LATIN AMERICAN ECONOMIC SYSTEM

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CHANGES IN EASTERN EUROPE: THEIR POTENTIAL FINANCIAL IMPLICATIONS FOR LATIN AMERICA

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I. INTRODUCCION

The dramatic -and largely unexpected- changes in Eastern Europe in 1989 are a major turning in Europe's post-war history. The changes not only are having profound effects in Eastern Europe itself, but also for the European continent, for East-West relations, and for intrnational relations in their broadcast and most global sense.

Clearly these dramatic changes will have a significant impact on Latin American countries; both new opportunities and new problems will arise. In what follows, we will examine mainly the direction of likely economic effects of East European changes on Latin American countries, emphasising effects on financial flows.

The paper will be structures as follows: In the next section II we will look at the size of East European economies, and their links with the international economy; this should provide a first quantitative framework for examining the magnitude of potential impacts on Latin American economies. Section III will examine briefly the nature of economic and political changes in Eastern Europe, as well as make some comments about possible likely trends. Section IV will look at the implications of these changes for Latin American economies, focussing mainly on effects on financial flows, but examining also briefly more qualitative effects. Section V will draw out the main conclusions from the previous analysis.

II. SIZE OF EAST EUROPEAN ECONOMIES AND THEIR INTERNATIONAL RELATIONS

In examining East European economies, we will look mainly at seven countries: Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania and Yugoslavia.

Small size of population and trade; difficulties in estimating output

A first striking feature is the small size of these economies on a world scale, particularly as regards their population, their output and their trade flows.

The combined population of the seven countries is estimated at 136 million, 2.5 per cent the world total 1/.

As regards total output, and output per capita there is some difficulty in determining exact or even approximate magnitudes. Estimates vary quite dramatically. For example, estimates for Hungarian GDP per capita vary between US$2,200 (estimated by the World Bank) and US$8,600 (estimated by the CIA).

The difficulties are partly due to intentional biases and estimates. It has now been recognised in Eastern Europe that previous governments' statistics were intentionally distorted to show good economic performance, either through tampering with reports by the now deposed leadership or systematically biased methodological approaches; though these statistical deficiencies are bein remedied, revisions are still incomplete 2/.

The main problems in estimating output or output per capita in dollar terms are technical. Firstly, East European countries estimated Net Material Product (NMP), which excludes many services included in GNP. Secondly, there is the problem of what exchange rate to use; estimates based on purchasing power parity (PPP), which are widely used (for example by the CIA) give fairly high levels of GNP per capita (see Table 1), ranging from US$5,500 for the poorest country to US$12,500 for the richest one, placing the East European nations within the lower half of "high income" countries, as classified by the World Bank; estimates based on official exchange rates put these countries in a lower range, broadly within the category of "upper-middle-income" countries used by the World Bank. Several important sources, such as the OECD (see Table 1) use an intermediate -but fairly high- estimate, which would also place East European nations broadly in the "high-income" category.

In terms of the purpose of this paper, two implications stem from the GDP per capita figures. The first one relates to the total size of East European GDP. Even if fairly high estimates of GDP per capita are used, such as those by Plan Econ., OECD and Amex Bank Review, the total of GDP for Eastern Europe would reach around US$700 billion, which is only around 15 per cent of the output of the European Community, and around 3 per cent of world production. Thus, as in the case of population and trade (discussed later) the East European region is, in terms of output, fairly small on a world scale.

TABLE 1

Alternative estimates of 1988 GDP per capita, in US$

	CIA (a)	Plan Econ., OECD and Amex Bank Review (b)	World Bank (c)
Poland	7,270	5,453	2,240
Hungary	8,660	6,491	1,930
Czecoslovakia	10,140	7,603	
German Democratic Republic	12,480	9,361	
Bulgaria	7,510	5,633	
Romania	5,490	4,117	

Sources: (a) CIA, Central Intellegence Agency, Handbook of Economic Statistics, 1989
(b) Plan Econ., Western Investor's Guide to Eastern Europe and Soviet Unin, Plan Econ., Report Vol.V, No. 42-43, November 1989; same figures used by AMEX Bank Review April 23, 1990 and by OECD Economic Outlook;June 1990.
(c) World Bank, World Development Report 1989, Oxford University Press (New York), 1989.

A second issue relates to the level of GDP per capita and its' implications for aid and other official flows. Particularly if the higher range of estimates for GDP is the more precise one, this would place East European countries well above Latin American countries, and far closer to the relatively poorer countries of Europe, e.g. Greece or Portugal. If this was the case, channelling of official flows (and grants) to Eastern Europe could be justified for important political, security or regional reasons, but not in terms of development assistance to poor nations; this gives clear support to the idea that official flows (and particularly grants) to Eastern Europe should be additional to aid and official flows to developing countries and should be granted through separate channels than aid assistance to developing nations.

Complements to GDP figures can also be used, to give a broader indication of living standards and relative prosperity of nations; this seems particularly relevant when there is some dispute about exact comparative levels of GDP figures. One such indicator, recently developed in a major UNDP Report 3/, focuses on human development, and measures this -for simplicity- according to three elements: Longevity, knowledge and decent living standards. As can be seen in Table 2, column 1, East European countries are all rather high in the ranking of human development; in an index going from 1 to 130, they all are in the range between 90 and 110, in the category of high human development, and standing fairly close to the most developed market economies, and well above most developing nations. Similar results are obtained if individual social indicators such as adult literacy rate, life expectancy (see columns 2 and 3 of Table 2) or under 5 years mortality rate 4/ are examined.

