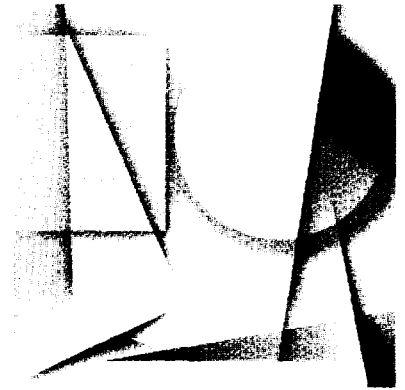


Transition and the World Economy



The global market that transition economies are reentering is an increasingly integrated one. World trade has grown far faster than global output in the past fifteen years, while total inflows of foreign direct investment (FDI) to developing countries have increased sixfold in just ten. Meanwhile a common set of overarching rules and institutions, including most prominently the new, 110-member World Trade Organization (WTO), has evolved to support even faster integration and to resolve disputes. Developing countries, many of which have recently made their own highly successful, if less comprehensive transitions toward more outward-looking economic policies, play an increasingly active part in this globalized economy. Exports and imports now account for 43 percent of developing countries' GDP, compared with 33 percent ten years ago. After years of isolation, transition economies may stand to gain even more from international integration than these other reformers. As Chapter 2 described, the economic benefits of moving into the world market are the benefits of internal market liberalization—writ enormous. Capital, goods, and ideas cross borders in response to demand and supply—rather than at the behest of a central planner—fueling faster growth in productivity, trade volumes, and national income. At the same time integration helps lock countries onto the path toward more-open trade, while membership in international institutions spurs domestic institution building.

Chapters 2 and 3, respectively, discussed the domestic importance of opening trade and of foreign investment. This chapter looks at transition economies' interactions with the rest of the world: trade flows to and from these countries and the consequences thereof for world trade; rapid and full-fledged membership in the WTO and relevant regional trade arrangements; and external capital flows to transition economies and the impact on other developing countries. The successful integration of transi-

tion countries brings benefits for the world economy—above all, by opening up almost a third of the world's population and a quarter of its land mass. A recurring concern, however, is that the transition countries' gains from this integration will come directly at other countries' expense. Such fears are understandable. Certainly, integration holds risks, as well as opportunities, for both sides. So far, however, the most commonly predicted global side effects of transition have not, by and large, been observed. As transition proceeds, many countries may indeed face adjustment costs. But the evidence suggests that these will be far outweighed by the benefits, for all countries, of being part of a larger and more competitive global marketplace.

The realignment of trade flows

Transition countries' potential trade growth . . .

Between 1978 and 1994 China went from being the world's thirty-second-largest exporter to its tenth-largest. Today the CEE countries and the NIS are similarly seeking to buy and sell in international markets. But how much will they trade—and with whom? Several estimates and projections based on economic models—and admittedly highly imperfect official statistics—broadly indicate the likely changes in trade patterns when the trade of the transition economies start has adjusted to market economy patterns.

These calculations suggest that the CEE countries have a large untapped potential for trade with established market economies, not simply those in nearby Western Europe but industrial countries further afield as well. In the mid-1980s the CEE countries were on average fulfilling just one-quarter of this potential. Since then, trade shifts away from former CMEA markets and toward OECD markets have closed the gap and produced a pattern of trade that is better attuned to market forces. For example, based on its 1985 income level, Hungary would have been expected to send 43 percent of its exports to the

European Union; the actual share was 14 percent. By 1994, however, the share going to the EU countries was 49 percent. As Chapter 2 described, those countries that have liberalized and stabilized furthest have made the greatest strides in reorienting their trade toward patterns that would be predicted for market economies.

Although the Soviet Union itself was a very closed economy, Soviet planners fostered specialization rather than diversification within each republic. The result was very little trade with the rest of the world and very large amounts of trade between republics. In 1989, for example, more than 90 percent of Belarus' trade was with other Soviet republics; that share would have been about 32 percent had all the Soviet republics been market economies. Nearly 70 percent of Russia's exports went to other Soviet republics, compared with a predicted level of only 16 percent. Overall, trade among the former Soviet republics accounted for more than four-fifths of their total trade in 1989. This pattern seems likely to be reversed when trade is determined by market forces. The same estimates suggest that, as market economies, the NIS would send fully three-quarters of their exports to non-NIS partners, mostly in Western Europe. By 1994 the Baltics had made substantial progress in reorienting their trade toward market economies, but most of the other NIS had done very little. As Chapter 2 pointed out, the slow pace of price liberalization and maintenance of extensive export controls to keep goods at home resulted in slow progress in reorienting trade in many of the NIS. Lacking the institutional and physical infrastructure and expertise to support new patterns of trade, some transition economies face a daunting task in exploiting their trade potential as market economies; this is especially true for the Central Asian republics, most of whose transport and communications routes run through Russia.

