Capital mobility in transition countries of Central Europe: macroeconomic performance factors and structural policies

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Abstract:

In the course of transition, the former centrally planned economies of central Europe have attracted increasing shares of the international capital flows to emerging market economies. Moreover, compared to other world regions, a relatively large share of these flows has been constituted of foreign direct investment. An exploration of the determinants of these capital flows, using a neo-classical model, provided only medium-low levels of explanation, and the importance of considering institutional frameworks. The remainder of the paper examines the influence of financial sector development and of privatisation on foreign direct investment, portfolio investment, and 'other' forms of investment.

Key words:

Capital flows Foreign direct investment Privatisation Financial sector Central Europe Transition economies

1.INTRODUCTION: FOREIGN CAPITAL IN THE TRANSITION ECONOMIES OF CENTRAL EUROPE

Global financial landscapes have changed significantly since the 1980s, not least through increased capital flows between developed countries and emerging markets (Blommestien and Biltoft, 1995). The latter were influenced by five main factors: (1) liberalisation of international capital transactions; (2) regulatory reforms of capital markets, both in the OECD members and emerging markets (Harris, 1997); (3) improvements in the macroeconomic performance of many developing and transition countries; (4) rapid progress in communication technologies and European Monetary Union preparations, which were reflected in interest rate reductions in the EU, and a search for alternative sources of higher yields by the portfolio managers of large institutional investors; and (5) privatisation and structural economic policies in many emerging markets. These changes are observed in most emerging markets, including the Central European transition countries (the Czech and Slovak Republics, Hungary and Poland).

Economic development in the centrally planned economies was based on extensive inputs of domestic labour and capital. While these generated high growth rates in the 1950s and 1960s, the relationship weakened thereafter. The domestic labour inputs were initially enabled by mass rural-urban migration, feminisation of the labour force, and relatively high population growth rates, but their generating power waned over time. As for capital sources, forced capital accumulation, reflected in limited consumption of consumer goods and services, was unable to offset a capital deficit. From the 1970s, some state socialist regimes sought capital inputs from developed capitalist economies. These mostly materialised as loans provided by Western governments or major institutional investors, rather than as portfolio investment or foreign direct investment. The capital loans provided to Poland and Hungary in the 1970s and 1980s were mostly allocated to inefficient development projects or

to imports of consumer goods. By the late 1980s, both countries had substantial foreign debts, with burdensome repayments. Capital outflows from Poland, in particular, meant that the central European countries experienced massive capital outflows in the late 1980s and early 1990s (Table 1). In total, the four transition economies received only $ 420 million of net foreign investment, 1990-1994, compared to the net $ 142.1 billion received by three Latin America countries (Argentina, Brazil and Mexico) and the $ 111.9 billion in three Asian countries (Korea, Malaysia and Thailand). The situation, however, changed in the second half of 1990s, and the four Central European transition economies had $ 43.6 billion of net capital inflows, 1995-1997. Although this still lags behind the other emerging markets in absolute terms, the structure and per capita distributions of the capital flows present a more complex picture (Table 1).

(Table 1 near here)

In relative terms (per capita net inflows), the four transition economies had the largest capital inflows amongst the emerging markets. Moreover, the structures of the flows differed with foreign direct investment being the main component in central Europe, indicative of a higher ‘quality’ (long-term capital with no increased foreign debt). This paper examines whether macroeconomic performance and prospects for short-term returns from financial investments, or long-term foreign investor considerations generated these major structural changes in capital flows

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2. CAPITAL FLOWS AND THE MACROECONOMIC ENVIRONMENT

While capital flows fluctuated over the short term in the 1990s, the emerging markets received considerable capital inflows from the developed countries over the longer term. These flows can be explained through different perspectives. The neo-classical approach, for example, is based on benefit maximisation, assumes efficient markets, perfect information, and rational behaviour (for example, the efficient markets theory). This approach starts from an analysis of capital asset pricing. Investment decisions are based on profit/risk factors. Investors weigh the present value of a stream of returns from relatively risk-free assets against the streams from assets in emerging markets, taking into account the country's risk premium. More fully elaborated neo-classical models also take into account different types of investment, for which foreign investors have different time horizons and objectives: capital gains (price arbitrages), dividend or interest yield, portfolio diversification, and combinations of these. There are also strategic investors, with very different objectives. An investor in a car factory, for example, is mainly interested in acquiring a new market, so that purchasing power, and labour market features are likely to be more important than stock market regulations and share prices fluctuations (of key importance to portfolio investors). Agglomeration effects also influence foreign investment decisions (Geenhuizen and Nijkamp, 1998: 111). Finally, speculative investors focus on short-term movements in interest and foreign exchange rates, and the margins between returns in the host country and international markets. This 'differentiating' approach is backed by risk/profit considerations on capital asset pricing. Another version of the neo-classical approach also starts with capital assets pricing, but assumes that investment decisions take place in imperfect markets with incomplete information. (Levine and Zervos, 1998) It assumes that investors are not always governed by rational considerations and analyses of underlying assets but tend to 'herd', imitating the behaviour of market leaders. 'Investor herding' accentuates unpredictability, and is weakly related to developments in real economies. In

practice, it is difficult to separate fluctuations in capital flows generated by imperfect information and subjective investment decisions, but 'herding' effects are mostly observed in portfolio and short-term capital flows, and are less significant for foreign direct investment.

While these approaches emphasise different factors in the analysis of capital flows, they are not contradictory and frequently overlap. The factors recognised by the capital asset pricing models can be assigned to two major groups, The first are internal (country specific) or 'pull factors', which refer to economic, social and political developments in an emerging market. They can be further subdivided (Lensink and White, 1998) into economic performance factors (such as GDP growth, inflation rates, trade and budget balances, saving rates, and wage levels) and creditworthiness factors (such as the debt to exports and GDP ratios, or international currency reserves to GDP). Secondly, external (country non-specific) or 'push' factors refer to developments in international markets, and can be expressed in terms of differences between rates of return on alternative investment on international markets and those in the host country. The two sets of factors are linked: there is an inverse relationship between the differences between rates of return on international and host country markets, and the importance of internal factors. This partly explains why the transition economies have been favoured during EMU preparations in the 1990s. As interest rates in the EU zone converged on historically low levels, investors sought alternative sources of higher-yield investments.

