14	0.76
Countries of the	1987	1.16	0.25	0.01	0.74	0.23
former Soviet Union	1990	1.17	0.21	0.01	0.66	0.21
	1993	1.17	0.31	0.29	0.96	0.13

Source: Industrial Development Report, 1996, p. 41.

Note: SITC—Standard International Trade Classification.

[a]Excluding SITC 67 and 68.

[b]For 1993, combined data of Czech Republic and Slovakia.

Baltic States received most-favoured-nation status under GATT while early in transition, and later on became members of the WTO and three countries of this subgroup—Czech Republic, Hungary and Poland—joined the OECD. These three countries together with Slovakia founded CEFTA in 1993 and a few others, including Slovenia and Romania, joined the integration in the following years.

By far the most important institutional arrangement reached by the seven CEECs (Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia) and the three Baltic States (Estonia, Latvia and Lithuania) are Association Agreements signed with the EU. These agreements, they provide a framework for gradual liberalization of trade between the contracting parties, have been instrumental for growing trade flows and provide a basis for negotiations for full membership of the EU. With the first group of countries (five countries) these negotiations started in early 1998 and will be followed with the start of negotiations with all the remaining transition economies (another five countries) with the signed Association Agreements.

Less favourable geographical position, slower progress in macroeconomic stabilization and industrial restructuring as well as the lack of institutional trade arrangements with western partners explain why the Russian Federation and other countries of the CIS have been much less successful in reorienting their trade flows. They continue to be still highly dependent on trade links with other transition economies. To a large extent, this reflects dependence of most CIS States on the Russian Federation rather than an intensification of their trade with other transition economies.

3.2 International financial integration

Two forms of integration: through institutions and through flows

The integration of transition economies into the world economy goes far beyond trade. One of the areas it expands to is in the area of international finance. In the pre-transition period, centrally-planned economies had been largely excluded from the global financial system, as most of them were not members of multilateral financial and as many of them, due to considerable debt service problems, had no access to international capital markets. Besides, equity financing was never applied in socialist countries and the decentralized system of bond financing was not in line with the centrally-planned economy (the subject is discussed in, Lankes and Stern).

Reintegration of the region into a global financial system started at the outset of the transition process, when practically all countries of the region rapidly joined the three key multilateral finance institutions, namely IMF, World Bank and EBRD.

This institutional integration was accompanied by a radical change both in the volume and composition of capital inflows to the region. In the early transition years, capital flows were dominated by flows from official western government sources, multilateral and bilateral; more or less all transition economies were their recipients. These official flows aimed at supporting and protecting profound political and economic changes in the region have paved the way for an increasing flow of funds from private sources.

In the early post-transition period, private sector funding sources took a rather cautious attitude towards the region as the country and commercial risks were perceived to be unacceptably high. Later on, when economic performance of the countries improved and the process of transition progressed, private capital started to enter the market, first slowly, then with great speed. In contrast to some degree of uniformity of official flows in the early transition period, private capital began quickly to differentiate across countries. Perception of investment and lending risk has been closely correlated with the progress of transition.

As shown in table 3, total capital flows to the region rose from around US$3 billion in 1990 to as much as US$61 billion in 1997. Due to the Russian financial crisis, the total volume of capital inflows to the region declined since then. With this volume, capital flows to the region still represent a small, albeit growing share of capital flows to all emerging economies (developing countries and transition economies taken together). This share amounted to around 13 per cent in 1996. On the other hand, however, the region participated in that year with higher shares in the emerging economies' GDP (20 per cent) and exports (22 per cent). As a fraction of their GDP, total inflows were consequently smaller than for many developing countries, and averaged 5.4 per cent over the 1990-1996 period) (Claessens and Oks and Polastri, p. 2).

Table 3. Net capital flows to transition economies, 1990-1997

(Millions of US dollars)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*
Total flows	3 396	14 464	24 874	23 832	16 035	33 399	40 704	61 122
Private flows	–8 355	-6 409	6 213	14 272	12 214	28 427	33 079	51 033
Equity investment	571	2 464	3 996	6 013	5 679	14 553	11 412	17 865
Direct	431	2 143	3 657	5 157	4 548	12 282	9 242	14 494
Portfolio	140	321	339	856	1 131	2 271	2 170	3 371
Commercial banks	–15 089	–8 226	996	1 412	1 976	8 412	11 102	7 800
Other private creditors	6 163	–647	1 221	6 847	4 559	5 148	10 565	25 368
Official flows	11 751	20 873	18 661	9 560	3 821	4 972	7 625	10 089
Int. finan. instituts.	1 112	5 729	3 607	3 124	3 001	3 459	3 756	4 257
Official bil. creditors	10 639	15 144	15 054	6 435	820	1 514	3 869	5 832

Source: Transition Report 1998, p. 7.

Note: Data cover Bulgaria, Czech Republic, Hungary, Poland, Romania, the Russian Federation and Slovakia.

Within the structure of capital flows to the region, the share of private flows has increased sharply; from less than 25 per cent share in 1993 to 84 per cent in 1997. While most CEECs and the Baltic States have practically ceased to rely on official financing, there are other countries, especially in the CIS group, which still do not fulfil criteria that are required for entering international capital markets. They therefore continue to rely entirely on official sources of foreign funding.

With respect to the achieved level of financial integration of transition economies into global economy the countries of the region can be classified into three groups.

The first group consists of countries that are at an advanced level of financial integration. Their main characteristics are the following: *(a)* they have resolved pre-transition debt problems, *(b)* they have strong institutional integration in the area of international finance (membership in major international finance institutions; some of them are members of WTO, and even of OECD), *(c)* they have started negotiations for EU accession, *(d)* they have practically ceased to rely on official flows of capital, *(e)* they have full access to private capital markets; *(f)* they have investment grade rating assigned by at least one of the leading three rating agencies, *(g)* they are at an advanced stage of capital account liberalization.

In the second group are countries that are at an intermediate level of financial integration. Their main characteristics include: *(a)* they have achieved some institutional integration in the area of international finance (they are members of international financial institutions), *(b)* they have Association Agreements with the EU, *(c)* they still rely strongly on official flows, *(d)* they have limited access to international capital markets; they either have no ratings or their rating is below “investment grade level”, *(e)* they are in an early stage of capital account liberalization.

The third group of countries includes those that are at a low level of financial integration. Their main patterns are: *(a)* their pre-transition debt problems are not yet resolved, *(b)* they have poor institutional integration into global economy (they are members of multilateral financial institutions, but they have no other institutional arrangement), *(c)* they rely entirely on official funding sources, *(d)* they have absolutely no access to funds from international capital markets.

In the continuation of this chapter, a closer look will be made at the trends and determinants of FDI and non-FDI private capital flows (commercial bank credits, bond issuing and portfolio equity investment) to the region.

Foreign direct investment

Before 1989, centrally-planned economies in Central and Eastern Europe were practically not on the map as a FDI destination. Since then, however, this type of investment inflow has been continuously increasing and is estimated to reach US$22.7 billion in 1999 (EBRD, 1999, p. 79). In spite of the fact that the region has become increasingly attractive for foreign investors, FDI inflow still represented, as shown in table 4, not more than 1 per cent of the region’s GDP in 1997 and 1998.

Table 4. Foreign direct investment in transition economies, 1989-1998

	Cumulative FDI-inflows (in US$ millions		*FDI-inflows per capita (in US$)*		*FDI-inflows (in % of GDP)*	
	1989-98 Total	*1989-98 Per capita*	*1997*	*1998*	*1997*	*1998*
Albania	423	132	13	14	1.9	1.5
Bulgaria	1 323	159	60	48	4.8	3.1
Croatia	1 997	444	72	190	1.8	4.2
Czech Republic	9 957	967	124	241	2.5	4.5
Estonia	1 382	953	89	396	2.8	10.6
FYR Macedonia	242	121	9	88	0.5	5.7
Hungary	16 459	1 627	163	144	3.7	3.1
Latvia	1 604	642	206	88	9.3	3.5
Lithuania	1 534	415	89	249	3.4	8.9
Poland	15 066	389	79	171	2.2	4.5
Romania	4 510	200	54	90	3.5	4.7
Slovakia	1 762	326	33	94	0.9	2.5
Slovenia	1 192	596	148	77	1.6	0.8
CEECs and the Baltic States	*57 451*	*184*	*30*	*53*	*1.1*	*2.1*
Armenia	328	89	14	63	3.2	12.6
Azerbaijan	3 102	408	144	135	28.4	24.9
Belarus	456	45	19	14	1.5	1.0
Georgia	526	98	44	41	4.5	4.3
Kazakhstan	5 661	372	84	74	5.9	5.1
Kyrgyzstan	332	72	18	11	4.7	3.1
Republic of Moldova	330	76	15	20	2.9	5.1
Russian Federation	8 901	61	25	8	0.8	0.4
Tajikistan	130	22	5	6	2.7	2.8
Turkmenistan	762	157	23	23	5.9	5.2
Ukraine	2 626	52	12	14	1.2	1.7
Uzbekistan	533	23	7	7	1.2	1.2
CIS	*23 687*	*34*	*11*	*7*	*0.4*	*0.3*
Total	81 138	80	17	17	0.7	0.7

Source: Transition Report 1999, p. 79.