TABLE 2

Countries	(1) UNDP human development Index ranking	(2) 1985 Adult literacy rate (%)	(3) Life expectancy at birth (years) 1987
Some LDC's			
Niger	1	14	45
Bangladesh	23	33	52
Egypt	45	45	62
Philippines	65	86	64
Peru	74	85	63
Brazil	80	78	65
East European			
Romania	90	96	71
Poland	98	98	72
Yugoslavia	100	92	72
Hungary	101	98	71
Bulgaria	104	93	72
Czecoslovakia	106	98	72
German Democratic Republic	110	99	74
Developed			
USA	112	96	76
Spain	115	95	77
United Kingdom	121	99	76
Canada	126	99	77
Japan	130	99	78

Source: UNDP, op. cit. in (3)

At present, the economies of the region are poorly integrated into the world economy as regards trade. According to the Institute for International Finance (IIF) estimates, the convertible currency trade of these seven countries with the rest of the world accounted for only around 1.6 per cent of world trade. If total trade is taken into account (thus including trade with the eastern trading bloc taking place in non-convertible currencies, estimated at prices significantly different from world market ones), th total figure, at US$240 billion in 1988 is far higher, and represents roughly 4 per cent of total world exports and imports.

In comparing with developing countries that have pursued export-led growth successfully, the East European role in world trade is very modest. For example, the combined convertible currency exports of the seven East European countries was only three quarters of the exports of Hong Kong and four-fifths of the exports of Korea and Taiwan.

Despite their low share of world trade, East European countries have accumulated sizeable external debt. IFF estimates total currency convertible debt at around US$115 billion at end of 1989, equal to one quarter that of Latin America. It is interesting to stree that East European debt was equivalent to 190 per cent of convertible currency export earnings, comparing favourably with a ratio of 290 per cent for Latin America.

The large debt overhang (of which almost 50 per cent is to commercial banks) is one of the factors which will discourage new private lending to Eastern Europe; for this -and other reasons (discussed below)- there is a large demand for public international funding of East European economies (as well as public debt forgiveness).

III. ECONOMIC AND POLITICAL CHANGE IN EASTERN EUROPE

Although the opening of the Berlin Wall acts as a powerful and convenient symbol of the dramatic changes taking place in Eastern Europe, the suddenness of these changes should not be allowed to disguise the ongoing nature of political and economic movements throughout this area. These began in Poland prior to Brezhnev's death in 1982, but had gained momentum since Gorbachov came to power. The whole process of change accelerated dramatically during 1989, firstly when Solidarity took on the leading role in government in Poland, and later when abruptly, spontaneous unrest broke out in East Germany, Czechoslovakia, Romania and Bulgaria, leading to major change in the political framework.

Observers in and of Eastern Europe initially indulged in what became known as "East Europhoria", that is a belief that rapid political and economic change would quickly lead to sustained growth. This over-optimism has begun to change rapidly as the magnitude of the task ahead began to become clear, and as economic performance began to deteriorate further in several countries in early 1990.

As the Economic Commission for Europe 5/ clearly put it, "Political change may often be very rapid, but economic adjustment is much slower: the certainties of the central planning system have been eroded more quickly than the alternative mechanisms of the market can be put in their place."

In mid 1990 the eastern countries were facing a number of different challenges. Policy-makers are attempting to restore political and social stability at a time when they are implementing economic stabilisation programmes, many of which will impose heavy burdens on the population in the near future; simultaneously they have to introduce fundamental reforms leading to the replacement of central planning by a decentralised market system. As a result, in the short term, policy priorities in Eastern Europe are on economic stabilisation and putting in train market-oriented reforms rather than on growth per se. Though this is true as a general trend, naturally there are variations between countries, with Poland providing an example of a country whose main focus is stabilisation and Czechoslavakia hoping for an acceleration of growth in 1990. The case of East Germany is a special one; because of its very rapid economic and monetary union with West Germany, it seems to be suffering more in the short term (in terms of output fall) but may later grow more than other East European countries.

Two elements further complicated the European economies' short-term outlook. One is that Eastern economic performance has been deteriorating in the recent past, with the 1989 performance probably the worst since the immediate post-war period. Apart from Czechoslovakia and the German Democratic Republic, output in Eastern Europe fell or stagnated in 1989; for the region as a whole, the Economic Commission for Europe estimates an increase of Net Material Product of a mere 0.5 per cent in 1989, reflecting a steep decline from the previous performance in the 1980's (see Table 3).

TABLE 3

Growth rates, Net material products produced, Eastern Europe, 1981-90

	1981-85	1986	1987	1988	1989
Eastern Europe	2.2	4.6	3.2	3.1	0.5 (a)

(a) excludes Romania

Source: ECE, op. cit

TABLE 4

Oil imports as % of hard currency exports

	at US$10	per barrel US$20	prices US$30
Bulgaria	40	80	120
Czechoslovakia	30	60	90
East Germany	22	44	88
Hungary	7	14	21
Poland	11	22	33
Romania	4	8	12
Yugoslavia	5	10	15

Source: Morgan Stanley

The other element complicating East European short-term outlook is the double oil shock dealt to them. Firstly, there economies had to adjust to the Soviet Union's decision to cut its oil supplies (previously sold at significantly subsidesed prices) to them and to charge the dollar market price; secondly, the cost of alternative supplies in the open market has been sent leaping upward by the Gulf crisis 6/.

Particular the Bulgarian, Czechoslovakian and East German economies are very sensitive to fluctuations in the oil price, as oil imports represent such a high proportion of their hard currency exports (see Table 4).

However, despite the rather gloomy outlook for the short-term (confirmed by recent ECE figures which report a 13.4 per cent decline in East European industrial output in the first quarter of 1990, compared with the same period in 1989), there are several positive elements which would enable a recovery or an acceleration of growth in the medium-term. Amongst these positive elements is the social consensus and support currently emerging in these countries for a rapid move towards a market economy; furthermore, the willingness of the Western market economies to support rapidly and significantly the process of reform in Eastern Europe (see below) through financial measures, improved access to markets, etc., will crearly give an important boost to the region's growth prospects.