The key question is the relative importance of internal and external factors for capital flows to transition economies? As indicated earlier, the answer is contingent for different investors, investments and time periods. An extensive literature review by Maxfield (1998) suggests that external factors have been more important. Several studies (for example, Fernandez-Arias, 1996) discovered a significant correlation between declining the US real interest rates and rising capital inflows into small developing countries in one period time lag.

The same study also analysed creditworthiness factors, derived from the secondary market prices for the countries' bonds. The higher the margin between the host country's and international real interest rates, the less important was the country's creditworthiness. The combined direct and indirect impacts of international interest rates explained 86 percent of the variation in capital inflows to an emerging market. The significance of external factors, mainly interest rates in the more developed markets, was also observed in other studies. The risk premiums paid by emerging markets reflected more their inflation and default histories than their current macroeconomic situations. Of course, the degree of global economic integration is positively related to the importance of external factors. Globalisation has opened new channels for capital mobility for the emerging markets, but has increased their volatility and unpredictability. Taylor and Sarno (1997) analysed portfolio flows from the USA to nine Latin American and nine Asian countries, 1988-1992, and established that global and country-specific factors were equally important for determining long-run equity movements. However, external factors (US interest rates, in particular) exerted more influence on short-run bond flows to emerging market.

Turning to internal factors, Lensink and White (1998) analysed 7 performance and 5 creditworthiness indicators for 60 Third Word countries (including sub-Saharan Africa). They found that the performance variables of annual GDP growth, trade balance/GDP, broad money/GDP and GNP per capita in constant 1987 $ were robust and powerful in explaining the attraction of foreign private capital. Gastanaga et al (1998) established the significance of GDP growth, corporate tax cuts, tariff jumping and trade liberalisation for increases in capital inflows into developing countries. Ul Haque et all (1997b) established that the ratio of foreign currency reserves to imports, the ratio of current account balance to GDP, and growth and inflation rates were most important in determining credit rating.

These studies mostly analysed macroeconomic indicators for samples of developing

countries, from various continents, with different development levels and capital regulation systems. Holland and Pain (1998) adopted a broader framework, focusing on 10 transition economies in Europe. In addition to macroeconomic data such as relative wages, relative (labour) productivity and risk factors, their analysis also included an institutional assessment. This 'structuralist' approach considers, for example, the role of the private sector, membership of international organisations, privatisation, the legal framework, the fairness of trading, and the efficiency of regulatory institutions. Holland and Pain's research did not incorporate all these conditions and was mainly limited to privatisation and EU integration. They found that privatisation methods, relative wages and EU proximity were the most significant factors explaining the share of FDI in national GDP. While explaining some two thirds of the international variance in FDI, the analysis had shortcomings. It did not, for example, consider time lags between the indicators values and FDI volumes, although it is reasonable to assume that long-term foreign investors react to changes in structural policies in the same year. Privatisation methods also changed over time, often abruptly, and can not be reduced to simple numerical values. The analysis also classified privatisation according to the original administrative models (voucher privatisation, direct sales, buy-outs etc.) and did not consider subsequent (re)privatisation through market mechanisms. Despite these shortcomings, Holland and Pain's 'institutional framework' analysis provides an useful approach to capital flows.

This paper seeks to identify the factors which were significant in attracting capital flows in transition economies. Initially, adopting a neo-classical approach, macroeconomic indicators were analysed following Lensink and White's methods, subject to two important modifications. First, we analysed *different types* of capital flows, as expressed in the net capital account balance in the International Financial Statistics of the IMF: foreign direct investment (FDI), portfolio investment (PI) and other investments (OI). Secondly, whereas Lensink and White's study was mainly concerned with low-income countries, 1987-1994, this

paper focuses on the Czech and Slovak Republics, Poland and Hungary, 1990-1997, as the most consistent group of European transition economies. The following variables were entered into the multiple regression equation: dependent variables FDI, PI and OI (net investment as a percentage of GDP) and the independent variables GROWTH (percentage annual GDP growth), INF (annual growth in consumer prices), CA (current account balance, as percentage of GDP), M2 (share of M2 aggregate in GDP), MARGIN (difference between real deposit rates in transition economies and average of deposit rates in the USA, UK and Germany), GDP (per capita, computed via exchange rates) and POP (population). The analysis did not consider the time lag between the indicator performance in the current year and investment flows for 'other investments'. Some 'other investments' were loan facilities arranged by international financial institutions, more concerned with strategic targets than speculative ends. Additionally, most of the 'other net investments' were short-term deposits, loans and securities owned by foreign private investors, which were based on price fluctuations for which the one-year lag would be too long. In contrast, current year and one-year time lag data were used for FDI and portfolio investment, but the time lag was significant only for the former. With respect to the MARGIN variable, the original aim had been to use differences in short-term interest rates in transition and developed markets. As these were unavailable in the early transition period, deposit rates were preferred to discount rates, due to their greater flexibility. The results are summarised in Figure 1.

Figure 1 near here

The analysis of capital flows to/from transition countries in Central Europe confirmed some of the findings of previous studies of developing countries but also emphasised the importance of differences in the structure of international investors' targets and time horizons. As for FDI, four independent variables were important at the 90 per cent confidence level, with GDP per capita and the ratio of M2 to GDP being most significant.

This broadly accords with Lensink and White's (1998) findings that FDI is most likely to be directed to economies with relatively high development levels (GDP per capita) and relatively developed financial systems (ratios of broad money to GDP). FDI investors have longer-term targets, and were less influenced by fluctuations in interest rates and trade balances. Decreases in inflation and increases in GDP growth seemed to provide a broader framework for investment decisions in these transition economies. However, the explanatory power of the model (R^2 = 0.372) was medium-low, indicating that other factors, not included in this analysis, were important in determining FDI flows.

The results were less convincing for portfolio investment (R^2 = 0.101). Only per capita GDP levels were significant (both for the current year and one year time lag). Portfolio investors were a diverse group, ranging from large pension funds and insurance companies with relatively stable yield policies for 'buy and hold' to speculative investors interested in short-term price arbitrage. This heterogeneity may have obscured the analysis of the independent variables.