Since the collapse of the Soviet Union, several largely unsuccessful attempts have been made to restore trade among the NIS and reduce adjustment costs through regional trade arrangements. Several "free trade" agreements have been concluded, but these were free in name only, because most of the countries preserved export controls on key products. Establishing a sound interstate payments system and convertibility of currencies is vital to market-based trade among the NIS. Removing trade barriers among the NIS alone is not the answer, especially because, as we saw above, under market-determined trade patterns much of their trade would be with countries outside the NIS. If agreements create barriers to reorienting trade and reintroduce the substantial diversion of trade that occurred under the Soviet Union, they will be counterproductive. Trade barriers should instead be removed on a nondiscriminatory basis, to deepen the integration of the NIS into the world trading system.

... And the implications for other countries

Transition economies offer the world great opportunities. Producers can look to new markets, and consumers can benefit from new products. Increased efficiency and resource mobilization in transition economies will expand the global supply of goods and services. The expected growth in inter- and intraindustry trade from integration—already evident in the CEE countries—will also increase world welfare by expanding the variety of products and encouraging gains from rationalization in industries subject to economies of scale. China's imports and exports have doubled in the past five years, while CEE's imports from OECD countries increased 216 percent and its exports to them 159 percent in the same period. Market economies, particularly the established industrial ones, have a strong interest in encouraging growth in these new markets by keeping their doors open. But reintegration will inevitably imply some adjustment costs. Some developing countries will face fiercer competition, particularly in labor-intensive products, while industrial countries' comparative advantage will also shift further away from these industries. However, where it has been possible to estimate the costs, they appear to be modest. Transition economies will not exhaust the world's appetite for variety, but only spur producers to invent and supply many more goods and services, for the benefit of many more people.

Should any countries fear the effects of transition economies' trade integration with the European Union? As noted above, the EU countries are already the CEE countries' main trading partners, trade between these regions having more than doubled since 1989. The CEE countries have proved exceptionally good export markets for the European Union, and the Europe Agreements (discussed below) between the Union and CEE countries provide free access to EU markets for most CEE manufactures. But there are still some restrictions on imports of sensitive products, agriculture remains protected, and the threat of contingent protection (antidumping and safeguard measures) limits the practical effect of liberalization measures on steel and chemical exports. Nevertheless, the Europe Agreements help to lock the CEE countries into open trade policies, thereby enhancing the credibility of their trade reforms. The evolving pattern of trade between the two regions is one of increasing intraindustry trade and of increasing processing and assembly activity by CEE firms. The Europe Agreements create incentives for EU companies to engage in outsourcing, where they provide designs and materials, monitor quality, and take care of marketing. Encouraging this form of trade helps EU firms exploit relatively skilled and cheap labor, while reducing the costs and risks that CEE partners face in developing new export markets.

There has been some concern in the European Union that a further opening of trade in sensitive products would impose heavy adjustment costs on EU producers. The evidence suggests, however, that complete liberalization of trade in these products would have only a marginal effect on EU imports, production, and employment because the CEE countries are only minor suppliers. Admittedly, long-term trade integration with the NIS could involve vastly greater trade flows. But even here the new flows would largely consist of the NIS sending increased supplies of energy—most notably, oil and natural gas—to Western Europe in return for a large volume of capital- and technology-intensive goods (machinery and equipment) and high-quality consumer durables.