As regards links with the rest of the world, it is important to bear in mind that even though Eastern Europe's economic growth may be relatively modest in the short to medium term, trade between it and the rest of the world may well expand more rapidly. According to estimates by Amex Bank Review 7/, East European economies export only aroun US$400 per head (in convertible currency) compared with exports of US$3,437 per head by EEC countries. Were East European countries' trade to come eventually into line with the average per capita trade in the EC the effect would be large; it would require an almost ten-fold increase in imports and add the equivalent of 10 per cent to existing world trade. However, while this dramatic change could occur, it would be possible only in the very long-term. Prospects for the next 5 years would be far more modest, but still potentially quite significant.

Diversity of East European experience, the special case of East Germany

Till now we have talked of Eastern Europe as a whole. However, it is also important to stress the diversity of Eastern Europe, both as regards their past economic and political history, their current economic and political structure as well as the pace and support for economic reform. These factors will not only affect these countries' future economic performance, but also naturally the impact which their economic evaluation will have on LDC's.

Just to illustrate the diversity of East European countries, we will do so with some external debt indicators, which are of relevance to Latin American economies, as the debt overhang is one of the elements which may constrain future growth of East European economies and their ability to import from Latin American (and pay for those imports). A clear difference emerges here between countries, such as Poland, Hungary, and Bulgaria with very high debt indicators and many payments difficulties and Czechoslovakia, Romania and East Germany, with minimal debt problems (see Table 5).

TABLE 5

External debt indicators, Eastern Europe, 1989

	Ratio of net debt to exports to market economies (%)	Ratio of net interest payments to exports to market economies (%)
Bulgaria	321	24.2
Czechoslovakia	51	5.1
East Germany	115	11.2
Hungary	342	24.6
Poland	456	41.7
Romania	-1	0.6

Source: ECE., op. cit, based on national sources and BIS-OECD estimates. There is also some divergence amongst different sources on the levels of external debt; however, the ranking of countries by debt indicators does not change, according to different sources.

The East German case is particularly interesting because of the speed and magnitude of the change; furthermore, it is also interesting because the magnitude of financial flows German unity will generate seem likely to have important effects both on financial flows to Latin American economies and on the cost of servicing existing or future commercial debt, particularly but not only that incurred in Deutsche Marks (DM). For this we will look here in some more detail at German economic and monetary union, so that in the next section we can examine its' likely effects on LDC economies.

East and West Germany have signed a Treaty to establish a monetary, economic and social union. Monetary union has already been implemented in July 1, 1990; this implies a unified currency area and the DM as the common currency; the liabilities and claims expressed in East German Marks were converted into DM.

Monetary union will, among other economic effects, act as a lever and catalyst for immediate market-oriented reforms in East Germany. It will be complemented by economic union, whose "essential features are private property, market competition, free prices and the free movement of labour, capital and services" 8/.

We will concentrate here on the aspect of German unity which will most affect Latin American countries; these include German money supply, German National Budget and Balance of Payments; reference to evolution of GDP and unemployment will be brief.

The terms of monetary union were slightly more generous than the Budensbank (German Central Bank) had wished; they offered and exchange rate for wages, salaries and pensions at a rate of 1:1. Furthermore, most East German individuals were allowed to convert up to 4000 GDR marks at the rate of 1:1; other claims and liabilities were converted from East German marks to DM at a rate of 2:1.

The effect on the German money supply resulting from currency conversion in East Germany is estimated to lead an increase in M3 (defined as cash in circulation, short-term deposits, time deposits up to 4 years and savings deposits at statutory notice) of around 10-12 per cent 9/.

This would seem to be a similar order of magnitude to the parallel expansion of goods and services, which occurs as a result of incorporating the East German economy into the DM area.

However, important uncertainties remain. These relate mainly to uncertainty as to the level of demand for money in East Germany, under completely new economic circumstances for their population. The task of steering German monetary policy becomes far more difficult.

German Economic and Monetary Union will create unavoidable financial burdens for the German National Budget. The main additional burdens relate to:

a) Anticipated state budget deficits in East Germany.

b) Expenses incurred during the take-off financing of the East German social security system.

c) Infraestructure and investment aid for East Germany.

d) Higher interest payments as a result of additional borrowing in capital markets and on other items.

Recent estimates 10/ for the all-German budget deficit calculate a very sharp increase, from around DM22 billion in 1989 (for West Germany alone) quadrupling to around DM100 billion in 1990, and further increasing to DM120 billion in 1991. This would imply an increase from less than 1 per cent of GNP in 1989 to over 5 per cent in 1991. This would exert a large pressure on both domestic and international capital markets (see below Section IV). Recent press reports 11/ indicate that projections of East German budget deficits are being increased, as additional expenditures are added for items such as pension and health insurance funds, extra Soviet payments and subsidies to companies for Comecon exports paid for in unusable transferable roubles.

Forecasts for the evolution of economic activity and of employment in East Germany vary considerably, with optimistic forecasters focussing on the long-term, and pessimistic ones focussing on the short-term. Indeed, there are fears that output will fall significantly in East Germany during 1990 and 1991, with sharp rises resulting in unemployment, and some risks fro social and economic stability. Figures for the first half of 1990, showing East German industrial output falling by 9.5 per cent in the second quarter, steel production declining by 30 per cent in the first half of 1990 and unemployment increasing from practically for the short-term. These trends would put further pressure on the National Budget, so as to avoid heavy social and political costs of German unity.

IV. LIKELY CHANGES IN FINANCIAL FLOWS TO AND FROM EASTERN EUROPE; EFFECT ON DEVELOPING COUNTRIES

a) Foreign direct investment

Eastern Europe provides both a set of opportunites and a set of obstacles to western multinational corporations and other potential investors.

The most compelling reason for foreign investors to be attracted to Eastern Europe seems to be strategic 12/. Being the first into the region can help secure a company's position for a potentially large and growing market place, not just for Eastern Europe but possibly for the Soviet Union and, for Asian investors, even to the EEC. Furthermore, those first to enter the market will have their pick of joint venture partners. The low cost of skilled labour will also attract export oriented manufacturers.