The surge of FDI to the region has been caused by a combination of factors, including strong interest of companies from home countries to spread their operations into new markets, improved macroeconomic performance in many countries in the region and reduction of barriers in trade of these countries among themselves and with advanced countries, especially with the EU. In a survey of 324 foreign firms operating in transition economies, the respondents have made the following ranking of their motivations for FDI: *(a)* access to local market, *(b)* access to human resources, *(c)* good business conditions for FDI, *(d)* financial focus—costs and profits, *(e)* marketing issues, *(f)* access to local resources, *(g)* base from which to operate, and *(h)* access to local technology (Andersen Consulting Survey, p. 19).

Geographical distribution of FDI inflows has been very uneven. The CEECs and the Baltic States attracted some 70 per cent of total 1989-1999 inflows, and even within this subgroup of countries, there is a big concentration, as Hungary, Poland and Czech Republic alone accounted for more than half of total inflows. There are several explanations for this high concentration of FDI inflows to these countries: *(a)* they are fairly advanced in the transition process in terms of macroeconomic, political and institutional stability; they have stable legal regimes regulating inflow of foreign capital and sufficiently good enforcement of the existing legislation, *(b)* they have traditionally strong business and trade linkages with the neighbouring developed countries, *(c)* geographical proximity seems to have encouraged not only TNCs but also small and medium-sized companies in EU countries to become international by investing the CEE countries, *(d)* prospective membership in the EU has attracted many foreign investors, notably companies from the EU, to relocate labour-intensive lines of manufacturing to countries in Central and Eastern Europe where wages are still well below the labour costs in their home countries, and *(e)* in some countries, like Hungary, FDI have been stimulated by the form and timing of privatization, as foreign participation has been one of its central pillars (Mrak, 1998, p. 254). A significant proportion of all FDI to the region has been associated with privatization. In 1995, for example, two-thirds of all FDI inflows to transition economies was raised this way. Foreign investment in "greenfield" projects got prominence in recent years, especially in countries where GDP was high and where the transition process had been well underway. In 1998, non-privatization investment already accounted for 94 per cent total FDI inflows (World Investment Report, p. 70).

Companies from the EU continue to account for most of the FDI inflows into the region. In Central Eastern countries and the Baltic States, their investment accounted for around two-thirds of total flows. The dominant position of the EU is only challenged in the Russian Federation and some other CIS States, where the United States accounts for a relatively high share.

In terms of sectoral composition, data indicate that in the early years of transition, a large proportion of FDI had gone into sectors mainly oriented towards supplying domestic markets, such as trade and distribution services. Later on, however, investments in manufacturing, banking and utilities have become increasingly important. Within manufacturing, it roughly accounts for around 60 per cent of total accumulated FDI in the region, early investments were made primarily in food, beverage and tobacco processing industries (World Economic and Social Survey, p. 122). Later on, foreign investors started to express more interest in broader sectors, including engineering, automobile production, textiles and chemical industries. This seems to indicate that manufacturing FDI in the CEECs countries are becoming more outward oriented and generate an increased trade flows, as foreign investors take advantage of relatively well-educated and skilled labour force at a cost much lower than in their home countries.

Following the experience of more advanced developing countries, some countries in transition have started to complement FDI inflows with the outflow of investments. In 1998, FDI outflows from countries in the region are estimated at US$2 billion (44 per cent decline against the 1997 level due to the Russian crisis) (World Investment Report 1999, p. 72). FDI outflows from the Russian Federation appears to be motivated primarily by the desire of investors to protect themselves against domestic instability. In other countries in the region, however, FDI outflow mainly reflects local companies' strengthening their traditional business and trade linkages among CEE countries, some of them have recently been parts of the same States, and is motivated by the search for a supply of key inputs and by requirements for a continuous market presence. Transition economies with significant outward FDI of this type include Croatia, Czech Republic, Estonia, Hungary and Slovenia.

Debt creating private capital flows

In contrast to FDI that has been continuously increasing throughout the whole transition period, debt creating private flows—they include commercial bank credits and international bond finance—have experienced two entirely different periods throughout the ten years of transition. The first one is the period of rapid growth that lasted until August 1998 when it brutally ended with the eruption of the financial crisis in the Russian Federation. Since then, volume of funds raised on international capital markets drastically declined. This is particularly the case for the Russian Federation and for some other countries of the region that used to have a restricted access to the capital from this market. Other transition economies, especially those with good credit ratings, continue to have rather good access to funds from these sources although at a higher spread than before the crisis.

3.3 Explaining disparities in the achieved level of economic integration

The previous two chapters provide ample, though fragmented, empirical evidence about trends in transition economies' global economic integration, i.e., about their growing participation in the international markets for goods, services and capital. To shed some more light on the achievements of transition economies in this area over the last decade, several other measures of these countries' internationalization could be applied. One approach is to try to capture the degree to which domestic prices and interest rates reflect their international counterparts; if markets would be perfectly integrated, prices would be the same everywhere. A measure of the extent to which a country has absorbed the global stock of technology and other knowledge would also be useful. (World Bank, 1996b, p. 20). In practice, however, all these measures are hard to calculate.

In order to quantitatively measure the achieved level of internationalization, the World Bank has constructed integration indexes that measure the initial level and the speed of integration. The indexes have been derived from direct measures of integration, such as ratios of trade and FDI to GDP, as well as from indirect measures, such as creditworthiness rating (a measure of access to international capital markets), tariffs (an indicator of disparities among domestic and international prices), and the share of manufactures in exports (an indicator of the country's ability to produce at world standards and absorb technical knowledge) (World Bank, 1996, p. 66).

By applying these indexes, one can draw the following three conclusions about the internationalization performance of transition economies over the 1990s: first, transition economies had a very low initial level of integration compared to all other regions of the world, second, the region as a whole has achieved significant advancement in terms of their integration into global economy, and third, similarly as in other regions of the world, there have been striking disparities among individual countries in the speed of their integration.

Among the explanations for differences among transition economies in the speed of their global economic integration, the following three seem to be the most important. The first and decisive one are the differences in the achieved level of transition. Empirical evidence clearly supports the conclusion that countries that have performed well in the transition process (see chapter 4), i.e., countries that have achieved high economic growth rates and have put their economy in order, are today also countries that have largely integrated themselves into global financial markets. On the other hand, countries that are considered to be slow transformers—they are characterized with low economic growth and slow pace of reforms—are today also lagging behind in the process of economic integration into the global economy.

The second important explanation deals with differences in the achieved level of institutional integration. All countries of the region have become members of the main international financial institutions, and thus there is no difference among them in this respect. Large differences, however, exist with respect to other institutional arrangements. Of crucial importance seems to be Association Agreement with the EU and especially the beginning of the EU accession talks. Both, and especially the beginning of accession negotiation, have clearly signalled to the private sector the perspectives of these countries in the next medium-term period.

Last but not least, differences in geographic location of countries, especially their proximity to main trade partners, have also contributed to uneven economic integration of individual transition economies into global markets over the past decade.

4 A decade of transition: achievements so far

This chapter begins with an explanation as to what is meant by the process of transition. It then proceeds with an overview of macroeconomic performance during the ten years of transition, and with a discussion of structural reforms in transition economies. The last part of the chapter summarizes the achieved progress in transition as presented in the EBRD's *1999 Transition Report.*

4.1 What is transition?

A decade ago, countries in Central and Eastern Europe embarked on a process known as a "transition from centrally-planned to market economy". In standard economic theory, there is no claim that market economies are necessarily better than planned economies. This means, in pure theory, that a perfectly planned system can be as efficient in allocation of resources as is a decentralized, competitive market mechanism. At this level of abstraction, market and planned economies are alternative ways of organizing an efficient allocation of resources (Allsopp and Kierzkowski, p. 4).