Many Mediterranean and African countries, currently enjoying preferential trade with EU countries, also worry that they will lose from trade liberalization between the EU and CEE countries. Several Mediterranean countries have enjoyed duty-free access to EU markets for industrial goods and preferential access for agricultural commodities since the 1970s. None of these preferences will be seriously eroded by the emergence of the CEE countries as EU trade partners. It is fair to say that their arrival on the scene may have deprived Mediterranean exporters of whatever geographical advantage in EU markets they previously enjoyed. But in fact the market share of nonoil exports of Mediterranean countries in the EU market has been stable. Mediterranean nations and CEE countries naturally have very different relative strengths—revealed comparative advantages—in world trade. Indeed, the export structures of the two regions hardly overlap at all. Longstanding restrictions on exports to EU agricultural markets are a much more important issue for a number of Mediterranean countries that cannot fully exploit their agricultural export potential. The countries of Africa that are signatories to the Lomé Convention also continue to enjoy preferential access to EU markets. For most, head-to-head competition with the CEE countries is relatively rare, again because the comparative advantage of the two groups of countries does not generally lie in the same goods or industries. In agriculture, too, these countries compete directly with CEE in only a few products. To be balanced against any adverse effect on the export side is the fact that rapidly growing CEE countries are themselves another potential market for the exports of the Mediterranean and African countries.

The CEE countries enter the international arena with relatively highly skilled labor, although some reorientation in educational priorities is needed, as discussed in Chapter 8. Because FDI brings not only capital and equipment but also managerial skills and ties to a trade network, in the longer run the CEE countries would be expected to compete in medium- or high-skill-intensive products rather

than in simple, labor-intensive products. This structural transformation would further reduce CEE countries' direct competition with low-income developing countries.

China's triumphant return to international markets has so far had the greatest impact on global trade of any transition country. As one would expect, given China's vast supply of unskilled labor, its export mix has been increasingly labor-intensive. With growth in China's exports in these types of products averaging 23 percent a year in the 1980s, labor-intensive exports rose from one-third of China's total exports in 1975 to three-quarters in 1990. Clothing, toys, sporting goods, and footwear together accounted for 30 percent of China's exports in 1994. Has China's rapid growth in labor-intensive products crowded out labor-intensive exporters from other developing countries in world markets? The answer appears to be no, for two reasons. First, and more important, China's export growth turns out to have replaced the exports of soon-to-be-high-income economies rather than other developing ones. And second, there is almost certainly more than enough demand for labor-intensive exports to go around.

China's dramatic growth in labor-intensive exports has been more than matched by a sharp decline in the export shares of East Asia's "four tigers"—Hong Kong, the Republic of Korea, Singapore, and Taiwan (China)—from 55 percent in 1984 to 24 percent in 1994. China's exports have simply replaced those of the tigers, so that their combined world market share has fallen for clothing, toys, and sporting goods (while remaining unchanged for footwear). The Chinese eclipse of the tigers has been fueled by FDI by the tigers themselves, whose firms in many cases simply moved their production lines to China. For example, about 25,000 factories in the Pearl River Delta region of Guangdong, directly or indirectly employing 3 million to 4 million workers, are engaged in subcontracting for Hong Kong companies. The tigers, meanwhile, have moved up the development ladder to produce more capital- and skill-intensive products.

Without the emergence of China, would other developing countries have captured larger markets as the tigers developed away from simple manufactures? Perhaps to some extent, but arguably the tigers vacated these markets precisely because of China's emergence. China's opening changed their comparative advantage in world trade, and instead of resisting, the tigers seized the opportunity, moving resources out of simple manufactures into more sophisticated lines of production and using their expertise to expand production in China.

There is a second reason why China's emergence as a force in labor-intensive exports has probably not affected other developing countries as much as many feared. That is the fact that world demand for these commodities from

developing countries has grown threefold over the past decade.

In addition, developing countries are sizable markets for each other. Substantial trade among developing countries, including considerable intraindustry trade, makes it possible for them to be simultaneously importers and exporters of a wide range of manufactured goods. Developing countries sent more than one-quarter of their exports of labor-intensive goods to each other in 1994. They can therefore benefit directly from each other's export expansion, even when they are exporting similar goods.

Integration into world trading institutions

The OECD countries have taken significant steps to normalize trade relations with transition economies. They have granted transition economies most-favored-nation status and eliminated quantitative restrictions that applied only to "state trading countries," and some have granted trade preferences that put the transition economies on a par with developing countries already enjoying such preferences. But normalization is not yet complete. Transition economies still face certain quantitative restrictions and differential treatment in antidumping actions in OECD countries, and only a few are formally protected by WTO rules and procedures. Six transition countries—the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia—are members of the WTO.

WTO membership is an important step for transition countries, and virtually all have applied to join. The WTO provides a firm institutional basis for the application and enforcement of multilaterally agreed trade rules on goods and services and on the protection of intellectual property rights. Each WTO member undertakes commitments to cap (bind) tariffs on imports and enjoys corresponding rights for its exports to member countries. No member may normally increase tariffs above bound levels without at least providing compensation. The WTO constrains various trade procedures to acceptable standards. For a country assuming obligations negotiated under WTO auspices, the requirement to maintain access to its market or pay compensation provides an effective constraint on internal pressures for increased trade protection.