There are however serious obstacles to investing in Eastern Europe. These include a legal system ill-equipped to protect the interests of foreign investors, and supply shortages for intermediate inputs. Furthermore, Eastern European infrastructure is very weak: modern communications equipment is scarce; transport facilities are rudimentary and make it hard to conduct business; accounting methods are more focussed on recording production than on financial performance.

Eastern European governments favour equity investment, particularly joint ventures, as a form of attracting foreign capital. This is firstly, because they are reluctant and/or may be unable to attract much international commercial lending; secondly, portafolio investment does not seem yet a practical mechanism because of limited development or nonexistence, of domestic capital markets. Thirdly, East Europen governments are keen to attract also factors linked to foreign direct investment, such as technology, skill training and management. Though most Eastern European countries are stressing their interest in joint ventures, (which combine capital inflows with other factors), some countries, and in particular Czechoslovakia, claim to be more interested in receiving know-how than the hard currency itself; they may therefore focus more on attracting licensing agreements, management contracts and franchise agreements.

Flows of private investment will increase most rapidly between West and East Germany, as the countries are unified. According to a survey of the Association of German Independent Entrepreneurs, more than 10,000 provisional contacts wer established between entrepreneurs in East and West Germany between December 1989 and mid-June 1990 alone; about 15 per cent of these (more than 1,500) had already resulted in specific cooperation agreements. One of the factors where most dynamism seems to have taken place is in banking; in 1990 alone the major West German banks plan to open more than three hundred banking offices in East Germany, either through joint ventures with East German banks or utilising new branches 13/. Another sector where West German investment is already playing a major rôle in electricity generation, as West Germany's three largest electricity generation companies have reached agreement to modernise and take control of East Germany's electricity generation industry 14/. There is, however, some patchy evidence that West German investment interest in East Germany is less clear in some industrial sectors.

It is difficult as yet to assess the likely magnitudes of foreign direct investment flows to East Germany and to the rest of Eastern Europe, partly because of the time lags which tend to occur between expression of interest, commitments and actual disbursements of funds. Furthermore, much of FDI seems to be slowed down by undertainties on the pace and success of economic reforms in these economies, and especially as regards definition of property rights, which has remained a murky area.

Given the vast size of global foreign direct investment flows worldwide, the fact that these flows do not seem to very supply constrained, and given the realatively small levels which will start flowing to Eastern Europe, the risk of diversion of foreign direct investment flows which would have otherwise gone to developing countries does seem somewhat limited. An important exception to this clearly is West Germany, a country from which large direct investment flows will clearly be going to East European countries. (In this sense it is noteworthy that West German capital is rather dominant already in Eastern European countries, accounting for example for 30 per cent of total foreign capital in Hungary and 35 per cent of the total in Poland).

As West Germany has been such an important source of private flows to Latin American countries, then there is quite an important risk of a deviation of German foreign direct investment flows that would have potentially gone to Latin America, to go instead to Eastern Europe.

b) Bond markets and Commercial Bank Lending

In recent years, some East European countries, such as Hungary and Bulgaria, have borrowed on the international bond markets.

Over the course of 1989, the costs to Eastern European governments of raising funds in the bond market as well as on the market for syndicated credits have risen sharply 15/. As the Institute for International Finance, the banker's own organisation correctly concludes: "this suggests that there are clear limits to the quantity of funds which these (East European) countries can expect to raise in international financial markets."

There are clear reasons for believing that many Eastern European countries are already close to the limits of total private international borrowing, and that as a result amonts of funds raised in international markets in the next few years may be less than in the recent pact. According to institutions like the OECD, the IIF, and the ECE, East European creditworthiness is deteriorating. This relates to factors such as: a) recent rapid increase in and high levels of indebtedness of some countries, such as Bulgaria, Hungary and Poland, b) recent poor economic performance, and c) uncertainties and short-term output losses due to political changes, as well as to anticipated political and economic reform.

As regards to commercial banks, it seems likely that the deteriorating creditworthiness detected by bond market participants will also affect the willingness of banks to make additional loans to East European countries. It is interesting to stress that the IIF report quoted above concludes that: "banks will take a cautious approach to future sovereign lending in Eastern Europe... commercial banks are unlikely to take the lead in providing finance to these countries" and even goes further in calling on "western governments to take the lead in organising assistance through their own national agencies and international institutions".

Within limited bank lending to Eastern Europe in the short to medium term, some distinctions should be made:

a) North American banks have been small players in Eastern Europe and in some cases have in recent years reduced exposure there. Their incentive to lend new money so as to protect existing exposure is small. Because European and Japanese banks already have a larger stake in the region, they may have somewhat greater incentive to lead. As in the case of foreign investors, West German banks will have special reasons to increase their exposure more. Furthermore, bank lending to Eastern Europe may in general be driven to a significant extent by the needs of banks' key corporate clients (with a substantial portion of bank lending being indirect, -to corporate clients- that will use the borrowed funds to support their own operations in the region). Thus, heavy involvement of West German investors (and possibly others, e.g. Japanese) would also tend to attract more bank lending.

b) Countries within Eastern Europe will not have equal access to bank credit. Factors such as level of indebtedness, prospects for political stability, the country's resource base, as well as trade ties with the Western economies, will contribute to determine creditworthinesss. In April 1990, the IIF concluded that based on this type of factor, the most creditworthy countries in East Europe were the GDR, Czechoslovakia and Hungary; to a certain extent, this type of assessment will change as economic and political circumstances do.

It would seem that the effect of changes in Eastern Europe, on bank lending to Latin America will -on the whole- be negligible. This is both because the enthusiasm of international banks to lend to Eastern Europe as fairly limited and because most of Latin American has very limited access to bank credit anyway.