'Other investments' were also constituted of different investor types and time horizons, but most were concerned with interest yields. Not surprisingly, the interest margin, ratio of M2/GDP and inflation rate were the most significant independent variables. The three combinations of underlying factors had medium strength explanatory powers, with the combination of inflation and margin being most influential. These two independent variables, however, were collinear. The combination of M2 and INF factors did not suffer from collinearity and offered the best explanation of the determinants of 'other' investment flows (R^2 = 0.422)

Analyses of variations in capital inflows and outflows must be approached cautiously, given their methodological problems. Different types of investment flows are

interchangeable. Investors in a car factory (FDI), for example, may hedge their long-term risk exposure to the market with a compensating financial transaction (Maxfield, 1998: 1207). The borders between FDI and portfolio investments are not always clear. Most transition countries have tried to follow EU practices (Directive 88/627/EEC) and, for example, have a 5 percent limit for the disclosing the identities of qualifying shareholders in publicly traded companies. However, in practice, individual investors wishing to take over enterprises may hide behind formally independent groups of portfolio investors. Furthermore, some short-term inflows may be used for leverage operations in the acquisition of portfolio assets or long-term assets.

There is also the question of the extent to which domestic investment is really domestic. Foreign investors were not allowed to participate in some privatisation programmes but in practice financed the new domestic owners. On the other hand, not all foreign investments were really foreign. There were thriving black and shadow economies in the transition states, with widespread tax evasion and money laundering. Capital frequently was transferred to international tax havens, only to reappear in the clothing of foreign investment, safe from tax office and police investigation.

Summing up, four factors were significant for capital inflows to transition economies in Central Europe: GDP levels, histories of low inflation, relatively high ratios of broad money to GDP, and relatively high margins between domestic and international interest rates. The latter two appear to be most important, which indicates the importance of financial sector development levels. In general, however, models based on macroeconomic indicators had low-medium explanatory powers. Macroeconomic stability seemed to be a required but not a sufficient condition for attracting large volumes of FDI. This suggests that more attention should be paid to analyses of the institutional framework of foreign capital flows. The institutional framework has both external components (association agreements with the EU,

for example) and internal ones. The next two sections consider the latter, and in particular the development of the financial sector and privatisation.

3. FINANCIAL SECTOR DEVELOPMENT

The role of foreign capital in a small open economy is determined not only by the volume and structure of capital flows, but also by the capacity to use these effectively, which normally requires an efficient capital market, a healthy banking sector and sound macroeconomic policy. These conditions were rare in the transition economies, and instead there were usually non-transparent and illiquid capital markets, weak banking and capital market supervision, high shares of non-performing bank loans, and a lack of effective investor protection.

Banking reform became a cornerstone of financial system reform. Except for the USA and UK, where capital markets account for the major share of capital flows, banks dominate investment financing in most developed national economies. Banks also have other functions in financial markets, notably clearing, settlement and foreign exchange operations. Singh and Weisse (1998: 617), drawing on the experiences of both the developed and newly industrialised economies, argue that 'developing countries would do better to reform the institutional structures of their banking systems rather than create stock markets, which require sophisticated monitoring. The banks are able to effectively evaluate credit risk, *ex post*, as well as monitor the performance of the management during the course of the investment itself'. In contrast, they consider stock market development and portfolio capital inflows to be speculative and unlikely to facilitate rapid long-term growth.

The evidence from the transition economies is mixed but does not confirm the role of banks as watchdogs of effective investment allocation. Despite rapid development of capital

markets in the transition economies, these essentially remained ‘bank economies’, with credit institutions being the main source of capital and remaining major players on national stock exchanges. Banking systems in transition economies developed via detachment of commercial and saving banks from central state banks, resulting in the creation of bank oligopolies. These were in state ownership and their privatisation was opposed by various political and economic interest groups in the name of ‘national interest’. There were also banks established by domestic and foreign private investors but, having to develop new market networks, they accounted for relatively minor shares of total domestic deposits and credits. In contrast, state-owned bank oligopolies inherited millions of relatively conservative customers in the household sector, and had a large share of total deposits. This imperfect competition had largely negative consequences for national finances. Firstly, bank oligopolies achieved wide spreads between deposit and lending rates, but these also contributed to the decreasing efficiency of financial intermediation (Knight, 1998). Secondly, increasing lending rates drove more borrowers to default but, as most had debts in the state-owned banks, the volumes of non-performing loans held by the latter increased sharply. Only a few larger companies were able to utilise alternative and cheaper sources of finance, such as international loan and debenture markets.

The reform of the banking sector and enterprise restructuring were closely related to bank privatisation and the entry of foreign capital. By 1998, the state and foreign shares of total bank assets varied across central Europe (Banker, p. 43, 1999):

	State (%)	Foreign (%)
Czech Republic	18	14
Hungary	12	62
Poland	48	16
Slovakia	49	19

Those countries which had privatised their financial sectors and sold the major financial institutions to foreign investors had new owners who were more interested in increasing investment efficiency. However, in these countries (Hungary, for example), the economic situation only improved gradually in the 1990s. Those countries where financial market reforms were more laggardly (Slovakia, for example, partly the Czech Republic) were less attractive to foreign investors. They not only had lower volumes of foreign capital inflows, but also lower quality capital structures, with short-term and often volatile speculative investments being significant. The question for the transition economies was not only how to attract capital, but also how to manage its structure, achieve a positive balance of capital in- and outflows, and allocate capital to development projects with high efficiency levels.

Various economic policies were used by national governments to attract foreign investment, ranging from tax breaks to government support via general infrastructure development. For the foreign investors, the key factors in decision making were: political stability, a stable macroeconomic environment, minimal levels of bureaucracy, and a non-discriminatory state approach to domestic and foreign investors (as indicated, for example, in the regular country ratings published by Euromoney). Tax breaks or infrastructure projects were less important. As for the macroeconomic environment, the transition economies were able to manage most of the external and internal shocks resulting from the collapse of the Council of Mutual Economic Assistance (CMEA) markets and the implementation of market reforms. In the relatively short period of four years (1990-1993) they halted the decline in their GDP, reduced inflation, and reorganised their production structures. The Czech

Republic, Hungary and Poland also established functioning democratic structures, ensuring relative political stability, and were assigned to the first group of candidates for the proposed EU eastern enlargement (CEC, 1998). There was less progress in Slovakia, especially under the Mečiar government's relatively authoritarian rule. While levels of macroeconomic and political stability were generally similar in the Czech Republic, Hungary and Poland, their attitudes to foreign investment differend with respect to privatisation.