Transition economies will benefit greatly from the rights attached to WTO membership. Participation will consolidate their access to international markets, providing some insurance against the arbitrary imposition of barriers by others. But transition economies will also benefit from accepting the corresponding obligations. Prompt and firm commitment to abide by WTO rules will greatly enhance the political feasibility of achieving and maintaining liberal trade regimes at home, in the face of the strong sectoral interests that are inevitably emerging.

Transition economies should therefore view WTO membership as an opportunity to further the reform of their trade regimes, not only to meet WTO requirements but also to increase economic efficiency through reducing distortions in trade policy. Relatively strict terms of accession—including comprehensive tariff bindings—can help reduce the payoff to domestic rent seeking. At the same time, without undermining the pressure on applicants to adopt liberal trade regimes, WTO members should do all they can to accelerate the process of admission. For some transition economies, technical assistance in meeting the extensive information requirements of accession would be helpful.

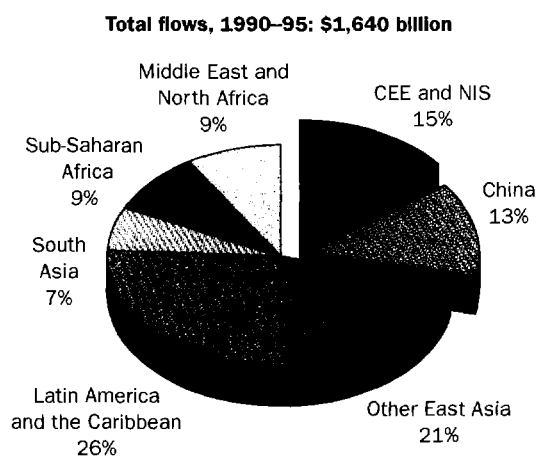
Integration into the European Union has profound implications for the transition economies concerned. The process began with the Europe Agreements and has entered a new phase with the preaccession strategy. The Europe Agreements signed between the European Union and six CEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, and the Slovak Republic; the agreement with Slovenia is not yet signed) and the Baltic states are the deepest and broadest of the EU Association Agreements. Like the association agreements signed with other countries, these agreements not only cover trade relations between the EU and CEE and Baltic countries but go on to deal with financial cooperation, commercial practices and law, and political dialogue at various levels. They also encourage these countries to liberalize trade among themselves, for example, through the newly created Central European Free Trade Association.

It has been more than four years since the first Europe Agreements were signed in early 1992. At the Copenhagen Summit in 1993 the European Union made its first commitment to CEE countries' accession. The so-called White Paper, published in June 1995, forms part of the preaccession strategy. It identifies the key measures required in each sector of the internal market, suggests an approximate sequence for legislation, and details the measures necessary for effective implementation and enforcement. Partly with this in mind, the European Union has been providing various types of assistance. Accession negotiations with some of the CEE and Baltic countries are expected to start soon after the conclusion of the EU Inter-Governmental Conference. Prompt accession should not be taken for granted, however: negotiations for the Union's most recent enlargement (with Austria, Finland, and Sweden) took less than two years, but negotiations with Spain took almost nine years. The benefits of accession are clear: political stability, free trade and capital flows, access to common funds, and locking into reasonably market-friendly policies.

Rapid EU accession would do much to sustain and deepen reforms in these transition economies. So what

Transition economies have absorbed only a modest share of global capital flows.

Figure 9.1 Capital flows to developing and transition countries by region



Note: Data for 1995 are preliminary. Source: World Bank 1996b.

stands in the way? One obstacle is the need to develop administrative and organizational structures in the CEE and Baltic countries to implement and enforce the rules of the Union. The biggest barrier, however, is the EU budget, some 80 percent of which goes to finance the structural funds, which offer aid to poorer EU regions, and the Common Agricultural Policy (CAP), which subsidizes farmers in member countries. Extending these policies, unreformed, to CEE countries would be expensive. Elements of the CAP were reformed in 1992, but further reforms are needed. Integration is therefore likely to involve a phased process that advances certain elements of EU membership—free trade in particular—faster than others, while at the same time possibly stimulating some helpful reforms in the Union itself. As far as the transition economies are concerned, the faster accession proceeds, the better.