Nonetheless, there will undoubtedly be some deviation of interest by bankers (especially in their advisory services) to Eastern Europe; furthermore, West German banks can be expected to increase their exposure sharply, particularly in East Germany and also in the rest of Eastern Europe, implying risk for deviation of some resources that could have gone to Latin America.

c) Debt

As detailed above, one of the key features of several East European countries in their large debt overhang. The form in which this debt overhang will be tackled may well have important effects in Third World debt management.

Two types of effects can be visualised. One is a substitution effect, whereby limited resources (e.g. from the public pool of resources for private debt reduction allocated in the context of the Brady Plan) would be used for Eastern Europe, thereby limiting available resources for similar operations for Latin America. Though clearly such a risk exists for the future, there seems at the time of writing little evidence that such a constraint has already started to limit debt reduction for Latin American countries 16/.

The second link between East European and Latin American countries' external debt is that of the precedents which the former can provide for the latter. In the case of Eastern Europe, there is a very strong political motivation and willingness by Western governments and in informed public opinion to provide very large debt reduction, where the debt overhang is constraining efforts at adjustment, structural reform and growth. Indeed, some analysts even explicitly would like to grant massive debt relief to Eastern Europe, if this were not a precedent for Thrid World debtors. Thus, a recent detailed study published by the Royal Institute of International Studies 17/ candidly says: "If the East European countries were the only problem debtors, one might take the view that the sheer stock of debt is such that there is no conceivable way in which it could be repaid. The best way out would simply be to forgive the debt and allow the countries to start again".

In spite of the fears of precedent, this and other studies 18/ argue for major debt and interest relief for Eastern Europe.

Indeed, Poland has already obtained exceptionally favourable terms in its' March 1990 Paris Club (official bilateral) debt rescheduling, for an upper middle-income country. Paris Club rescheduling is particularly crucial for Poland because its' total bilateral debt, US$27 billion, is very large and represents about two-thirds of total Polish external debt.

In March 1990, Paris Club creditors allowed Poland to reschedule virtually all payments on pre-cut off date debt falling due durign the consolidation period, as late interest and, more significantly, most of the moratorium interest were capitalised. The total amount counsolidated, US$9.4 billion, was the second largest in the history of the Paris Club, the largest rescheduling, US$10.9 billion was also with Poland in 1985. Creditor countries also agreed to set up a joint working party, with Polish government representatives, "to examine matters relating to Poland's financial obligations to Paris Club governments".

Official creditors tried to state that this did not create a precedent, by stating in the Agreed Minutes that they were granting terms and conditions which reflected "their support for the foar-reaching and historic changes taking place in the Polish economy". However, these exceptional rescheduling terms should be examined very carefully by debtor countries, especially relating to: a) the outcome of the working group in debt reduction, which is to report in March 1991, and to which the Polish government is reported to have requesto 80 percent debt reduction 19/, b) larger maturities (Poland was the second middle-income country to obtain fourteen years), and c) capitalisation of moratorium interest, a novelty in the framework of the formal Paris Club procedures.

Till 1990, the Paris Club had ruled out debt reduction except for some low-income countries. Pressure to help Poland may eventually bring the exception that could break the rule 20/.

d) Official Flows

Perhaps the area where there seems to be most risk of diversion of financial resources from flows to LDCs to Eastern Europe is that of official flows, and particularly that of ODA, as the supply constraints (of available funds) seem much sharper, especially in donor countries where the budgetary situation is particularly tight. Though some observers believe that such diversion would only be short-term (based on high initial costs of tansition), there is increasing evidence that the timescale for change, and therefore the need for Western Support will be very long 21/. It should be emphasised that the risk of deviation of ODA flows is relevant to only some Latin American countries (mainly very poor ones), which are major recipients of such ODA flows; for the major Latin American countries, it is only the deviation of non-concessional official flows that is a source of concern, as they practically receive no aid anyway.

In what follows, we will briefly review the available, as yet rather incomplete, information on official flows to Eastern Europe, and examine risks of diversion of resources.

Given the clear interest in Western Europe to support the changes in the East, the President of the Commission of the European Communities provided some ideas of the scale of aid that he thought might be provided by the EEC to Eastern Europe 22/; he suggested that if the six East European countries were given the same support as provided by the Community to its own depressed regions, the level of assistance (through the EEC and the European Investment Bank) would amount to roughly US$23 billion a year, for the next 5-10 years. The Economic Commission for Europe has estimated that implementing Mr. Delors' proposal would absorb around 0.45 per cent of the European Community's GDP in 1989.

Even though this is clearly an upper limit to potential contributions from the EEC to Eastern Europe, the magnitudes suggested here have caused fears amongst LDC governments of potential diversion of flows DAC Aid Ministers have reacted with repeated reassurances that "support for Eastern Europe will not diminish their determination to give high priority to their development cooperation with the Third World".

There is as yet no comprehensive estimate of total Western support to Eastern Europe; however, the OECD has been mandated to produce such an estimate by late 1990. Some preliminary estimates have been produced by the ECE, EC and others.

Western support for Eastern Europe was originally undertaken in response to appeals from Hungary and Poland, and given the name of PHARE (Pologne/Hungrie: Assistance à le Reconstruction Economique). The EC was given responsibility for coordinating the efforts of 24 Western countries that agreed to participate; in June 1990, the G-24 representatives responded to changes in Bulgaria, Czechoslovakia and the GDR by broadening this initiative to also cover these countries. The broadened PHARE programme (which provides grant money) approved in June 1990 will have a substantial budget for the coming years; for 1991, the approved budget reaches around US$1 billion, and for 1992, the approved budget will increase to around US$1.2 billion; these funds will be spent in support for economic reform and for investment projects. Discussion has now begun for possible support to the Soviet Union.

G-24 governments and international financial institutions have committed some US$6.3 billion in new credit facilities and grants to Poland and US$4.8 billion to Hungary. Of these around US$1.4 billion for Poland and US$0.5 billion for Hungary are grants; the ECE estimates that US$0.6 billion of grants has been given to Poland in 1990 alone.