4. PRIVATISATION: PRECONDITIONS AND POLICIES

Privatisation in central Europe was a large scale process of redefining property rights. By 1995, the assets involved in privatisation accounted for 72.8 percent GDP in the Czech Republics, 48 percent in Slovakia, 16 percent in Hungary and 26.2 percent in Poland (Williams and Baláž, 1999; Csépi and Lukács, 1995; Češka, 1995; Pater, 1995; and Porvazník, 1994). Initially, privatisation schemes were mainly analysed from the viewpoint of government policies and the neo-liberal rhetoric prevailing in the region in early 1990s (Ash et al, 1994; Ridder and Zajicek, 1995; Rutland, 1997). Little attention was paid to the preconditions of privatisation and the influence of interest groups in most transition countries.

The national models of economic development had diverged by 1989 in central Europe. Hungary and Poland, for example, had dismantled central planning at least in the small business sector and had decentralised enterprise management (Fogel and Etcheverry, 1994). They also secured significant foreign loans in the 1980s. By 1989 about one third of the labour force in Poland was employed in the private sector, producing one quarter of GDP. Poland and Hungary had also experienced the so-called spontaneous or *nomenklatura* privatisation (Ash et al, 1994). In Hungary, private businesses had also been established by individuals working outside the public sector (in retailing, hotels and restaurants in

particular). In the public sector, state institutions ('holdings', enterprises, and banks) began to diversify their activities and emerged as owners of diverse subsidiaries (Voszka 1993: 89). Therefore, many of the preconditions of ownership transformation were in place in Hungary and Poland by 1989, including market institutions, entrepreneurial behaviour, and the decentralisation of property rights form the central state to local economic units.

Czechoslovakia, in contrast, remained more wedded to central planning (Landesmann and Székely, 1995) and had little experience of market reforms. This explains why mass privatisation schemes (the Coupon Privatisation), which favoured domestic and foreign financial institutions, was less opposed in the former Czechoslovakia by the managerial class in the early stage of transition. In Poland and Hungary, these classes had more experience of the opportunities provided by the redefinition of property rights and opposed mass privatisation. In Poland, mass privatisation did not start until 1997 whilst it has been insignificant in Hungary. Hence, the balance of power between domestic and foreign interest groups was an important factor in channelling FDI to particular countries, especially in the early stage of transition. Holland and Pain (1998: 16), for example, argue that 'countries with a programme of direct privatisation through cash sales have attracted relatively higher inward investment then those countries using voucher privatisation'.

Hungary's main comparative advantage was its gradualism. Market reforms were introduced from the 1970s (Stark, 1997), while the 1991 Accounting Law and the Financial Institutions Law introduced accounting, bankruptcy and banking practices similar to those in the EU. As a result, bankruptcies increased sharply, and given the outstanding debts with the banks, the financial system was in crisis within a year. The state bailed out many banks and enterprises in default and, by end of 1993, $ 3 billion had been spent on purchasing non-performing loans and enterprise debts, and recapitalising banks with capital adequacy ratios close to zero. The state became the major shareholder in the largest commercial

banks and hoped the banks would initiate enterprise restructuring. The bank managers, however, had little incentive to do so and the Hungarian Ministry of Finance failed to monitor effectively the recapitalisation funds. In short, the state proved to be an ineffective majority shareholder. The poor loan portfolio of the banking system changed only after the large banks had been privatised and the entry of foreign investors increased competition (Koch 1998). Bank privatisation was also reflected in reduced spreads between interests on loans and deposits, with positive consequences for economic efficiency.

The pace of Hungarian privatisation and enterprise restructuring increased, with foreign investors being prominent. In 1990, over 1800 state-owned enterprises were earmarked for privatisation, with book values of $ 30 billion (Csépi and Lukács, 1995). Strategic investors were sought for the large companies, while medium-sized companies were sold to foreign or Hungarian investors through competitive bidding. Smaller companies were either directly sold or implemented their own privatisation programmes. Sales to foreign investors dominated the privatisation process, and by end of 1994 385 such sales had generated almost $ 4 billion. In contrast, ESOP (employee privatisation) schemes and restitution schemes accounted only for $ 1.2 billion.

In Czechoslovakia, in early 1990, the coupon privatisation temporarily favoured the financial lobby (banks and investment privatisation funds, IPFs), which in many cases were backed by foreign capital. Coupon Privatisation through the IPFs was supposed to promote collective investment and create a liquid market with large numbers of listed shares and strong institutional investors. Whereas in developed market economies there are two major forms of collective investment institutions, mutual funds and holding companies, the Czechoslovak government tried to create a new type of hybrid institutional investor. This was to be problematic and, after the Harvard Funds of Viktor Kožený (Fogel, 1994) had been positioned to control 40% of all Czechoslovak coupons, the federal government belatedly imposed (via the

1992 Investment Companies Act), a 20% ceiling (latter reduced to 10%) on the privatised assets obtained by any one investment group. While the IPFs were defined as portfolio investors, they were also expected to be actively involved in company restructuring.

In practice, the Czechoslovak coupon privatisation scheme was effectively controlled by 14 institutions - nine banks, two insurance companies and two investment groups. In Slovakia alone, the five largest investment companies acquired 43% of all investment coupons, whilst the twenty largest investment companies acquired 58%. Over the next two years, these investment companies became decisive players on the Slovak capital markets, being able to determine the prices of stocks. In the Czech Republic, the situation was similar: the IPFs obtained 71.8%, with the top six funds obtaining 41.1%, of the total investment coupons points. However, after the transfer of assets into the IPF portfolios, the funds (and their parent banks) found that approximately 95 percent of the shares were illiquid, and the accounts of the underlying companies were in the red.

One consequence of the Coupon Privatisation was the reluctance of potential foreign investors to invest in the privatised enterprises. Where, for example, 97% of the shares in an enterprise were allocated to Coupon Privatisation, these were diluted among thousands of minor shareholders and there was no clear and strong owner. The participation of foreign investors was usually dependent on the establishment of major shareholdings (usually by securities dealers, assembling packages of minor stakes). In contrast, if only 10-20 percent of the shares in an enterprise were allocated to the Coupon Privatisation, the rest (the majority) remaining with the Czech and Slovak National Property Funds, potential investors could try to purchase majority stakes from NPFs. In practice, however, there were a number of enterprises where 30-60 percent stakes had been allocated to the Coupon Privatisation, and where future ownership rights were unclear. Even if, for example, a foreign investor assembled 40 percent of the diluted shares, the NPF could sell the remaining 60 percent to

another investor as one block. This created a high level of risk for the foreign (minority) investor, due to low levels of minor shareholders protection.