Capital flows and transition

One might have expected huge imports of capital, both private and official, to participate in financing the costly economic and political transformation required in countries undergoing transition. At the beginning of the transition in Europe there were concerns that large capital flows to CEE and the NIS would raise world interest rates at the expense of developing countries. However, except for the

former East Germany (see Box 1.1), CEE and the NIS have not absorbed a great deal of foreign capital—either private investment flows or official external assistance.

Has transition caused a major diversion of private capital flows . . .

Between them the countries of CEE and the NIS absorbed 15 percent of total capital flows to developing and transition countries in the period 1990–95 (Figure 9.1). Net resource inflows are much lower and even negative to some countries, once debt service and capital flight are taken into account. Capital flight from Russia alone has been estimated at some \$50 billion for 1992–95, although part of this represented capital exported through Russia from other NIS.

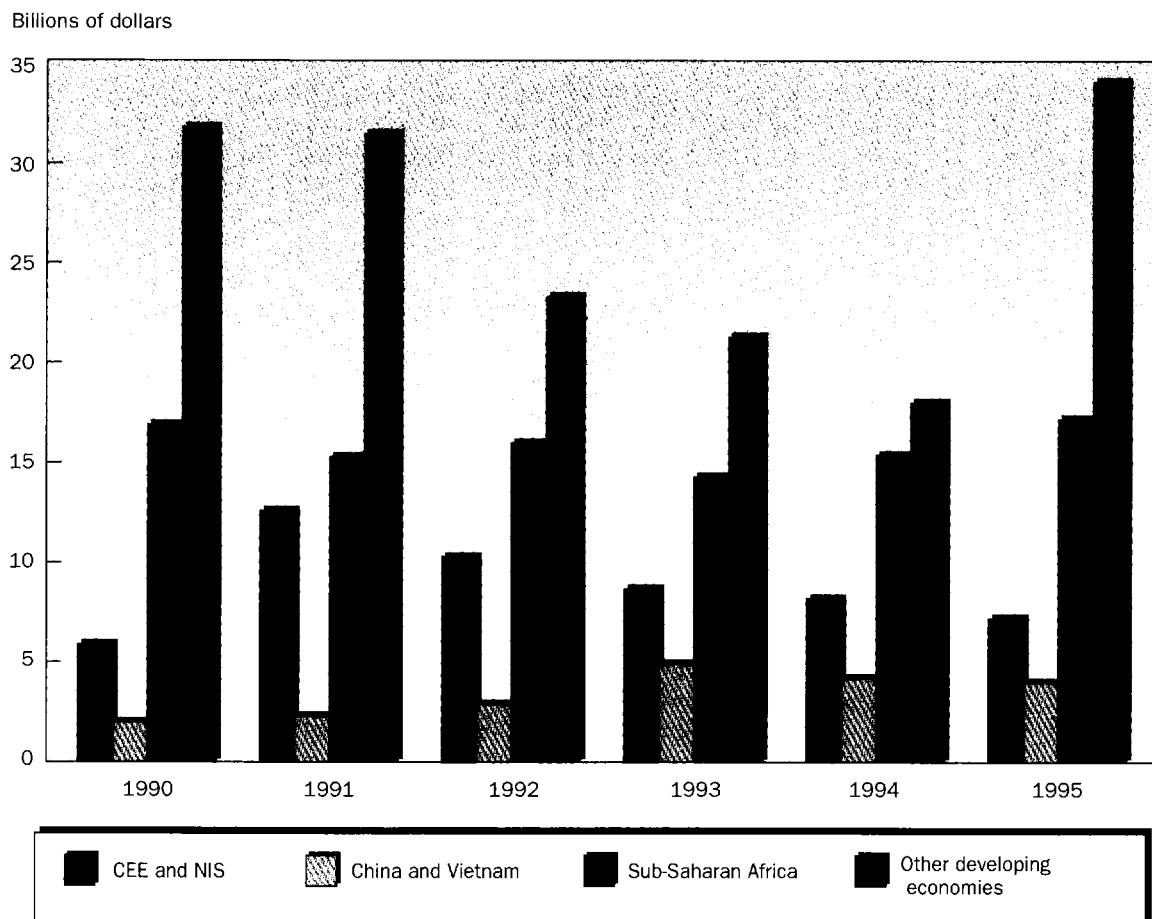
Private capital flows to developing countries increased dramatically during the 1990s, with a surge in FDI and portfolio equity investment. CEE and the NIS, however, between them attracted just 13 percent of total private capital flows to developing and transition countries in 1990–95. In 1994, FDI to CEE and the NIS was only \$6.5 billion, equivalent to the total received by Malaysia and Thailand. The distribution of these limited FDI flows among them has also been highly uneven. The Visegrad countries received fully three-quarters of the total, whereas many other countries in the region are still all but untouched by foreign investment (see Chapter 3). Capital flows to China more closely followed the trend for developing countries, with private sources accounting for the lion's share. FDI to China was \$33.8 billion in 1994, second only to flows to the United States. However, a substantial portion consisted of domestic funds recycled as foreign investment to take advantage of fiscal concessions.