The relative magnitude of the effort can be seen by comparing with total ODA flows, which in 1990 can be expected to reach around US$60 billion; thus aid to Poland would roughly be aroun 1 per cent of total ODA flows to developing countries, a relatively limited amount, by a relatively large one if the size of the Polish economy and population, and above all its' level of income is considered. If such aid flows to Poland are sustained, if other East European countries would receive similar amounts of aid, and if those resources were at least partly to come out of aid budgets, then fears of some (though not very major), diversion of resources are clearly justified. Furthermore, if the Soviet Union were to receive equivalent (to the size of its' economy) grant support in future years and those were not entirely additional, clearly the risk of diversion of aid resources would become a fairly major issue.

As regards multilateral flows, the EEC has approved European Investment Bank (EIB) lending to Hungary and Poland for ECU1 billion over a three-year period.

Poland obtained a US$723 million stand-by from the IMF, in late 1989, which triggered off a number of western credits, including a US$500 million bridge loan from the BIS and gave access to Poland to World Bank funds; some US$1.0-US$1.4 billion were earmarked by the World Bank for disbursement to Poland in 1990 and US$2.5 billion during 1990-1992. Poland also received, from the major industrial nations, a special credit, of US$1 billion, known as a Stabilisation Fund, which is intended to provide Poland with a supplement of reserves to support its' new foreign exchange regime.

Given the balance of payments problems and the magnitude of structural reforms being undertaken by Poland and the other Eastern European countries, some of which, like Czechoslovakia adn Bulgaria, joined the IMF and World Bank in September 1990, it would seem likely that they will continue to draw significant amounts form the Bretton Woods and other multilateral institutions. In the near term, multilateral institutions, such as the World Bank, have some leeway to expand total lending with existing resources, and therefore ensure additionality rather than "crowding out" of lending to LDC members; the World Bank's US$75 billion capital increase in 1988 in particular allows it to add to its' programmes without making cuts to others. Over the longer term, however, both the World Bank and the IMF may require an increase in resources to take account of its' expanded membership and their fairly large financial requirement (particularly if and when the Soviet Union joins). Such an increase in resources would not be difficult to obtain, provided there is political willingness to do so, as in the case of the World Bank most of the OECD contributions would be in the form of callable capital, that is guarantees, rather than cash. These guarantees would allow the Bank to increase its' borrowing from international capital markets where, in contrast to foreign aid, supply constraints are much less significant; in the case of the IMF the process of increasing quotas has been increasingly difficult, and has led to a decline in the real value of the size of the IMF; such a trend may be more difficult to reverse.

Similar considerations to those applied to the World Bank may apply to the European Bank for Reconstruction and Development, (EBRD), a new financial institution set up by 42 countries in May 1990, to help the emerging democracies of Eastern Europe 23/.

Before examining the financial features of the EBRD, we will briefly look at that institution's origins and objective. After the collapse of Communist regimes in Eastern Europe in the last quarter of 1989, the West moved rapidly to pledge support for new leaders committed to market economies and pluralist democracies. While most governments thought in terms of bilateral aid, France proposed a bolder initiative; the creation of a new international development bank to help finance Eastern Europe's transition.

When President Mitterand introduced this idea at the annual summit of the 12-nation European Community in December 1989, it was promptly endorsed. The French probably had their own reasons for proposing the bank, not the least to provide some counterbalance to the prospect of a Europe dominated by German economic might. It could also enhance the economic union of Europe; its President-Designate Jacques Attali has already suggested that the EBRD could be 'the embryo of a confederation of Europe, as the European Coal and Steel Community was the embryo of the Common Market in the fifties'. In any case, the idea of a new bank for Eastern Europe held a political appeal that no EC government felt able to resist.

The Community decided to open creditor membership in the bank to countries outside the region. The USA was lukewark at first, not least about the membership of the Soviet Union. Recognising that EBRD would happen in any case, however, it swallowed its doubts and joined, along with the Soviet Union, making the new bank the first such institution to include the two superpowers in its membership. Also noteworthy among the creditor shareholders are Mexico, Egypt and South Korea.

Developments then moved at remarkable speed. The first talks were held in January 1990, with 36 nations present and with President Mitterrand's adviser, M. Attali, providing much of the driving force. By the seventh meeting, in April, representatives of 40 nations and two European institutions had reached agreement on the bank's charter, its initial size, and the distribution of power among shareholders. At a final negotiating session in May, the bank's membership appointed M. Attali as President-Designate and agreed to locate the institution to London. The Articles of Agreement were formally initialled by its member states in May 1990. From start to finish, the new bank was agreed in just five months.

The Articles come into force when they have been ratified by states representing at least two-thirds of the total shareholding and the present estimates are that this will be achieved by the first quarter of 1991. In the meantime, President-Designate Attali has been given a wide-ranging mandate by prospective members to begin preparations immediately. These authorise him to prepare detailed organisational proposals and recruitment procedures, and to draft the Bank's first three-year business plan.

He has resources too; notably an ECU 10m (US$13m) advance from the European Investment Bank (EIB), temporary accomodation in London and a number of professional staff on loan from their governments.

The EBRD shares many characteristics of other multilateral development banks. Like them, it will channel funds from international capital markets to its borrowers but it is distinctive in its private sector focus, its commitment to environmental protection and its overtly political orientation. As stated in its charter, the Bank's broad aim is '...to foster the transition towards open-market oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism, and market economies'.

The explicit commitment to political transformation is unprecedented among the multilateral agencies. Although by no means immune from the pressures of international politics, the established development banks deal with the governments in place and do not confine themselves to any particular type of government.

The decision to give EBRD such a mandate reflectes Western determination to sustain the region's break with communism. It also draws attention to the lively foreign interest which the major shareholder countries will have in the success of the Bank.