Most enterprises were heavily indebted to the banks and many had a legacy of substantial 'environmental costs or debts'. In many cases, foreign investors would have found it easier to take over the assets of bankrupted enterprises. However, the Czech and Slovak governments feared the social and political impacts of rising unemployment and, therefore, made bankruptcies virtually impossible. The banks, which were the main creditors, were also wary of bankruptcies, because most of their capital was invested in the enterprise sector in the early transition period. There was a genuine fear that bankruptcies could have cascading effects across the entire economy. Therefore, instead of selling unprofitable enterprises to foreign or domestic investors, the banks continued to accumulate non-performing loans.

The Czech government tried to solve the problem by transferring privatisation income from the National Property Fund to the banks, but with few positive results in the two main state-owned commercial banks and the savings bank. Their closure was politically impossible since most of their financial sources came from household savings. By the mid-1990s, the once highly praised Czech privatisation programme was riddled with contradictions. Not least, while most state-owned enterprises were privatised and the private sector accounted for some 70 percent of GDP, property rights were confused. The banks had a conflict of interest being the main lenders to and the owners of these enterprises (both directly and indirectly via the IPFs). This and other contradictions were reflected in their poor asset management. For example, the largest Czech bank, the *Komerční Banka*, had been partly privatised via coupon privatisation, but this failed to introduce either new capital or foreign management know-how. Analysing the bank's asset management, Snyder and Kormend (1997: 126) comment that 'credit allocation decisions cannot be explained as the

outcome of the profit maximisation. The real-sector consequence include delays in enterprise restructuring, less than optimal equity financing and an over-reliance on short-term credit'. The IPFs, which controlled some 70% of the assets from the coupon privatisation, also could not exercise control over individual enterprises, because the 1992 Investment Company and Fund Law limited their holdings in any one company to just 10% which effectively made them portfolio investors.

In 1998, the Czech government finally decided to privatise the bank oligopolies and permit the entry of foreign capital into the sector. The *Investiční a Poštovní Banka*, for example, was acquired by the *Nomura* group, the *Československá Obchodní Banka* by *KBC*, and the *Agrobanka* by *General Electric*. The closed-end IPFs were also forced to sell their holdings in major Czech enterprises, and many of the new owners were probably foreign, although this is difficult to verify. In April 1998, a new Securities Commission was established, with extensive powers to combat fraud, market manipulation and non-transparency (Jones, 1998a).

Our analysis agrees with McDermott's assessment that the 'vouchers left restructuring options quite constrained by a concentrated industry, ineffective IPFs and equity markets, low foreign investment and social malaise'. But his opinion that the problem was not so much the assignation of property rights so as to avoid conflicts of interests, but rather the distribution of property rights amongst interest groups and the creation of institutions for mediating compromises and solving conflicts (McDermott, 1997: 83 and 99) has not been borne out by events. The redefinition of ownership rights has led to clearer ownership structures and the establishment of majority owners. Economic agents sought to acquire majority stakes or effective executive powers in the privatised enterprises either by obtaining qualifying holdings from the National Property Funds (perhaps in exchange for political and financial support), or by 'tunnelling' the enterprise, whereby they surreptitiously

siphoned off its assets to their own businesses. In most cases, the agents were managers of former state-owned enterprises. For them, as for other investors, minority stakes in medium-sized enterprises were risky due to limited protection of minor investors (Baláž, 1996). Few IPF managers tried either to defend shareholders rights or to restructure the underlying companies. Instead, they copied the transfer pricing practices of the enterprise managers which, in the shorter term, offered better (if mostly illegal) returns on investments.

Many financial and individual investors were unable to obtain strategic share holdings and therefore sold their minority stakes to managers and domestic (strategic) and foreign investors in the so-called 'Third Wave of Privatisation'. This started in 1995 and was driven less by the legislative and organisational activities of the state, than by market forces. The agents in the Third Wave had various backers. In the Czech Republic, the managers of banks and several former IPFs backed most take-overs. They collected the diluted shares of the IPFs, used leverage effects and obtained majority stakes in privatised enterprises. In order to avoid the 10% ceiling rule, the IPFs were transformed to holding companies. In this way, relatively modest amounts of initial capital enabled the creation of large holding empires. It was the 'Third Wave', which finally created effective owners of the enterprises privatised via mass privatisation programs. Their sources of capital were rarely disclosed and the new owners hid behind anonymous Ltd and Plc companies. But given the shortage of domestic capital, it is assumed that foreign capital was important.

The situation in Slovakia was broadly similar to that in the Czech Republic. Domestic banks were burdened with increasing shares of bad loans and the capital market became a place of market manipulation. The 'Third Wave' also occurred in Slovakia, if in a different form. After 1994, the Mečiar government was backed by domestic management lobbies, which benefited from cancellation of the Second Wave of coupon privatisation and international privatisation tenders, and their replacement by direct sales to 'government friendly' managers,

who acquired almost all the assets privatised in 1994-1998. After several such 'direct sales' damaged the positions of foreign investors (e.g. the EBRD in case of the *Slovnaft* privatisation, see Williams and Baláž, 1999), foreign investors' interest in Slovakia slumped. However, many of the new domestic owners were unable to manage effectively and, after some time, sold their assets to other (more capable) interest groups. These groups also used leveraging finance to take over companies formerly controlled by the IPFs. Similarly to the Czech Republic, the identity of the new owners remained obscure but, while some were probably foreign, the share of domestic investors was probably higher in Slovakia.

Poland followed a different pathway. Instead of creating nation-wide bank monopolies, 9 regional banks, 4 specialist banks and a foreign trade bank commenced operations after 1989. Polish governments reluctantly accepted the entry of foreign capital into the bank sector, but was only encouraged where the banks had structural problems (Koch, 1998). Therefore, most banks were privatised by domestic investors or remained in state ownership. The state, however, forced the banks to continue lending to heavily indebted state enterprises, which was 'counter-productive as it leads to continuation of long-standing client relationship with questionable profitability with troubled state-owned firms' (Abarbanell and Bonin, 1997: 60). Therefore, despite initial reluctance, the government eventually permitted the gradual entry of foreign capital into the bank sector. This was facilitated by the insider information scandals associated with the privatisation of Bank Śląski. By 1998, 10 of the 14 Polish banks were in private hands and the privatisation of the remainder was under way (Jones, 1998b). Delays in the bank privatisation, however, had negative consequences for enterprise restructuring and foreign investment in the sector.