. . . Or of foreign assistance?

Given the relative failure of many CEE countries and NIS to capitalize on the growth of investment in emerging markets, a key goal of foreign official assistance must be to help them create a more attractive environment for private inflows and thus help them restructure toward international competitiveness. Annual net flows of official development finance—including official development assistance (grants and official concessional loans) and official nonconcessional loans—to CEE and the NIS averaged \$8.8 billion in 1990–95. This has not, however, diverted official assistance from the world's poorest regions (Figure 9.2). For example, grants to the transition economies rose dramatically, from \$641 million in 1990 to \$4.7 billion in 1995, but grants to Sub-Saharan Africa increased in this period as well. Former Soviet clients have, however, lost aid—these countries received an estimated \$4.5 billion from the Soviet Union in 1987, for example, and \$554 million from Eastern Europe in 1985, but these flows have now virtually ceased.

Official assistance for transition economies has not been at Africa's expense.

Figure 9.2 Official development finance to developing and transition economies



Note: Official development finance consists of official development assistance (grants and concessional lending) plus nonconcessional lending. Data for 1995 are preliminary. Source: World Bank 1996b.

All in all, then, transition has not absorbed a large slice of global capital flows. As transition economies recover, demand for investment in infrastructure, economic reconstruction, and private sector development will rise. As their creditworthiness improves, they could absorb a larger share of world capital flows and could increase total global demand for capital, raising world interest rates. But as noted in Chapter 2, in the long run all countries tend to finance the bulk of their investment from domestic rather than foreign savings. Moreover, any impact on world inter-

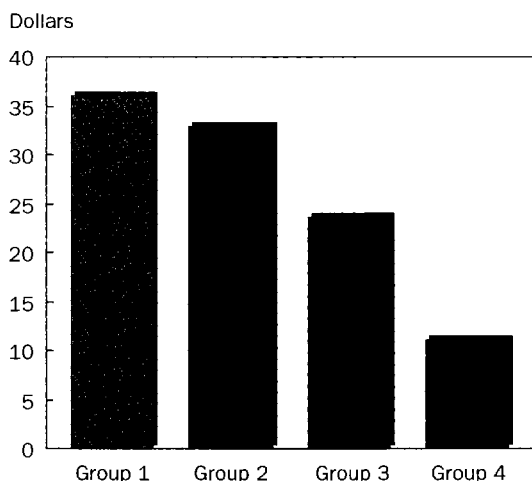
est rates of rising demand for foreign capital from transition economies would be small compared with that already exerted by the combined budget deficits of the OECD countries, now running at some \$700 billion a year.

How can external assistance help transition?

Through the early years of reform in CEE and the NIS, a major share of official assistance has taken the form of balance of payments and budgetary support and of debt relief. Official support from the international financial institu-

Reforming governments receive the most external assistance.

Figure 9.3 Net official capital inflows per capita by country group



Note: Data are annual averages for 1990–95 (CEE) or 1992–95 (NIS); 1995 data are preliminary. See Figure 1.2 for the countries in each group. Countries severely affected by regional tensions are excluded. Source: World Bank 1996b.

tions and individual country donors has typically been much larger, relative to population or GDP, for those countries that have advanced further with reforms (Figure 9.3). For example, by the end of 1993 the Visegrad countries, in the first of the reform groups in Figure 1.2, had received more than half of disbursements by the international financial institutions to the region. In 1994 official lending shifted to the NIS, which had previously obtained little funding, as reforms advanced there. Among the NIS the Baltic states, which have undertaken substantial reforms, received more official assistance in relation to their population as well as to GDP than, for example, did Belarus.