Why then did countries in the region consider the market system as a better allocation mechanism than a planned system at the time when the communist regimes collapsed? The main reasons seem to be huge failures in the planned system, especially failures on political issues (for example, the lack of freedom and democracy) as well as failures on economic efficiency issues (for example, impossibility of getting enough information, suppression of individual incentives). The deep economic inefficiencies of planning became increasingly evident over time. After posting high annual economic growth rates during the 1950s and 1960s, the economy of this region decelerated and in 1990 it actually contracted. Social indicators worsened as well during the 1980s confirming the troubled state of the system.

In response to these unfavourable developments, countries of the region have rejected central planning and have embarked on a transition process towards decentralized market system underpinned by widespread private ownership. Transition encompasses two closely interrelated processes. The first one is a major change in the coordination and allocation system while the second one involves a change in efficiency. The long-term goal of transition is the same as that of market economic reforms elsewhere, i.e. to build a vibrant market economy capable of delivering long-term growth and living standards. What distinguishes transition countries from reforms in other low and middle-income countries is their starting point as centrally planned economies and consequently the deepness of the required changes. Transition involves the dismantling of one system and its replacement by another. This, of course, means that fundamental reforms must penetrate to the rules of the economy and society as a whole as well as to the institutions that shape behaviour and guide organizations (Allsopp and Kierzkowski, p. 5).

An objective of transition economies—to reach an industrialized countries' level of economic and social development—provides a clear benchmark what they would like to achieve by the end of the transition process and this benchmark provides a guideline for actions to be taken by transition economies along this way. For many countries in the region, accession to the EU is, in fact, considered also as a final stage of the transition process (see Fidrmuc, for example, for a discussion of relations between CEECs and EU). At the June 1993 Copenhagen European Council, the EU set conditions for those associated countries of CEECs and the Baltic States who wish to join the Union. Besides political criteria (stability of institutions guaranteeing democracy) and legal requirements (adoption of the acquis communautaire), the Council adopted the following two economic criteria: *(a)* the country should be a functioning market economy, and *(b)* the country should have a capacity to cope with competitive pressure and market forces within the EU. These two criteria clearly indicate that the transition process and accession to the EU are by and large two sides of the same coin. An accession country from the region will not be able to become an EU member unless it substantially completes its process of economic transition.

4.2 Overview of macroeconomic performance

Output

All countries in transition experienced a substantial decline in recorded output in the early years of transition. The initial output loss reflected: *(a)* the introduction of price and exchange rate liberalism resulting in a significant cut of domestic purchasing power, *(b)* general collapse of the former system of enterprise linkages and finance, and *(c)* the breakdown of the socialist trading block.

The difference in initial conditions and policies led to a much greater decline at the beginning of transition in the CIS than in the CEECs. There is another difference between these two groups of countries with respect to output development over the recent decade. In the CEECs (and the Baltic States), output since 1989 has followed a U-shaped pattern, with the minimum point being reached in 1992 or 1993. As a result, the aggregate output of the group almost returned to its 1989 level. In some CEECs, the output in 1999 already surpassed the one from the pre-transition period; Poland (index 114), Slovenia (index 104) and Slovakia (index 100). In contrast, the output pattern in the CIS, except the Baltic States, has been one of continuous decline with the exception of 1997. Consequently, the GDP for this group of countries was in 1999 only slightly more than one half of its pre-transition level. The output developments for this group of countries have been strongly dominated by the performance of the Russian Federation where GDP in 1999 was equivalent to 55 per cent of the one registered in 1989 (EBRD, 1999, p. 73).

Not all sectors of the economy were equally hit by the beginning of their transformation from centrally-planned to market-based systems. Trade liberalization, the new power of consumer preferences and the cut-back of defence spending are only some of the reasons explaining why industrial growth rates were even more disappointing than the GDP rates.

Poor industrial performance in the first years of transition has caused a significant drop in the region's contribution to the world industrial output. The decline has been the most pronounced in the CIS and the Baltic States where their share in the world manufacturing value added (MVA) output was more than halved in the

1990-1995 period (from 3.4 to 1.5 per cent). Contribution of the CEECs to the global industrial output was reduced much less drastically, from 2.1 to 1.6 per cent, over the same time period (UNIDO, 1996, p. 39). Different scale of industrial sector losses may partly be attributed to differences in the structure of manufacturing and partly to timing and sequencing of the transformation process applied by different groups of countries.

The sharp decline of the industrial sector output in the early 1990s accompanied by a strong performance of the services sector has resulted in a dramatic shift in the economic structure of transition economies. The general pattern is that the service sector has gained substantially in most transition economies in terms of GDP share at the expense of industry, and to a lesser extent agriculture. Through this process, a highly distorted structure of centrally-planned economies with exceptionally high shares of industry and a depressed services sector has in many transition economies become much more in line with the usual distribution of GDP across sectors in developed market economies. There is, however, one crucial difference between transition economies and developed market economies in this respect. While in the latter, the services sector has grown steadily in proportion with structural requirements of the overall economic development, in transition economies, the shift in the GDP structure has been made through a deep recession, especially in the industrial sector, in a very short period of time.

Disinflation, fiscal and current account balance

Disinflation

Already in the pre-transition period, countries from this region had experienced either high inflation or significant but repressed inflationary pressures. With the exception of Poland and Hungary where inflation, due to an early anti-inflation policy, was reduced in the first year of transition, in practically all other countries of the region prices rose sharply in the early transition period. The size of price increases amounted to over 100 per cent and in most countries of the former Soviet Union to even more than 1,000 per cent a year. This initial jump of inflation has by and large been a result of a combination of factors including price liberalization, sharp drop in output and large fiscal and quasi-fiscal deficits. As there were actually no alternative sources of finance, large budget deficits were financed almost exclusively from monetary sources, and a result was a rapid growth of inflation (EBRD, 1999, p.59).

By the mid-1990s, however, most countries of the region succeeded to drastically cut inflation. In 1995, for example, there were five CEECs where inflation was reduced to a single-level digit while in all other seven countries of this group the inflation rate was below an annual level of 35 per cent. Good progress in this area of transition was at that time made also in the CIS. In some countries of this subregion, such as, Georgia, Kyrgyzstan and Republic of Moldova, the annual rate of inflation was reduced to below 60 per cent in 1995 (EBRD, 1999, p. 76).

There is no doubt that initial disinflation has been one of the most remarkable achievements of the first decade of transition. It has been, however, confirmed very quickly that macroeconomic stability is not sustainable if it is not accompanied with appropriate structural adjustment measures. Experiences of some CIS have clearly demonstrated that weak macroeconomic foundations, especially large fiscal deficits and problems in the banking sector, combined with the negative implications of the Asian and especially Russian crisis contributed to the recent revival of inflation in these countries. There are at least five countries from this part of the world, Belarus, Kyrgyzstan, Republic of Moldova, the Russian Federation and Turkmenistan, where the annual rate of inflation either doubled or almost doubled between 1997 and 1999.

Fiscal imbalance

An important source of inflationary pressures in transition economies has been significant fiscal deficits. They peaked in 1992, when the combined government deficit of CEECs and the Baltic States amounted to 5.1 per cent of GDP and that one of the CIS countries to 17.6 per cent of GDP (EBRD, 1999, p. 77). Strong fiscal imbalances were caused by developments on both, revenue and expenditure sides.

Decline of taxes collected from the contracting state sector, administrative problems associated with the introduction of VAT and generally poor tax administration are the main explanations for the overall revenue fall in government budgets of almost all transition economies in early 1990s. In some countries, especially in the CIS, large tax arrears have not only become a form of implicit subsidization of inefficient companies but they have also further reduced the already shrinking revenue base. On the expenditure side, transition has exposed governments in the region to new challenges, though these challenges were different for different groups of countries. In more advanced countries of the CEECs, relatively generous safety-net provisions were introduced in the early transition period. In this period, many countries of this group had used pension schemes as a policy instrument aimed at reducing negative social implications of large-scale layoffs. As a consequence, pension systems have entered into extensive deficits and have over time become a growing fiscal burden. It is for this reason, why pension reform is today so high on the political agenda in practically all CEECs. In the countries of the CIS, where the safety net was largely non-existent, the main issue on the expenditure side continues to be how to reduce subsidies to enterprises.

Between 1992 and 1997, government deficit was on a downward trend in practically all countries of the region. In 1998 and 1999, however, some countries in the region registered a deterioration of their fiscal position due to a combination of internal factors, such as adjustment to the EU, as well as external factors, including the Russian and Kosovo crises (see, EBRD, 1999, p. 77).

Current account and capital flows

As far as the current account of transition economies is concerned, it has been in deficit throughout the whole 10-year period. This is in line with the conventional theory that moderate current account deficit is acceptable and even desirable for countries that have been faced, on the one hand, with drastically reduced savings rates, and on the other hand, with rising demand for investment. The problem, however, is how to define what is a sustainable balance of payments deficit and when the deficit becomes unsustainable, i.e. when the country losses its ability to regularly service its external debt obligations.