Polish enterprise privatisation was based on two basic programs (Pater, 1995). Firstly, 'privatisation via liquidation' was designed mainly for small and medium-sized enterprises, and usually involved leasing the company assets to managers, employees or other investors;

foreign investors were excluded. Secondly, ‘privatisation via commercialisation’ was used for large and medium-sized enterprises. These were converted into joint-stock companies, with majority or minority stakes being offered to domestic and foreign investors. The major parts of these companies were sold via the mass privatisation programme, which created the National Investment Funds (NIFs). The scheme placed a small number of NIFs (operating as join-stock companies) in charge of over 500 state-owned enterprises. Seeking to avoid the mistakes of the Czech and Slovak programmes, they tried to create effective owners of the privatised companies. Any one NIF was allowed to obtain a 33% stake in some 30 firms (Ellerman, 1998), but this had one major shortcoming: it did not define clear ownership rights, and therefore a repeat of the Czechoslovakian experience is anticipated. There is likely to be a struggle over property rights until clear majority owners are established, which would have a positive influence on foreign investment. However, at the end of the 1990s, FDI per capita remained low in Poland compared to Hungary or the Czech Republic.

5. THE STRUCTURE OF CAPITAL FLOWS DURING TRANSITION

The four transition economies in Central Europe had different starting positions in 1989 and their structural economic policies were significantly different during the transition period. These divergences, in turn, were reflected in different foreign capital structures (Table 2).

Table 2 near here

Given differences in privatisation policies, Hungary's success and Slovakia's poor record in attracting FDI are not surprising. There were also significant differences in the integration of the state socialist countries into international financial markets. By the late 1980s, Poland and Hungary had accumulated relatively large foreign debts, reflecting relatively high investment income flows (with deeply negative balances). In contrast, Czechoslovakia's policy had been to minimise its foreign liabilities. On the credit side of the investment income balance, the centrally planned economies had virtually no foreign direct and portfolio investments in other countries, so that their investment income was generated by loans (rarely repaid), mostly to other state socialist regimes such as Libya and Vietnam. The flows on the debit side were also mostly constituted of loans, originating from Western private and public bodies. The interest on these loans had been a significant burden for Poland, in particular, since the early 1980s. The market reforms in the transition economies did have some positive impacts on their investment income. Hungary, for example, was able to re-pay much of its foreign debt. Poland, however, had to request debt re-scheduling in the mid 1990s. The previously strong foreign debt position of the Czech and Slovak Republics deteriorated over time especially their short-term commitments. In the Czech Republic, for example, the high volume of short-term liabilities to foreign creditors led to financial crisis and depreciation of the Czech koruna in 1998.

As argued above, privatisation policies and the international investment position in the early 1990s have had a major influence on the volumes and structure of foreign capital flows from/to the transition countries in Central Europe. In addition, a number of specific developments determined the net inflows of foreign capital to individual countries, including the national systems of financial market regulation, monetary policies and macroeconomic policies.

Foreign direct investment

Foreign direct investment was rare in the former state socialist economies. The IMF for example, estimated that in 1989 there were some $ 268 million of FDI inflows into the former Czechoslovakia, Hungary and Poland. In contrast, their total accumulated FDI, 1989-1997, was $ 39.0 billion. While the increase was striking, it was by no means exceptional. In the same period, the newly industrialised countries in Latin America and Asia received far larger foreign investments. For example, three Latin America countries (Argentina, Brazil and Mexico) received US$ 131.5 billion whilst three Asian countries (Korea, Malaysia and Thailand) received US$ 44.5 billion of FDI. There were several reasons for the relatively low inflows of foreign capital into the CE economies. First, with the exception of Poland, these were relatively small economies with relatively limited internal markets. Secondly, the privatisation methods in the Czech and Slovak Republics, and partially in Poland, favoured domestic investors. Thirdly, the transition economies in Central Europe had had less direct political and economic contacts with potential investors from the Anglo-American countries. Instead, some of their principal sources of investment, such as Germany and Austria, had been less prominent in capital exports than the USA or the UK.

Given their size differences, the volume of FDI inflows has be assessed in relative terms. In the period 1995-1997 (after implementation of the main privatisation programs), central Europe had the highest per capita capital inflows amongst the emerging markets. It also had the most advantageous structure of capital inflows, with FDI per capita levels being

four times higher than in south-east Asia. At the level of individual countries, Hungary was the clear winner, followed by the Czech Republic. Poland should have been attractive to FDI, given its domestic market of 36 million people. Foreign investors have, however, been wary since Poland announced a moratorium on debt servicing. Slovakia had the poorest reputation because of its opaque privatisation policies, and received the lowest volumes of per capita FDI.

Portfolio investments

Minority investors in the region faced difficulties because privatisation had created a situation whereby concentrated ownership, (domestic or foreign) was associated with better corporate governance and higher share prices (Claessens, *1997).* Therefore, portfolio investors were wary of the region, and FDI became the main vehicle for foreign investment.

While portfolio flows traditionally tended to be more volatile than FDI, they were not insignificant. Large international institutional investors (Blommestein, 1997) sought alternative investments in the face of decreasing interest rates in developed economies (in the wake of EMU preparations). This had profound implications for the development of financial markets in the transition economies: increased liquidity levels in local capital markets, and the introduction of a new market culture. Those countries which sought to attract major international investors had to improve their accounting, evaluation and disclosure standards, protect minority investors, and design a regulation framework compatible with those in the OECD countries.

Portfolio investment accounted for a significant part of the net capital inflow in the Czech Republic. Foreign investors where mainly interested in shares in the early 1990s (because of the Coupon Privatisation scheme), but their interests gradually shifted to the debentures. Several leading Czech companies, mostly in the power supply sector, launched international issues. In Hungary, portfolio investment has developed since 1993 and

accounts for approximately one half of total net capital inflows. The main targets were government bonds, T-bills and other debentures. In the late 1990s, there was an outflow of portfolio investment in the Czech Republic and Hungary, resulting from the general mistrust of emerging securities markets after the Asian and Russian financial crises. Moreover, both the Czech and Hungarian markets were small, and foreign investors were reluctant to increase their shares in the country's market capitalisation beyond certain ceilings. The reputation of the Czech capital market had also been damaged by widespread fraud, low liquidity and non-transparency. The newly established Securities Commission, for example, found that 40 % of issuers failed in their disclosure dates in 1998, while listed company systematically did not announce negative events which could affect investors. There was also routine fraud and mismanagement (Anderson, 1999).