Has external financial assistance been adequate? This controversial question can be answered in a number of different ways. Aid under the Marshall Plan after World War II averaged 2.5 percent of the incomes of the recipient countries at the time. Total official disbursements to the CEE economies, which have generally progressed furthest in their reforms, accounted on average for about 2.7

percent of their combined GDP in 1991–93. Underrecording of GDP in these economies may bias this ratio upward, but on this measure Marshall Plan disbursements were not materially larger than official flows to CEE. The Marshall Plan did, however, embody a larger grant element, and it was much more generous relative to the donor economy's income, at 1.5 percent of U.S. GDP.

Has the timing of external financial assistance been appropriate? This is another hotly debated issue. External finance has supported a number of stabilization programs, creating confidence (as was true of the Polish stabilization fund) or reducing the need for monetary financing to cover budget deficits (Chapter 2). However, one of the main findings of this Report is that liberalization, stabilization, and structural and institutional reforms have been highly complementary. Macroeconomic pressure often underpins the incentives for microeconomic change, so that external assistance programs in transition economies must be developed carefully—walking the narrow path between facilitating reform and diminishing its urgency—and must lock in reforms through conditionality. Indeed, ill-conceived or premature lending can create large external debts that complicate subsequent reforms—as shown by the experience of certain lines of credit awarded by export credit agencies.

Even after inflation has been brought down to moderate levels, external assistance may be needed—within limits—to help some countries bridge a transitional fiscal gap. Whereas government spending as a share of GDP still exceeds reasonable limits in some countries, other transition governments are small relative to their core functions. Some governments have been forced to cut social protection and public investment, probably to levels below those needed to sustain reforms. Some, with limited capacity for administering taxes, end up imposing distortionary taxes to meet their spending needs, at huge cost to economic efficiency (Chapter 7). Meanwhile a number of governments are themselves in arrears, undermining hard budget constraints elsewhere in the economy (Chapter 2). These problems merit close attention by assistance agencies. However, budget support should always be conditional on policy reforms, notably in the areas of tax policy and administration, budget management, targeted poverty programs, and human resource development.

As this Report has described, adjusting to a market economy involves sharp economic declines in some regions and social costs that may have political implications. In these areas assistance can speed recovery, for example through funding severance pay and extraordinary demands on local governments in distressed regions, as well as possible environmental costs associated with plant shutdowns. It may be necessary—and desirable—to cushion the impact of transition on certain regionally concen-

trated and overbuilt industries, such as Ukraine's coal sector (see Box 3.2). Here again, support needs to carefully target temporary losses and to address them without undermining the longer-run credibility of reforms and labor market incentives.

Yet, as ever, the development of market-supporting institutions is fundamental to transition. Postwar Western Europe already had long experience with markets, and the associated institutions—property rights, information, and legal systems and courts, as well as skills in using them, honed over generations of experience—were all well in place, so foreign aid could readily promote reconstruction and recovery. Even now, many developing countries have a stronger institutional base for a market economy than do most transition economies at similar levels of income. Foreign support therefore needs to embody a large component of technical assistance and institution building in areas that constitute critical reform bottlenecks. This involves helping create institutions such as independent

central banks and property arrangements that make reforms more effective and harder to reverse. Bilateral assistance, including that provided by the European Union, has had a large component of technical assistance. The international financial institutions have also engaged heavily in this kind of institution building, across a wide range of areas, in addition to transferring financial resources.

Building institutions takes time and sometimes involves restoring entire professions in areas essential to a well-functioning market economy. For example, although considerable support has been given to privatization and the drafting of new legislation, more needs to be allocated for the training of judges and other legal professionals and for the upgrading of judicial facilities (Chapter 5). Technical assistance should encourage local capacity building through, among other things, more involvement of local participants. Far greater stress is needed on economic education in the broad sense as well as hands-on training in key marketable skills (Chapter 8).

Box 9.1 Business skills training is good for business—for trainers and trainees

Efforts to teach market-related skills and business know-how in transition countries have had a somewhat mixed record. But two programs show how to overcome the pitfalls and create valuable follow-on effects.

In early 1992 the World Bank's Economic Development Institute launched a training program to support enterprise restructuring and privatization in transition economies, based on learning by doing and helping local talent and stakeholders to help themselves. The 180 trainees recruited since the program began—including enterprise and bank managers, consultants, government officials, and parliamentarians—have worked with over forty local partner institutions and trained over 4,000 other participants. Evaluations by independent consultants concluded that the program has been highly cost-effective and has had a great impact on enterprise reform and private sector development. Dozens of enterprises have successfully restructured and privatized as a direct result.