Current account deficit and consequently also capital inflows into the region have undergone four different periods and this stands for all the three groups of transition economies, i.e. for the CEECs, for the Baltic States and for the CIS. The only difference is that in the latter group of countries, current account deficits were always larger. In the first period, between 1990 and 1992, there was a sharp increase of current account deficits, as traditional exports to other ex-socialist countries practically collapsed, while imports from the West, following trade liberalization, increased drastically. Most of the deficit of that time was financed from official sources, including multilateral financial institutions. In the following two-year period, i.e. in 1993 and 1994, current account deficit decreased, as output started to recover and exports began to increase due to its geographical reorientation towards the West. In the third period, between 1995 and 1998, current account deficit rose again, as high output growth rates were supported with quickly growing imports. The deficit was financed, on the one hand, with drastically increased inflows of FDI, especially in the CEECs, and on the other hand, with private sector debt financing, mainly in the form of syndicated loans and issuance of bonds. Eruption of the Russian crisis in August 1998 marks the end of this third period and the beginning of the fourth one. As funds from foreign private sources have dried out for most of transition economies, they have been actually forced to adjust their current account deficit to levels that are sustainable to the reduced level of foreign funds available.

Reversal of inflation, renewed growth of fiscal imbalances and reduced access to international capital market have been witnessed in some countries of the region over the last two years are only some of the indications indicating that macroeconomic stability in these economies is still very fragile. Consequently this means that countries in transition continue to be highly vulnerable to different kinds of shocks, both internal and external. There is a growing body of literature analysing the signs and/or indications of a country's vulnerability. The following indicators are usually mentioned within this context: *(a)* the rate of inflation, *(b)* the size of the fiscal deficit as proportion of GDP, *(c)* the size of the current account deficit as proportion of GDP, *(d)* the external debt burden, *(e)* the foreign exchange liquidity status, and *(f)* financial sector indicators.

Employment, labour productivity, wages and international competitiveness

Employment

Transition from centrally-planned to market economies has been associated with major changes in the level of employment. Prior to transition open unemployment was almost non-existent in the region. The situation reversed dramatically following the output collapse in early 1990, registered unemployment grew throughout the region. It exceeded 15 per cent in Bulgaria and Poland, and amounted to between 12 and 15 per cent in Croatia, Hungary and Slovakia. In contrast to these countries, the unemployment rate remained rather low in Czech Republic, between 3 and 4 per cent, and even lower in some countries of the CIS, such as Belarus, the Russian Federation and Ukraine (data from EBRD, 1999).

A revival of output growth in more advanced countries of the region over the last few years has so far not lead to a significant revival of registered employment. Unemployment therefore remains uncomfortably high and this can at least partially be explained with the continuing process of labour shedding. Persistent high unemployment in the region is in contrast with initial expectations that fast growing private sector development will be able to absorb a significant proportion of the labour force previously employed by the state sector. The evidence for some CEECs shows that most state to private sector labour force flows take place without any intervening spell of unemployment and that a large proportion of those who become redundant in the state sector drop out of the labour force rather than shift to the private sector (EBRD, 1999, p. 59). This in fact indicates that the region is increasingly facing the problem of structural unemployment where people who have become unemployed have little or no prospects to re-enter the labour force.

Labour productivity

Defined as a number of units of output produced per employee, labour productivity declined drastically in the first years of transition. This trend has been caused by a sharp drop in output accompanied by a much slower process of laying-off a redundant labour force. In the CEECs, the measured productivity reached the lowest level after two to three years of transition, i.e. in 1992 and 1993. Since then, productivity has been increasing continuously although factors contributing to this upward trend have changed over time. In the first half of the 1990s, productivity gains were mostly independent from capital investment. Higher productivity was achieved primarily through further reduction of a redundant labour force and through better utilization of existing manufacturing capacities. In this respect, there are significant differences among transition economies. While in some CEECs, manufacturing capacities utilization was more than 70 per cent in 1995 (Czech Republic—84 per cent, Slovakia—76 per cent, Poland—71 per cent), in the Russian Federation this proportion was only 33 per cent in the same year (Rapacki, p. 6). In the following years, the source of rapid productivity growth in several CEECs has been mostly investment related. This source of productivity gains is aimed at reducing incremental capital-output ratio (ICOR) through either replacement of the existing capital stock or through its expansion.

As shown in table 5, labour productivity in industry for several CEECs, including Croatia, Czech Republic, Latvia and Slovenia, increased over 40 per cent in the 1999-1998 period, while in the case of Hungary and Poland, the increase was as much as 60 per cent. The driving force behind this upward trend has been fresh capital investment accompanied by an inflow of improved technologies and modern management methods and by positive developments in the area of product innovation. In contrast to the explained J-curve pattern for labour productivity in most CEECs over the ten years of transition, manufacturing productivity in the Russian Federation, after a drastic fall in the early transition period, remained at a more or less unchanged level since 1994.

Table 5. Labour productivity, real wages* (both in industry) and unit labour costs 1993-1998

	1993-1998		*1993-1998*
Bulgaria		Lithuania	
productivity in industry	13.9	productivity in industry	24.0
real wage in industry	–0.5	real wage in industry	126.2
D-mark unit labour costs	11.3	D-mark unit labour costs	342.3
Croatia		Poland	
productivity in industry	46.5	productivity in industry	60.0
real wage in industry	127.0	real wage in industry	61.4
D-mark unit labour costs	70.2	D-mark unit labour costs	11.9
Czech Republic		Romania	
productivity in industry	49.7	productivity in industry	23.3
real wage in industry	54.8	real wage in industry	–0.1
D-mark unit labour costs	30.8	D-mark unit labour costs	23.3
Estonia		Russian Federation	
productivity in industry	28.7	productivity in industry	Na
real wage in industry	92.4	real wage in industry	–28.9
D-mark unit labour costs	206.6	D-mark unit labour costs	Na
Hungary		Slovakia	
productivity in industry	61.1	productivity in industry	36.7
real wage in industry	14.7	real wage in industry	41.1
D-mark unit labour costs	–27.8	D-mark unit labour costs	30.0
Latvia		Slovenia	
productivity in industry	54.3	productivity in industry	42.4
real wage in industry	79.1	real wage in industry	37.6
D-mark unit labour costs	129.8	D-mark unit labour costs	7.6

Source: Transition Report 1999. p. 74.

*Real wages are PPI-based.

Wages

Trends in real wages in transition economies over the last ten years have by and large corresponded to the labour productivity trends. In line with the decline in productivity, real wages also fell in the early years of transition. Later on, when labour productivity turned upward, this trend has been accompanied by a general trend in real wage increases. There are, however, significant differences across the countries of the region with respect to the pace of labour productivity growth, on the one hand, and the intensity of real wage increase, on the other. As shown in table 5, in countries, like Croatia, Slovakia and the Baltic States, real wage increase (expressed in local currency) exceeded substantially the productivity growth during the 1993-1998 period. On the opposite side of the spectrum are Hungary and also Romania with productivity growth much faster that the real wage growth over the same period. In the rest of the countries for which data are available the two trends more or less closely corresponded.

International competitiveness

Although the concept of international competitiveness lacks universally accepted definition, there is a much broader consensus that the factors underlying competitiveness can be broken down into two broad components. The first one addresses the issue of costs. If costs in a given country are low, then the country can export goods—this is so-called “cost competitiveness”. If, however, country can export goods due to the image its products have or due to their high quality and/ or technological or market specifics (even if these products are not cheaper than the rival goods), then we talk about non-price or “qualitative competitiveness” (OECD, 1998, p. 7).

As far as cost competitiveness of transition economies is concerned, one indicator that can be applied is wages measured in a foreign currency. In has to be underlined, however, that dollar or D-mark wages reflect not only changes in labour productivity but also local/foreign currency rate developments. Experience over the last years indicate that an important part of wage increases expressed in foreign currency in this part of the world is to be attributed to the real appreciation of their currencies, as prices in these countries have risen faster than in advanced economies, while exchange rates vis-à-vis currencies of these countries have either remained stable or depreciated more slowly than inflation. Real appreciation of local currencies, especially in a number of CEES and the Baltic States, has been claimed to be one of the main reasons for their growing current account deficits and for losing their international competitiveness (on this issue, see Havlik, p. 9-15 and J. P. Morgan, p.11-12).