The interest of foreign portfolio investors in Polish securities was moderate throughout the 1990s, despite Poland having one of the earliest and best regulated capital markets in the Central and Eastern Europe. However, delays in the mass privatisation programme limited the availability and range of stocks and private sector debentures. Interest in Slovak securities was even lower, especially after the second round of coupon privatisation had been replaced by direct sales, which led to Slovak capital market acquiring a reputation for low liquidity, lack of transparency and insider dealing (Baláž, 1998).

Other investments

There were also a broad variety of flows, ranging from official aid provided by international financial institutions to speculative sales/purchases on the banking and securities markets. The latter provided the major part of total turnover, and exceeded turnover in portfolio and FDI flows. The net capital inflow, however, was lower than in case of the FDI. Large volumes of highly volatile speculative capital flows posed problems for national governments and central banks in transition economies. Speculative capital was

attracted by interest rate differences between the region and world money and capital markets. In advanced economies, with highly mobile capital, the sterilisation of such flows has little sustained effect. In the transition economies, short-term capital is more likely to spill over into domestic money markets and feed inflation. The banking system, which was supposed to mediate capital inflows, had structural weaknesses and insufficiently prudent supervision. In these circumstances, it would be reasonable for central banks to impose capital controls, limit the foreign exchange exposure of domestic banks and steer foreign capital towards financial instruments with longer maturity dates (Ul Haque et al, 1997a). The transition economies, however, sought early membership of the OECD which required the removal of capital controls. Governments and central banks therefore decided on different, solutions.

Most central banks realised the dangers of a liquidity crisis similar to that in Mexico in 1994 and sought to sterilise speculative capital inflows by one of two methods: central bank securities issues and application of money multipliers, such as raising the reserve requirements imposed on domestic banks. These policies, however, were costly because of the impact of increasing interest rates on the state debt. They were also opposed by private enterprises which considered international finance a cheaper alternative to high domestic interest rates. Raising the reserve requirements on commercial banks de facto replaced a tax on government with a tax on banks (Begg, 1997). Since the banking sector in transition economies was fragile, the additional burden endangered the entire system. The most serious crises were in the Czech and Slovak Republics, where indecisive privatisation of the largest banks allowed them to sink under increasing volumes of non-performing loans.

The Czech and Slovak governments, and enterprises in particular, tended to engage short-term commitments with foreign banks. These policies resulted in a liquidity crisis and depreciation of the Czech currency in 1997. There were similar developments, but with more

serious currency consequences in Slovakia in 1998 and 1999. It became clear that prudent fiscal policies, which aimed to cut government budget deficits, were the main economic policy instruments for eliminating the negative consequences of speculative capital inflows and outflows. Prudent fiscal policies had to be accompanied by liberalisation of exchange rate regimes. Since the early 1990s, the transition economies had pegged their currencies to currency baskets of the $ and DM (Euro). Exchange rates were permitted to fluctuate within a range set by national banks. In the early transition stage, this helped reduce uncertainty in the domestic macroeconomic environment. Domestic inflation in that period, however, was far higher than prevailing international rates. In the early 1990s, national governments sought to reduce inflation but, paradoxically, less attention was paid to rapid increases in real wages. With exchange rates pegged (although adjusted via planned subsequent devaluations in Poland and Hungary), there was rapid real appreciation of exchange rates and wage levels. The appreciation resulted in declining competitiveness, decreasing exports and deepening trade deficits. High trade deficits, in turn, made it difficult to sustain the national exchange rates, as occurred, for example, in the Czech Republic in 1997 and Slovakia in 1998. The national banks tried to defend the current rates, but the high costs of intervention forced them to introduce a regime of fluctuating exchange rates. In a long-term view, the introduction of fluctuating currency regimes and cuts in government budget deficits helped to bring the transition countries into line with economic policies in the EU and OECD. These policies, in turn, provided economic environments which were more attractive to foreign investors, who were a source of higher-quality investment, notably FDI. If there is any general conclusion to be drawn from these developments, then small open economies in transition must apply sound fiscal and foreign trade policies in order to maintain both domestic macroeconomic stability and sustainable levels of capital inflows.

In terms of ‘other investment’ flows, the experiences of the transition countries in Central Europe were similar to those in most emerging markets: currency attacks, volatile

speculative flows attracted by interest rates differentials, and financial crises. The trajectories of individual countries were also affected by specific developments, resulting from different starting positions in 1989, and from national policies of international indebtedness management.

In the state socialist period, Hungary obtained foreign capital almost exclusively via bank loans and the central government was the main recipient of these. Most of the funds were not directed to the production sector, but were used to offset a negative trade balance and, in fact, mainly funded purchases of consumer goods. Loan repayments in the 1990s caused significant economic difficulties. Fortunately, the outflow of loan capital was offset by large inflows of foreign direct investment. In the late 1990s, loan capital again increased in importance but the Hungarian banks were now the principal recipients. Many of the banks had been privatised by foreign investors, and their new owners mostly allocated the borrowed funds to the production sector. Poland had also been heavily indebted since the early 1980s and its economy was burdened with high levels of interest and principal repayment. Its position was weaker than Hungary's, and this was reflected in larger inflows of speculative capital. Slovakia had the highest level of foreign capital secured via international bank loans to government and private enterprises, while FDI and portfolio investment were negligible. The structure of capital inflows reflected foreign strategic investors perceptions of the Slovak government in the period 1994-1998. Bank loans had reached relatively high levels by the end of the 1990s and the country faced the threat of a liquidity crisis. In the Czech Republic, there was a visible shift from government financial transfers towards private flows during the 1990s. While the government ceased to be the main recipient of loan capital, Czech banks and enterprises started to borrow abroad, adding to the economy's foreign debt. By the end of the 1990s, a large part of Czech and Slovak government and private sector debt was in short-term commitments included in the 'other investment' category.

Foreign loan capital inflows can have ambiguous results. On the one hand, they may offset general capital shortages in a transition economy and provide the domestic private sector with funds at lower rates than are available from domestic banks. Even short-term loans may have this beneficial effect. On the other hand, widespread reliance by central government on foreign finance almost inevitably seems to result in a liquidity crisis. This was the case of several Latin-America countries in 1982, Poland in the 1980s, Mexico in 1993 and 1994 and, to a lesser extent, Slovakia in 1998. Financing domestic growth from foreign funds may have positive results only where these funds are invested in export-oriented industries, generating inflows for the repayments.