The career of Mrs. Smirnova, a deputy director of the textile conglomerate Mayak in Nizhniy Novgorod, Russia, illustrates the potential benefits. Fresh out of the program, she had Mayak introduce international accounting standards before they were required by law, and retrained its accountants. She then initiated the firm's breakup into thirteen independent companies. Her business plan for Mayak won an international award, and around 70 percent of Mayak's production

is now exported to the British market. A conference on business planning for Russian textile enterprises, which Mrs. Smirnova organized, led to the creation of various business associations, and working together with other graduates she has advised companies throughout Russia, in Kazakstan, and in Uzbekistan. All this has created momentum for similar restructuring activities by many other companies.

The East/West Enterprise Exchange Program at York University in Toronto puts a great emphasis on building personal business links in the program it has been running since 1989. It has brought over 450 business delegates from CEE and the NIS to Canada. Selection of delegates is based on the criteria of sponsoring Canadian firms, which fund the program in partnership with government, other donors, and the delegates themselves, who pay fees to participate. Delegates first take classes in business practices, accounting, marketing, and a range of associated topics. They then work with their sponsors to develop business plans to serve as the basis for future deals. An independent evaluation of the program concluded that it was having a significant impact on delegates' knowledge and attitudes and contributing positively to their careers. It was also contributing to business cooperation: preliminary estimates put the volume of technology transfers, trade deals, and joint ventures resulting from the program at many times the program's cost.

Because of the importance of new business entry for growth, assistance should also be strongly conditioned on reforms to reduce regulatory and other barriers, including access to premises. Carefully designed programs can combine commercial and educational objectives, and some may return more than their cost (Box 9.1). Business advice and financial support to the private sector should come mainly from the private sector itself, that is, from private business support services, equity investors, and private lenders of working and investment capital. These services and suppliers exist in embryo in some transition economies, not at all in many others. Does this justify a role for assistance agencies? Yes, if that role is assisting financial system reforms to speed the emergence of prudent and capable lenders and investors; and yes, if it means providing training and technical assistance to managers and entrepreneurs to overcome years of isolation from market forces. But no, if it means simply financing investment through government restructuring agencies.

As already noted, some countries face more of a transition problem, while others face more of a development problem. For the first group, heavy dependence on external assistance should be considered a temporary phase until reforms create an environment that can attract private capital. A key purpose of official financial assistance must be to bring down, decisively and sustainably, the barriers to committing external and domestic private capital, especially private equity investments. Some countries have passed through this phase very quickly. The Czech Republic, for example, drew on International Monetary Fund (IMF) credits and other official loans relatively heavily in 1991 and 1992 but started to repay the IMF earlier than planned (as did Poland in 1995). Equally encouraging, private capital flows picked up, rising to \$2.85 billion in 1994 from \$585 million two years earlier.

Some transition economies, however, may require longer-term development assistance. These include the

Central Asian countries and a number of others whose economies have been severely disrupted by regional tensions. Yet even in these cases donors need to ensure that assistance strengthens rather than undermines reform. It might be tempting to think that the ability to replace official capital flows with private capital flows is a function of the level of income. In fact, it owes much to government policies. China, one of the poorest transition economies, relies mostly on private capital.

The agenda

The rapid integration of the global economy in recent decades springs from the widespread recognition that economies invariably achieve more working with each other—exchanging goods, capital, and ideas—than acting alone. The failure of the Soviet ideal of “socialism in one country” is further confirmation, if any were needed, of this simple truth. But ensuring that the transition economies realize their potential as members of the global trading system will not be easy—for them or their supporters. For the new entrants, the first step is to adopt the economic, social, and institutional policy reforms outlined in this Report, in order to attract foreign investors and foster growth. For those outside, particularly international bodies such as the European Union and the international financial institutions, it will mean careful consideration of how to help transition countries in ways that support rather than delay long-term reform. Speeding the removal of existing trade barriers, along with further direct efforts toward integration, will bring perhaps the largest and most immediate benefits for transition countries. But more-direct forms of support, such as short-term financial assistance and, critically, helping countries acquire much-needed skills and institutions, are also important. Finally, the integration process must be buttressed, on both sides, by determined efforts to allay fears about the costs of greater global competition and to persuade those diffident of integration that, in the long term, all they stand to lose is their isolation.