Taking into account the above-mentioned exchange rate considerations, wages measured in foreign currency are a rather poor indicator for making an assessment of the country’s cost competitiveness. A much better and more widely applied indicator is the so-called “unit labour cost (in foreign currency)” which is a ratio of labour related expenses measured in a foreign currency against the productivity of labour. Table 5 shows that over the 1993-1998 period, Slovenia, Poland, Bulgaria and especially Hungary performed much better in terms of their cost competitiveness than all other countries included in the table. In all three Baltic States, for example, unit labour costs more than doubled.

When interpreting these data, it has to be underlined, however, that the data refer to annual changes only. They, therefore, do not tell us what is the nominal level of the unit labour costs. For countries in transition, unit labour costs are still significantly lower than in industrialized countries and a cheap labour force therefore continues to represent for them an important comparative advantage. This is much more the case in the CIS and the Baltic States than in the CEECs. Slovenia and Croatia, for example, display fairly high unit labour costs; they were 62 and 65 per cent, respectively, of the Austrian level in 1998 (Havlik, p. 9).

In addition to conventional “cost competitiveness” analysis, much work has been done over the recent years to identify in what segments of their economies countries in transition have comparative advantages. As discussion of this subject goes well beyond the scope of this paper, here is a general conclusion of one of the empirical researches that has been completed only recently. According to this research, comparative advantage in countries in transition is biased towards resource and labour intensive industries in virtually all transition economies, while there is a strong disadvantage in high-tech sectors and a mild disadvantage in agriculture and heavy industries (see, EBRD, 1999, p. 178-180).

4.3 Structural reforms

If the major objective of the macroeconomic policies is to create a stable environment, then the major objective of the microeconomic policies and structural reforms is to actually accomplish the transition and to make a transition economy a viable and competitive long-term actor on the internal market. Macroeconomic reforms alone, although necessary, do not lead automatically to supply responses needed for a comprehensive transformation to a market economy. These reforms, namely, do not deal systematically with structural weaknesses of the country’s economy, with the lack of entrepreneurial cadres as well as of managerial and supervisory personnel, and also with the inadequacies in technological, financial accounting and marketing areas.

To address these weaknesses, a clearly defined set of microeconomic policies and structural reforms is needed. They will help to develop a strong economy and a strong economy will be better prepared to absorb shocks and will contribute towards achieving macroeconomic objectives, especially the low level of inflation. Within this general framework, structural reforms have several objectives. They are aimed at *(a)* creating conditions conducive for a higher level of investment which is required for sustainable economic growth and increased employment, *(b)* increasing international competitiveness of the economy by improving the efficiency of factor markets, and *(c)* designing policies and measures which make the transition process socially and environmentally sustainable.

Major components of structural reforms to be addressed in the rest of this chapter include: *(a)* adjustment of the legal and regulatory system, *(b)* financial sector reform, and *(c)* enterprise sector reform, including privatization, promotion of SMEs and enterprise restructuring.

Similarly, as in areas of macroeconomic stabilization, there are huge differences among individual transition economies in terms of the progress achieved in the structural transformation of their economies. Countries that have already carried out a comprehensive macroeconomic stabilization programme, primarily the CEECs and the Baltic States, are typically also countries that are now in a more advanced stage of transition. In contrast, countries that have been late with the introduction of macroeconomic measures are lagging behind also with structural transformation processes.

Adjustment of the legal system

Being aware of the fact that an appropriate legislation is a necessary condition for an efficient transition from a centrally-planned to a market economy, all countries in the region started at the very outset of the transition with a comprehensive reform of their legal and regulatory systems. Although the design of a fully operational legal and regulatory framework takes time and makes heavy demands on scarce human resources of these countries, many of the transition economies have already gone a long way in drafting laws in all areas fundamental for economic transformation. By now, a large majority of countries have adopted property, contract, security, bankruptcy, competition and company legislation.

Although passing the legislation is an important step forward, experiences gathered over the recent years increasingly show that this is of limited relevance if not accompanied by all necessary by-laws as well as with effective implementation and enforcement. In property legislation, for example, the letter of law typically puts private property on equal footing with state property. Yet several of these new rights still remain limited by various limitations. In some countries in transition, for example, there is a general lack of a reliable land registration system, which in turn makes the validity of a transaction over such a property dubious.

Similar problems may be observed in practically all other legal and regulatory areas. Bankruptcy legislation, for example, is a legal segment that is of key importance for effective economic transformation of transition economies. Efficient bankruptcy law includes procedures for both liquidation and reorganization of problem firms, plays several important roles in market economies. It provides failing firms with an orderly procedure of exit and ailing but potentially viable firms with a means of restructuring. It also promotes the flow of credit by protecting lenders (World Bank, 1996a, p. 91). Although many transition economies have adopted well-designed bankruptcy laws, inadequate judicial and administrative support have in some cases slowed down their implementation.

In order to assess the progress made by individual countries in transition in the area of legal reforms, EBRD has constructed legal transition indicators. They assess the situation in this area on the basis of two criteria. The first one—"extensiveness"—assesses the extent to which commercial legal rules approach those of more developed countries regarding their impact on commercial transactions. The second one—"effectiveness"—assesses the extent to which legal rules are clear, accessible and adequately implemented administratively and judicially. Based on these two criteria, the best performing countries are those ones in the CEES and the Baltic States groups, especially Bulgaria and Hungary, followed by Czech Republic, Estonia, Poland, Romania, Slovenia and the former Yugoslav Republic of Macedonia (EBRD, 1999, p. 44).

Financial sector reform

Transition to a market economy has required a drastically changed role for the financial sector. The main challenge in this area has been, and still is, to overcome the legacy of the past and at the same time to design and develop an efficient system of financial markets and institutions. There are at least three reasons why financial sector restructuring has been of strategic importance for transition economies. First, without an active financial market mechanism, their economies, having abandoned planning, have no alternative allocation mechanism. Second, through intermediation of financial institutions, resources can be channelled directly to enterprises and to the real sector in general. Third, efficient financial institutions help impose a hard budget constraint on enterprises.

Taking into account the dominance of banking in the overall financial system in countries in transition, as well as the nexus of non-performing loans and enterprise sector losses, the banking sector has been in the forefront of financial sector reforms (for an extensive discussion of these interlinkages, see, for example, Wijnbergen, 1998). It is for this reason why this chapter only deals with banking sector reforms and does not discuss issues related to securities markets and non-bank financial institutions. It should be mentioned, however, that development in these two segments of the financial sector has been extremely rapid in some countries of the region over the recent years. Securities markets and non-bank financial institutions, therefore, clearly offer a substantial potential to complement the banking sector in meeting financial needs of the corporate sector, and particularly of larger companies, in the years to come.

Introduction of market reforms has forced banks to start their transition from passive distributors of credit to professional bankers. As in other market economies, banks in countries in transition are now required to be active in meeting their clients' financial needs on the one hand, and on the other, they have to adhere to capital adequacy criteria and new accounting rules regarding the provisioning of debt.

The banking sector transformation process over the recent decade has been challenged by several problems. Some of them are the following: First, high concentration of banking markets. Market shares of the top five banks in a country very often still account for between two-thirds and four-fifths of the market. These high shares, a direct legacy of the pre-transition period, reflect continuous dominance of state banks or former state banks in many countries of the region. Second, high share of non-performing loans. As a result of transition shocks, huge financial losses have been accumulated by the enterprise sector in all countries of the region and their mirror picture has been appearance and/or increase of non-performing loans in the balance sheets of banks. Third, high transaction costs. It is apparent that the high level of non-performing debts has compelled banks in many transition economies to maintain quite wide margins between lending and deposit rates. Another reason for high transaction costs are high operating costs of banks. Due to lower efficiency of the banking sector, these are typically twice as high as in developed market economies. Fourth, inadequate access to bank loans. Bank lending is highly concentrated on existing customers from mid-size and large companies, very often still in state ownership. The de facto privileged access of these companies to bank lending limits the amount of credit available to new potential borrowers, especially SMEs and individual entrepreneurs. Fifth, lack of active involvement of banks in the restructuring of the corporate sector; In addition to difficulties in the enterprise sector, the reasons for this problem include the lack of banking staff with experience in credit and risk analyses, insufficient information on the creditworthiness of potential clients, and an environment with inadequate protection of lenders' property rights. The appetite of banks for corporate financing has been further reduced because of their preference for non-corporate securities. Investment in government papers carries similar if not higher yield as lending to enterprises, but with practically zero risk.

In spite of all the above presented difficulties, countries in transition have gone a long way in transforming their banking systems. The transformation has been implemented through a combination of policy measures. In addition to the replacement of the original mono-bank system with the two-tier banking system across all countries of the region, government policies in this area have typically included reforms in prudential regulation and supervision, recapitalization and privatization of state-owned banks and new entrance of new private banks.