A second unique feature of the EBRD is that the majority of its exposure will be to the private sector, through loans and equity investments. Specifically, at least 60 per cent of the Bank's total annual loans and investments must go to the private sector, and at least 60 per cent of the Bank's exposure in any one country over the first five years must be in the private sector or in state-owned enterprises that are shifting to private ownership and control. The remaining 40 per cent of the EBRD's resources may finance the public sector.

While it is not seen as an agency for the provision of soft aid, the EBRD's charter provides for the creation of Special Funds which would be additional to its ordinary capital resources and could be financed by voluntary grants or concessional finance which could permit soft loans. One possible use for such Funds would be to finance the provision of technical assistance, which the Bank is also encouraged to provide, rather than supply it on commercial loan terms. However, no member state has yet stated an intention to contribute to such Funds and they may prefer existing mechanisms for providing soft aid.

While participants in the EBRD agreed from the start that the basic purpose of the Bank should be private sector development, the formal restriction on public sector support is largely due to US insistence. With a similar concern in mind, the EBRD's members quickly agreed that the Bank should not make programme loans to governments. Only project finance will be allowed.

In the event, provision for up to 40 per cent exposure in public sector projects was included, for two main reasons. First, the private sector in the region is so small that it was feared the Bank would have had a hard time finding clients. More fundamentally, it was argued that Eastern Europe's new governments have a major role to play in the transition to market new governments have a major role to play in the transition to market economies, e.g. in strengthening the run-down infrastructure, and in fostering development of the financial system.

Provisions in its Articles for environment protection are the third unique feature of the EBRD, with a commitment 'to promote in the full range of its activities environmentally sound and sustainable development' and to report annually to its Board on this subject. Although other multilateral development banks have become increasingly sensitised to the need to include environmental concerns in their project selections, they do not have the same constitutional commitment to this.

The EBRD will have a capital base of 10 billion ECU, around US$12 billion. It will be able to make investments and loans totalling up to this amount in Eastern Europe over five years (that is around US$2 billion annually). Thirty per cent of the capital will be paid in by the Bank's members, of which at least half wil be in cash payments (the latter would equal around US$2 billion). The remaining 70 per cent of capital stock will take the form of callable capital. As with the case of other regional development banks, this money will not actually be paid "up-front"; its main purpose will be to provide backing for loans which the new Bank will be able to raise on the World's financial markets, and thus where competition with institutions lending to Latin America (e.g. Inter-American Development Bank) should be very limited. However, the part of resources devoted to capital paid in by governments (and particularly that part paid in cash) to the EBRD may imply some risk of "crowding out" new resources for example from other multilateral organisations, <u>unless additionality is again clearly established</u>.

TABLE 7

Members of the EBRD

Members of the EBRD with their shares of the Bank's capital stock

European Community	%	Other European countries	%
Belgium	2,28	Austria	2,28
Denmark	1,20	Cyprus	0,10
France	8,52	Finland	1,25
FR Germany	8,52	Iceland	0,10
Greece	0,65	Israel	0,65
Ireland	0,30	Liechtenstein	0,02
Italy	8,52	Malta	0,01
Luxembourg	0,20	Norway	1,25
Netherlands	2,48	Sweden	2,28
Portugal	0,42	Switzerland	2,28
Spain	3,40	Turkey	1,15
United Kingdom	8,52		
EC	3,00		
E/B	3,00		
EC total	51,00		

Recipient countries		Non-European countries	
Bulgaria	0,79	Australia	1,00
Czechoslovakia	1,28	Canada	3,40
German DR	1,55	Egypt	0,10
Hungary	0,79	Japan	8,52
Poland	1,28	Korea, Republic of	0,65
Romania	0,48	Mexico	0,30
U.S.S.R	6,00	Morocco	0,10
Yugoslavia	1,28	New Zealand	0,10
		United States	10,00

Perhaps one of the best ways for Latin American countries to lobby for levels of aid and multilateral lending to be sustained to them, and not be crowded out by Eastern Europe, is to emphasise that assisting Eastern European countries has different policy objectives than channelling flows to Latin American and other developing countries. Given East European countries' relatively high income levels, assistance to them is mainly required for motivations such as the wish to contribute to potential stability, to solidarity (in the case of Europeans) with other Europeans, to make their transitions to market economies as successful as posible. Though these are important objectives for the developed countries' governments and peoples, they are clearly distinct from those motivating development assistance, which are mainly alleviating poverty and extreme poverty. As a result, it is important to separate as distinctly as possible funds going to Eastern Europe from those going to developing countries, and attempt to ensure that the former are additional and thus do not come, directly or indirectly, from budgets earmarked for assistance or lending to developing countries.

As regards official flows to Latin American countries, there is also a qualitative effect arising from changes in Eastern Europe. These relate to renewed emphasis on political conditions (relating to human right and democratisation) as part of overall conditionality attached to these flows.

Another important effect of events in Eastern Europe (and the Soviet Union) are likely changes of their own development assistance to Latin America. Confronted with their own problems, (including large budget deficits) related to major economic and political changes, these countries are very unlikely to increase aid to developing countries, and have already started to reduce such flows fairly significantly. The Development Assistance Committee (DAC) estimates that for the 1987-88 period, the average annual/value of ODA from CMEA countries was US$4.7 billion, of which US$4.2 billion came from the Soviet Union, US$0.2 came from East Germany and US$0.3 billion came from the rest of Eastern Europe (total CMEA development assistance representing around 9 per cent of world ODA). Clearly a decline in such flows (and of the practice of preferential pricing in their trade with developing countries) will be damaging to the LDC requirements of such aid.

e) Interest rates

One of the most important likely effects of changes in Eastern Europe on financial flows to and from LDC's in the impact on international interest rates.

In particular, German interest rates (both short and long-term) have already risen quite significantly in 1989 and the first half of 1990, and are projected by different sources, including the OECD, to continue rising, though more moderately in 1991 (see Table 8). There seems to be agreement among different analysts that the major factor explaining the increase in German interest rates was the prospect of monetary union with East Germany, operating according to the OECD, through three main channels. First the expected increased long-term future demand for long-term loanable funds (both by the private and government sector) has already pushed up real interest rates; secondly, inflation expectations may have risen (for reasons discussed in section III above); thirdly, the risk premium (for long-term bonds) has increased, due to increased uncertainty.