Countries across the region differ not only in terms of the design of these policies but even more in terms of their implementation. The transition countries that have been strong performers in banking sector restructuring share a number of features. Of particular importance are effective domestic and foreign entry and exit regulations, which facilitate the entry of foreign banks, and thereby foster competition and encourage the development of new banking products (Nsouli, p. 4). Foreign banks' share of the banking market in CEECs increased to 32 per cent by the mid-1999, with the largest shares in Hungary—48 per cent, Czech Republic—41 per cent and Poland—33 per cent (*Financial Times,* 10 November 1999, p. 4). One of the important problems that has been addressed by all advanced countries in transition in the early stage of economic transformation is the problem of bad debts. There have, however, been two completely different approaches applied in dealing with this problem. Some countries have opted for a centralized or top-down approach with a special workout agency established to handle bad debts taken over from banks, while others have followed a decentralized or bottom-up approach, leaving banks and enterprises to directly negotiate solutions.

Enterprise sector reform

This segment of structural transformation is clearly at the very heart of the transition process and, in general, involves processes associated with the transition from a public dominated to a private dominated economy. These processes include: *(a)* introduction of financial discipline and competition in the enterprise sector, *(b)* private sector development through both privatization of state-owned firms and promotion of new private firms, and *(c)* restructuring of enterprises in both, pre- or post-privatization periods.

Introduction of financial discipline

The first years of transition had been characterized by a sharp deterioration of enterprises' liquidity position, as their sales were drastically reduced or even stopped due to the opening of the markets to foreign competition while the banks became, in a changed environment, much more reluctant in extending new loans. In circumstances of strong liquidity squeeze and with a clear priority to pay labour first, enterprises typically started to defer their payments to suppliers. This has resulted in a rapid increase of inter-enterprise arrears and in some cases also of enterprises' arrears on their tax and social security payments. In order to address this problem, several countries in transition have implemented complex schemes of netting out arrears between firms.

In addition to curtailed bank lending, sharply reduced government subsidies, being made either through direct or indirect budget transfers or through subsidized energy and/or other input prices, have been another important element of imposing financial discipline on the enterprise sector. In the Russian Federation, for example, total federal subsidies fell from 32 per cent of GDP in 1992 to about 6 per cent of GDP in 1994 (World Bank, 1996a, p. 45). In spite of these positive developments, direct productive subsidies still amounted to between 0.5 per cent of GDP (Armenia) and 6.5 per cent of GDP (the Russian Federation) in 1998 for the 20 countries in transition covered in the EBRD's Business Environment and Enterprise Performance Survey. Another conclusion based on the findings of this survey is that state firms in transition economies tend to have a privileged access to government credits for investment financing. On average, state firms in this region continue to receive 26 per cent of funds for fixed investment from the state. In the so-called "CIS periphery", it includes "Caucasus" and "Central Asian countries", this share is as high as 39 per cent (EBRD, 1999, 137).

Privatization of state-owned enterprises

In contrast to market economies, developed and developing, where a mixed economy has prevailed and where privatization has meant an enhancement to already existing market rules in economic activity, for countries in transition, privatization has become one of the crucial tests for the commitment of new governments to the establishment of a market-based economic system and a political system based on private property rights and individual freedoms.

Practically all countries of the region have pursued privatization on two parallel tracks. The first one, called "small-size privatization", refers mainly to privatization of retail outlets, transport equipment and service enterprises. This segment of privatization has, typically, not been politically controversial and has received strong popular support, as procedures were relatively transparent and positive effects strikingly visible on a relatively short run. As a result, "small-scale privatization" has been, with the exception of a few countries, such as Belarus and Turkmenistan, actually completed throughout the region (see EBRD, 1999, p. 24).

In contrast, the so-called "large-scale privatization", i.e., privatization of former state-owned enterprises, has proved to be more complicated than originally thought and as a consequence, the advances here have been, in general, much slower and also less uniform across the countries of the region. Slower pace of "large-scale privatization" has been typically caused by one or a combination of the following reasons: high capital requirement, major restructuring needs, restitution problems, regulatory and governance weaknesses and also political sensitivity or even resistance.

Countries have applied a wide range of methods for privatizing their large and middle-sized companies. Some countries, Hungary and Poland are the most notable but not the only cases, have been successful in selling their enterprises to strategic, often foreign investors. Others, such as Slovenia, Croatia and the former Yugoslav Republic of Macedonia, have relied more on internal ownership transformation in the form of management buy-outs. An imperative for a massive and rapid privatization to be done in an environment with the lack of prospective strategic buyers explains why voucher privatization has also been extensively used in the region. Countries as diverse as Armenia, Bulgaria, Czech Republic, Slovakia, Poland, the Russian Federation, Ukraine and Slovenia have privatized large stocks of their assets by applying various voucher schemes (see, for example, EBRD, 1996, chapter 2).

According to the EBRD, the most complete "large-scale privatization" has so far been implemented only in Czech Republic, Estonia, Hungary and Slovakia. These countries have already privatized more than 50 per cent of state-owned assets. They continue to keep under state control only a limited number of "strategic" enterprises and public utilities. With the exception of Albania, Azerbaijan, Tajikistan, Turkmenistan and Ukraine, all other countries in the region have also made significant progress in the privatization of their large-scale enterprises (see EBRD 1999, p. 24).

Promotion of SMEs development

SMEs, as the most vital and dynamic component of market economies, play an important role in their overall economic growth. They typically account for more than a half of a country's output and employment, are represented in all major branches of manufacturing and services sectors, and are likely to be less concentrated in urban areas than large-scale enterprises. For all these reasons, SMEs constitute an ideal vehicle for the promotion of economic and social development.

Over the ten years of transition, countries in the region have made a significant progress in the SMEs sector. Laws setting up legal framework for small businesses have been adopted and the countries have actually witnessed an impressive growth and development of their SMEs. The process has been marked especially by the surge of new small firms created either in the form of start-ups, mainly in trade and service sectors, or through spin-offs of large state-owned enterprises.

In spite of the fast development of the SME sector throughout the region over the recent years, there are several kinds of difficulties and barriers entrepreneurs are still facing. Some of them are common to all countries of the region while others are more country specific. The most important barrier for even faster development of SMEs are inadequacies in the area business regulation. Over the years, major improvements have been made in this area in several countries. Many other obstacles have also become less pronounced as transition proceeds. For example, macroeconomic stabilization has resulted in reduced inflation and lending rates, improving overall business environment for SMEs. Now, small businesses also depend less on large state-owned enterprises for buying inputs and for selling their outputs. They also have better access to specialized training aimed at quality improvement, management and technology counselling. Last but not least, sometime hostile social environment to SMEs development has turned into a much more positive one.

Table 6 shows how entrepreneurs from 20 countries of the region perceive the importance of different kinds of barriers. Barriers in the area of taxes and regulations are perceived as the single most serious obstacle to operation and expansion, followed by inflation and the lack of access to finance. In terms of variations among different country groups in the region, a higher average intensity of barriers is consistently reported by entrepreneurs in the CIS and south-eastern Europe than in the central Europe and the Baltic States. Across all major categories of barriers, they become greater the further east the enterprise is based (EBRD, 1999, p. 151).

Table 6. Main barriers for the entry and expansion of SMEs

	*Early transition**	*Recent entrants***
Taxes and regulations	3.28	3.25
Inflation	3.04	3.21
Financing	2.97	3.21
Corruption	2.53	2.58
Anti-competitive practice	2.44	2.50
Infrastructure	2.01	2.23

Source: Transition Report 1999, p. 151.

Note: Average value of perceived barriers on a 1-4 scale, with 4 representing a major obstacle.

*Enterprises founded between 1989-1996.

**Enterprises founded since 1997.

Enterprise restructuring

In the world of constant changes and globalization, enterprise restructuring is centrally concerned with improving the efficiency with which an enterprise adapts itself to changing constraints and opportunities in an international environment. Firms throughout the world must continuously restructure in order to maintain their international competitiveness and therefore profitability, both challenged by increasing global competition and rapid technological change. For countries in transition, enterprise restructuring is even more important. For them, it does not only mean maintaining enterprise profitability but rather a process of transforming a highly distorted economy with many loss-making firms into a viable market economy in which most industrial enterprises are internationally competitive and profitable (for an empirical analysis of this subject, see Pohl and Djankov and Andersen).

Enterprise restructuring in countries in transition involves activities at both, policy and enterprise levels. Although restructuring at the company level is essential, it cannot be effective if not closely coordinated with policies at national and sectoral levels. Successful enterprise restructuring, for example, depends crucially on the quality of corporate governance and it must be accompanied by sound macroeconomic policies and strict financial discipline. Policies related to privatization and policies determining relationship between enterprises and their creditors are of crucial importance as well. Balancing the objectives of not to prematurely close enterprises and avoiding the moral hazard incentives that they will be bailed out again in the future, is one of the most difficult tasks of enterprise/financial sector reforms in the region.