Furthermore, within Germany (and throughout Europe) upwards pressure on interest rates has been reinforced by changes occurring in the rest of Eastern Europe; rebuilding these economies through fairly significant capital investment is seen to imply both an additional call on world savings in the 1990's, and greater pressure on the supply potential of OECD economies, pushing up both the real and inflation components of interest rates across all European (and possibly across all OECD) markets.

Table 8

Interest rate developments in Germany

	1987	1988	1989	1990	1991
Short-term rates	4.0	4.3	7.1	8.8	9.2
Long-term rates	6.2	6.5	7.0	8.8	9.1

Source: OECD, Economic Outlook, June 1990

The increase in interest rates, caused by German monetary union and by increased investment demand in Eastern Europe, will increase the cost of borrowing and of servicing existing debt for all Latin American economies, thus imposing a fairly significant additional burden on already severely constrained balance of payments.

V. CONCLUSIONS

The impact of changes in Eastern Europe on developing countries is as yet difficult to ascertain in detail, as events are beginning to unfold. A preliminary assessment can be made, with a need to review it and to monitor actual trends.

The main preliminary conclusions are:

a) Eastern European economies are small on a world scale as regards their output, population and their trade. Therefore their effect on creating additional demand for developing countries will also be relatively small.

b) As regards financial flows, the impact of changes in Eastern Europe seem likely to be bigger, as there seems likely to be some deviation of resources, particularly official ones from Latin American countries to Eastern Europe. Given initial imbalances, the costs of such a complex transition and the political support for large official flows into Eastern Europe, resources channelled to that region are likely in the medium-term to displace some development assistance. Furthermore, some countries in Latin America will be further affected by the reduction of development assistance from Eastern Europe and the Soviet Union, reduction which has already begun. As regards private flows, the risk of deviation is far smaller, as supply is far less constrained; there seems likely, however, to be some deviation of German private flows (particularly direct investment) to East Germany, from funds that could have been invested in Latin America.

There will therefore be a likely asymetry of effects, with stronger (and mainly problematic) effects in the financial aspects, and weaker (and mainly positive) effects in the trade aspects. An active effort must be made by Latin American entrepreneurs, governments, regional organizations, etc. to benefit from trade expansion effects. Relevant research should support such an effort.

c) It is important to emphasise that most East European countries do not fall into the category of developing countries, due to their relatively higher levels of GDP per capita and their even relatively higher welfare indicators (such as life expectancy).

Official support for them from donors should therefore be additional and remain separate from funding to Latin America and other as it's motivation differs from that of development assistance.

d) Very important effects from changes in Eastern Europe may well be indirect ones.

One of them is the rise in German (and other European) interest rates, resulting from the funding of German monetary and economic union which will reduce

German net savings. This will increase debt servicing costs for developing countries.

A more positive effect may be the precedent which East European external debt rescheduling/debt reduction operations may contribute to get for Latin American debtors. Again here active efforts by Latin American researchers and debt negotiators are required, to monitor developments in East European debt negotiations and use them - where relevant - as precedent.

FOOTNOTES

1. Source: Institute for International Finance, Building Free Market Economies in Central and Eastern Europe: Challenges and Realities, Washington D.C., April 1990.

2. For a good discussion on these problems, see "New thinking about national statistics" in Economic Commission for Europe. Economic Survey of Europe in 1989-90, UN, 1990 Geneva.

3. UNDP Human Development Report 1990, New York, OUP 1990.

4. See, UNICEF, The State of the World's Children, 1990.

5. Economic Commission for Europe, Economic Survey of Europe in 1988-89, p.5

6. J. Dempsey, "Ailing eastern Europe sails into an oil slick", Financial Times, August 15, 1990.

7. "Eastern European Reform, Calculating the Impact on Trade, Lending and Investment", Annex Bank Review April 23, 1990, vol.17, N° 4.

8. Treaty between the Federal Republic of Germany and the German Democratic Republic, establishing a Monetary, Economic and Social Union, 18 May, 1990.

9. See, for example, Deutsche Bank, German Economic and Monetary Union, July 1990, Frankfurt, West Germany; OECD, Economic Outlook, June 1990, Credit Suisse First Boston "The Interim Arithmetic of GEMU", April 1990, London.

10. For example, Deutsche Bank, op. cit.; press reports.

11. D. Goodhart "East's budget deficit widens", Financial Times, August 10, D. Marsh "Bundesbank urges Kohl to curb public spending" Financial Times, Nov. 1, 1990.

12. See, for example, IIF, op. cit.

13. Deutsch Bank, op. cit.

14. "W. German utilities to take over East's power industry" Financial Times, July 30, 1990.

15. For details, see, OECD Financial Market Trends, February 1990.

16. See, for example, M. Faber and S. Griffith-Jones (eds.), Approaches to Third World Debt Reduction, IDS Bulletin vol. 21, N° 2, April 1990.

17. J. Rollo, with J. Batt, B. Granville and N. Malcolm The New Eastern Europe: Western Responses, RIIA and Pinter Publishers, London 1990.

18. See, for example, M. Nuti "Internal and international aspects of monetary disequilibrium in Poland" in EEC, European Economy, March 1990, N° 43.

19. Interview material.

20. See, R. Portes "Development vs. Debt: Past and Future" in Faber and Griffith-Jones (eds.), op. cit.

21. See, for example, Rollo et al, op. cit.

22. Address by Jacques Delors to the European Parliament presenting the Commission's Programme for 1990, Strasbourg, 17 January 1990 (EC press release).

23. For details, see UK Treasury Economic Progress Report N° 208, June 1990, and ODI The European Bank for Reconstruction and Development Briefing Paper, London, September 1990.