At the company level, enterprise restructuring is also a complex process. To be successful, it has to efficiently combine skills as diverse as management and organization skill, marketing, accounting and financial control, specific training, and technical and technological matters concerned with product adaptation.

The complexity of the tasks associated with enterprise restructuring is the main explanation why countries in the region have achieved slower progress in this than in many other areas of transition. According to the EBRD, none of the countries in transition has reached the standard and performance typical for advanced countries in this area. Nevertheless, significant progress in enterprise restructuring has been made in a number of the CEECs and the Baltic States, especially in Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. Better enterprise restructuring results in all these countries can be attributed to both their overall advancement in transition and their efforts for an early accession to the EU. All other countries in the region are considered to be less successful in restructuring their enterprise sector (see, EBRD, 1999, p. 24).

4.4 Conclusions about the overall progress made by countries in transition

The most comprehensive analytical tool for making an assessment of the overall progress achieved by an individual country in the transition process has been developed by EBRD, for its annual publication *Transition Report.* In 1994, EBRD designed a rating system that focuses on the main elements of a market economy—markets and trade, enterprises and financial institutions. The following eight dimensions of transition are being covered in the system: *(a)* small-scale and *(b)* large-scale privatization, *(c)* enterprise governance and restructuring, *(d)* price liberalization, *(e)* trade and foreign exchange liberalization, *(f)* competition policy, *(g)* banking reform, and *(h)* capital markets. In addition to these eight core dimensions of transition that have been measured by each *Transition Report* since 1994, new indicators have been designed in order to measure progress in some other areas of reform. One set of these new indicators measures the extensiveness and effectiveness of the legal framework for markets (see above, "Adjustment to the legal system") while another set assesses progress in the development of commercial infrastructure.

Progress in each of these areas represents an improvement in how well markets, enterprises and financial institutions function and the progress is measured against the benchmark set by industrialized countries. The measurement scale for each individual indicator ranges from 1 to 4+, with 1 representing little or no change from the old regime and 4+ representing a standard that is in place in a mature market economy.

The overall transition indicator, it scores across all countries and all eight core dimensions of reform, provides a summary measure of overall progress in reform across the region. This indicator—presented in the *1999 Transition Report*—shows a significant progress over the 1994-1999 period, from 2.45 to above 2.70, but registered only a marginal increase in the following two years. In 1999, there were five countries (Kazakhstan, Uzbekistan, the Russian Federation, Kyrgyzstan and Belarus) that registered even a decline in their average transition indicator scores in comparison to the previous year. The main single factor for this development is the Russian crisis and its negative regional repercussions.

Looking on the progress of transition reforms from a more long-term perspective, two main patterns emerge from the indicators presented and discussed in each year's *Transition Report*.

First, clustering of countries within particular geographical subregions. The data show that the average transition indicator score tends to decline the further east the subregion is located. The two subregions in the west, Central Europe (Hungary, Poland, Czech Republic, Slovakia, Slovenia and Croatia) and the Baltic States (Estonia, Latvia and Lithuania) had the highest average transition indicator scores in the region amounting to more than 3 in 1999. Countries in all other subregions had a lower score indicating less progress achieved in the transition process. The data also show that the variation among individual countries within subregions increases from west to east. The average scores for countries in the "central CIS" (the Russian Federation, Ukraine and Belarus), "Caucasus" (Georgia, Armenia and Azerbaijan) and "Central Asia" (Kyrgyzstan, Kazakhstan, Uzbekistan, Tajikistan and Turkmenistan) diverge widely.

There is a wide range of structural, political and geographical factors that have contributed to the differences among the subregions with respect to their achieved progress in transition reforms. Among others, these factors include: *(a)* large differences in initial structural and macroeconomic imbalances, *(b)* policy choices made with respect to the timing and sequencing of reforms; "shock therapy approach" vis-à-vis "gradualist approach", and *(c)* different geographical proximity to the West; countries closer to the EU have benefited from the process of integration arising from trade with Western countries and from strengthened political cooperation with this group of countries. The EU accession process has proved to be an extremely powerful instrument for speeding up the process of transition.

Second, persistent disparity across different areas of transition reforms. The data show that progress in areas in which the task of the state was to withdraw from all economic responsibilities has been particularly fast. By their nature, reforms that involve liberalization, i.e. elimination of government imposed restrictions on prices, trade and the market for foreign exchange, are reforms that saw rapid progress early in the transition. Areas of reforms in which transition requires redistribution of assets, i.e. small and large-scale privatization, have on average moved steadily over the period, with small-scale privatization moving much faster than privatization of large-scale company assets. The third set of areas of reforms are those ones that involve building and/or rebuilding of institutions, i.e. enterprise restructuring, banking sector reform, introduction of competition policy and the establishment of securities markets and non-bank financial institutions. In these areas of institutional reforms, the progress has been the slowest. This is not surprising taking into account that institutional reforms inevitably take time as they require not only the enactment of new laws but also the capacity of the authorities to enforce the legislation (Stern, p. 5).

5 Prospects for the future of transition

5.1 The challenges and issues ahead

In 1989 and immediately after that, there was a broadly shared belief that transition to market economy would be a rather short and simple process. Based on a set of policy measures agreed upon by influential international financial institutions, political bodies and professional economists, the so-called "Washington consensus" was accepted as a common wisdom of policies that would move transition economies from stabilization to growth. This set of policy measures—it has also paved the way for the integration of transition economies into global economic environment—had been stressing the importance of liberalization, privatization, opening of transition economies and financial discipline (Kolodko, p. 5).

After ten years of experience, it has become obvious that transition is a highly complex, difficult and lengthy process. There is no doubt that substantial progress has been made by the countries in the region in transforming their economies from centrally-planned to market-based economies. However, as discussed in the previous chapter, the advancement in transition has been unevenly distributed both across the countries of the region as well as across different areas of transition. There seems to be a growing consensus among numerous analysts that the region as a whole is now approaching the end of the first phase of transition. The analysts also agree that while the process of change in the first phase of transition has been remarkable, the tasks here have been in many respects more straightforward than those that follow.

The main challenges of the new, second phase of transition—its main objective is sustainable economic growth—are to make these new market economies function more efficiently and to build on the foundations established in the first phase of transition. The agenda for the new phase of transition should also incorporate issues that have not been addressed properly in the first phase of transition, as confirmed by recent developments in the world, especially by the financial crises in Asia and the Russian Federation. Last but not least, there are some important issues for transition economies that have been either missing or have been largely underestimated in first decade of transition. These issues—they include institution building including redesign of the role of the state, improvement of corporate governance in the enterprise and financial sectors, investment in both education and infrastructure, and social inequality—must find an appropriate place in this new agenda. True, more attention has been given to these issues since the mid-1990s, and especially in the last two years, but much more has to be done on these issues in the future.

5.2 Responses to the challenges

In order to respond effectively to challenges of the next phase of transition, countries of the region must continue with their structural reforms. Deeper and radical changes are needed in both public and private sectors. Institutional strengthening and improved governance are expected to constitute the key elements of the next phase of transition. They are both needed to support a well-functioning market economy and thus to create a climate for investment and consequently for long-term economic growth.

At a more operational level, six segments of structural reforms have been identified as being of particular importance for the second phase and therefore for the future of transition. Each of them will be discussed in some detail in the rest of this chapter.

Changed role of government

The process of transition does not simply mean withdrawal of the state from directing economic activity. What transition means in this area does mean, is to transform the role of the state so that it will become supportive to markets and to private sector development. In order to function well, market economies need governments that are efficient in establishing and enforcing legislation and other rules for *(a)* promoting social objectives, *(b)* raising funds required to finance public sector activities, *(c)* spending these resources productively, *(d)* bringing required corrections and control over the functioning of the private sector, and *(e)* enforcing contracts and protecting property (Nsouli, p. 5).

Governments in transition economies will need to establish rules that include openness, transparency and credibility in government action as well as the absence of bureaucratic interference, discretionary regulations and corruption. Introduction of these rules would create an environment that is conducive to the efficient functioning of market forces, and would therefore be important for the development of the private sector. They would also reduce the perception of risk, and thereby helping to attract investment. Providing a sound investment climate for entrepreneurs not only yields important benefits in terms of economic performance but also strengthens their capacity to create new jobs, and consequently to help alleviating the social costs of structural reforms in the future.

Continuation of enterprise sector reforms

Reform of the enterprise sector will continue to be at the heart of the next phase of transition and this relates to both the entry and growth of new private firms as well as for the restructuring of privatized and state-owned companies. Within this framework, the enterprise sector needs to design and put into operation sound practices on which effective business activity depends. This includes a significantly strengthened corporate governance *(a)* that holds managers accountable to shareholders for their performance, *(b)* that gives confidence to those providing finance, and *(c)* that can ultimately result in management decisions and investment which can deliver growth. One of the important lessons from the past ten years of transition is that the method of privatization has a strong influence on the ownership structure and therefore on corporate governance in the post-privatization period (Exeter and Fries, p. 27). In the following years, capital markets are expected to exert an increasing influence over corporate governance standards in enterprises. Pressures for enterprise sector reforms will be further intensified by the growing need for investment funds as well as by corporate governance problems in firms with internal ownership and in firms with highly dispersed ownership (Stern, p. 1 and 10).

Another crucial issue in this area is enterprise sector restructuring. In the first phase of transition, activities in this area have been focused on liberalization and privatization, while restructuring of politically and socially sensible sectors, such as agriculture, steel, shipyards, mining, has too often been slow and/or inconsistent. It is restructuring and privatization of these sectors that will become much more prominent in the next phase of transition. As mentioned before, enterprise sector restructuring is a complex phenomenon that goes well beyond these sectors. Therefore, coordinated activities of all, enterprises, states and creditors, will be needed in order to design and implement appropriate solutions. As far as the role of the state in this process in concerned, it should promote market discipline and put in place effective bankruptcy procedures, while at the same it should ensure that financing will be made dependent on a well-regulated and supervised financial sector and good business practices. Such actions should, in fact, harden the budget constraint on enterprises.

Enforcing of financial sector reforms

By improving the intermediation process between net savers and net investors and by increasing efficiency in the allocation of financial resources, reforms in this sector are fundamental to promoting economic growth. In spite of significant achievements in this area over the last decade, the financial sector in transition economies, even in some of the more advanced countries, is still far below the efficiency level of financial institutions in industrialized countries.

In order to increase efficiency of financial institutions, and therefore to reduce the gap vis-à-vis industrialized countries in this area, the next stage of financial sector reforms in transition economies should address three core areas. First, an enhancement of the competition through *(a)* wider opening of the sector to foreign competition, *(b)* accelerated privatization of state-owned financial institutions, especially banks, and *(c)* internal restructuring of financial institutions aimed at both, reduction of operating costs and at broadening the range of services offered to clients. Second, an improvement of the regulatory framework, among others, in the following areas: *(a)* various forms of financial institutions' exposures, and *(b)* financial conglomerates and connected persons. Third, strengthening of the supervision through *(a)* improved quality of auditing, *(b)* right priorities and practices, *(c)* well trained and motivated staff capable of handling off-site and on-site examinations, and *(d)* close cooperation among supervisors responsible for different segments of the financial system.

Human resource development

One of the important comparative advantages of centrally-planned economies was, on the one hand, their highly qualified labour force, and on the other hand, a rather well established R&D base. Both education and R&D development had, however, been characterized by several specific features that differed significantly from the corresponding features in market economies. Education under the socialist system, for example, was emphasising an excellent basic education, especially in math and sciences, and a rather inflexible vocational and career-specific training. The system neglected adult education as well as subjects like economics, management and law, all of them very important for a market-based economy. As far as R&D is concerned, socialist countries had large communities of scientists but they were organized primarily around national academies of sciences and therefore had rather weak connections with the enterprise sector. R&D financing was almost entirely done by the state.

Throughout ten years of transition, drastic changes have been introduced into the educational system of transition economies in order to make the system adapted to the needs of the market economy. Three sets of developments have been noticed in this respect: *(a)* basic education enrolment has remained at a traditionally high level, *(b)* secondary education has become much more flexible, and *(c)* tertiary school enrolment has increased with a shift away from engineering programmes and with growing enrolment in social sciences. In the R&D area, the transition shock and the lack of policy guidelines for the transformation of technological capacities has in most countries in transition resulted in a significant reduction of capacities. This applies to both, the number of institutions in R&D as well as the number of researchers employed therein.

If countries in transition would like to increase the international competitiveness of their economies, they will have to significantly strengthen their human resource capabilities. This implies that education and especially rehabilitation of R&D capacities in the region will have to get a much more prominent place in the next phase of transition.

Improvement of physical infrastructure

Most countries in transition inherited severely distorted physical infrastructure. The problem was not only an underprovision of certain services but even more so their low quality and disregard of resource costs and environment. In order to address these problems, transition economies have been faced with large needs of building new infrastructure networks and replacing the existing old technology. Response to these needs have been strongly influenced by the severe pressure on government finance.

The strategic objective of physical infrastructure development in transition economies in the next period is to move towards a reliable and cost efficient provision of infrastructure services which will take due account of security of supply, safety of the population and protection of the environment. In order to achieve this objective, a whole range of coordinated policy measures has to be designed and put into operation. Their common denominator is a more commercial approach to infrastructure development. This approach includes policy measures aimed at *(a)* easing price control of infrastructure services and redefining their tariff setting, *(b)* strengthening competition between service providers, *(c)* creating a legal framework conducive to private investors, and *(d)* establishing an appropriate regulatory system with a clear and coherent allocation of powers and responsibilities. Only if these measures are introduced and effectively put into operation will investment in infrastructure become attractive for private, including foreign entrants. Private involvement in infrastructure financing is absolutely necessary if countries would like to reduce the gap between their financial needs for investment in physical infrastructure and public financial resources available for this purpose.

Reducing poverty and income inequality

In the area of social development, two broad trends have been registered in the region during the first decade of transition (for details, see EBRD, 1999, p.16-20). First, the transition has been accompanied by an increased number of poor people in almost all countries in the region, though the increase of poverty has been the largest in countries where the output fall has been sharpest. As a consequence, large sections of the population have been exposed to substantial declines in living standards. Second, there has been a drastic increase in income inequality throughout the region. The increase has been much pronounced in the CIS than in the CEECs. In the Russian Federation, for example, income inequality measured by the Gini index increased from 0.24 to 0.39 from late 1980s to the mid-1990s (World Bank, 1999b, p. 30-31). Increasing poverty and income inequality, though perhaps unavoidable in early years of transition, is becoming a serious obstacle for public confidence in, and acceptance of, the reforms required in the next phase of transition. It is becoming increasingly clear that there is a limit to poverty and income inequality beyond which political support for necessary reforms may become in question.

In order to address these growing social pressures, governments throughout the region, and especially in countries with the most severe problems in this area, will have to play in the future a much more active role in controlling poverty and income distribution. It is true that over time, institutional changes and increased competition should reduce economic rents and therefore also income inequalities. This process will take time, however. In the meantime, and in a combination of fiscal and social policies, governments will have to design and put in place well-targeted social safety nets for the most vulnerable segments of the population.

5.3 Challenges for UNIDO

The process of globalization and its impact on development issues of countries in transition necessitates that international organizations, including UNIDO, to critically re-evaluate its technical cooperation strategies and policies and re-design the areas of intervention and programmes of assistance in the countries of this region along the lines of the new development paradigms, UNIDO business plan and service modules which includes 16 possible areas of intervention.

The structural reforms that the countries in transition need to vigorously pursue, constitute at the same time the challenge for possible intervention by UNIDO, especially in such fields as sustainable industrial policies and strategies including a conducive institutional support, private sector development with emphasis on small and medium scale enterprises, microeconomic improvement of the industrial enterprise performance including environmental norms, clean and energy efficient technologies, investment and technology promotion and human capacity building.

As the countries in the region differ in many aspects, the type and scope of intervention need to be differentiated to reflect the priorities established by each group of countries in this region. Those countries which applied for EU membership would definitely require assistance associated with facilitating their access to the EU with the quality of manufacturing products and environmental norms applicable in the EU structures. The priorities of the countries in the NIS region will be associated with local capacity building and institutional support to strengthen their position vis-à-vis transnational conglomerates and global agents of development.

In both cases, UNIDO's intervention will aim at supporting the changing role of the national governments faced by globalization in promoting its sustainable economic and industrial strategies and policies through direct support to agents of economic and industrial development, through institutional support to strengthen market reform and through capacity building in order to prepare the local personnel to become the partners for foreign investors, experts and promoters of its own industrial sustainable development.

UNIDO could also assist in addressing the issues of global concern that the process of globalization enables to promote in a coordinated manner, for example to combat ozone depleting substances under the Montreal Protocol Fund, and in implementing the United Nations Framework Convention on Climate Change and the Kyoto Protocol in order to improve the energy efficiency used by the industrial sector.

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