6. CONCLUSIONS

The 1990s were a new period in the history of capital mobility in Central Europe. Capital inflows, in per capita terms, surged in all the transition economies to levels matching those in other emerging markets. Even more importantly, the capital structure was dominated by FDI.

Most analyses of capital mobility are concerned with the statistical evaluation of macroeconomic performance and creditworthiness indicators that are widely available and relatively amenable to econometric modelling. These studies are usually based on broad samples of countries, which allows the elimination of country-specific factors. This approach provides insights into some of the basic preconditions for attracting foreign capital (GDP levels, inflation history, growth rates, size of the monetary aggregates, etc.). But this approach does not allow us to understand differences in the experiences of individual countries, which otherwise are broadly similar in terms of development and their economic and political histories. These differences can only be understood by reference to the

structural economic policies of particular countries. Such an approach (for example, see Holland and Pain, 1998) has its own difficulties (problems with time-lags, the quantification of privatisation policies, etc.), but does seem to provide a deeper understanding of various types of capital mobility.

Given the above qualifications, it is argued that cross-county studies of capital flows in very different economies and societies are problematic. There is considerable diversity not only within the group of transition economies, but even within the group of four most developed transition countries, the Czech and Slovak Republics, Hungary and Poland. These four countries may have had similar development levels, applied comparable macroeconomic policies and moved closer to EU membership, but they also had different structural economic policies, especially in respect of privatisation and the revitalisation and regulation of their financial systems. The latter have profound significance for both the volume and structure of capital flows.

Our statistical analysis indicated that financial system development levels were one of the basic pre-conditions for attracting and channelling FDI. Countries like Hungary, which privatised its financial sector in early stages of transition, enjoyed the advantage of a more sophisticated financial environment in the latter transition stages. Private capital flows to the privately-owned financial institutions exerted a leverage effect on the domestic economy. Those countries where the main financial institutions were in the public sector faced problems of inefficient investment allocation, reflected in increases in non-performing loans. Foreign groups in these economies had less opportunities and greater reluctance to invest in heavily indebted and poorly managed businesses. Such enterprises had to rely on short-term borrowing on international capital markets at less advantageous borrowing terms.

Privatisation of the financial sector was closely connected with general privatisation

policies. Firstly, sales of financial institutions to foreign investors accounted for a significant part of total privatisation sales to foreigners. Secondly, the countries which limited the participation of foreign investors in the financial sector also applied restrictions and discriminatory practices to those classes of domestic investors which were insufficiently 'government friendly'. So-called 'strategic enterprises' in particular, were excluded from sales to foreign investors, but were privatised by favoured domestic interest groups at large discounts.

The choice of privatisation policies was the second major factor shaping the volume and structure of capital flows. Those countries applying mass privatisation schemes (Czech and Slovak Republics), which generated neither real capital nor clear ownership, attracted relatively little foreign investor interest. Countries which had corrupt privatisation programmes, favouring 'government friendly' enterprise managers (Slovakia, partly the Czech Republic), also did not attract strategic investors. 'Manager privatisation' also generated little new capital. The new owners frequently were unable to manage effectively, lacking capital and, or managerial skills. Effective owners in these cases were found only after the 'Third Wave' of privatisation in the Czech and Slovak Republic, where (mostly anonymous) foreign and domestic bidders assumed control of bankrupted enterprises. It follows that the countries applying standard privatisation models (domestic and international tenders and auctions) attracted most strategic investment in the form of FDI. Hungary's experience indicates that the FDI inflows resulted not only from the immediate sales of Hungarian enterprises to foreign investors, but also from creation of a favourable economic and institutional environment. This environment included not only a cheap and educated labour force and stable macroeconomic performance (which also existed in other countries), but a relatively healthy financial infrastructure with falling deposits/loans spreads. In contrast, those countries which hesitated over privatisation of their main enterprises and restructuring their financial sectors had to seek alternative financial sources and rely more on short-term

capital, which made them more vulnerable to international currency speculation.

There have been significant variations in privatisation policies within central Europe, due not only not to differences in the overall economic strategies of national governments but also to the influence of economic and political interest groups. Where creative privatisation had started before 1989 (Hungary and Poland), there were more established classes of domestic entrepreneurs who opposed mass privatisation schemes. The Hungarian government, however, was able to sell most of its strategic enterprises to foreign investors in the early 1990s. Over time, the influence of domestic interest groups also increased in the Czech and Slovak Republics and Poland. This was reflected not only in the cancellation of mass privatisation schemes, but also in the growing resistance of domestic classes to potential foreign competitors in the mid-1990s. Domestic owners (including the public sector), however, had variable levels of management skills and limited capital sources and, in the longer term, have not been able to prevent the growth of foreign investment.

The results of the liberalisation of capital movements have been ambiguous. The transition economies liberalised their trade and capital accounts far more rapidly than the newly industrialised economies in Asia. The Asian countries opted for a more gradual approach, with the trade account being opened first, followed by later liberalisation of the capital account. In contrast, the transition economies applied the ‘big-bang’ approach to the regulation of capital flows. On the one hand, this helped them to secure a significant part of the foreign capital available in the emerging markets in the 1990s. On the other hand, the rapid liberalisation of international capital movements came before the implementation of important market reforms, for example in the money, exchange rate, securities and real estate markets. The lack of such reforms made the respective markets vulnerable to sudden outflows of foreign finance. The countries, which maintained a pegged regime of exchange controls (Czech and Slovak Republics) experienced high real appreciation of their national

currencies and were forced to abandon these regimes after attacks by foreign speculators. The cascade devaluation regimes, applied by Hungary and Poland, proved more stable and also helped to maintain lower deficits in trade balances.

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Table 1: The financial account of the Balance of Payments for selected emerging markets, 1985-1997

	$ million			Per capita, $		
	1985-89	1990-94	1995-97	1985-89	1990-94	1995-97
	Czech and Slovak Republics, Hungary and Poland					
Total	-17,534	420	43,588	-274.8	5.9	675.8
FDI net	255	14,452	26,697	4.0	224.5	413.9
Portfolio net	0	8,139	7,203	0.0	126.3	111.7
Other investment net	-17,789	-22,171	9,688	-278.8	-344.9	150.2
	Argentina, Brazil and Mexico					
Total	-59,191	142,147	124,068	-235.2	516.0	428.8
FDI net	19,469	46,022	81,071	77.7	168.0	280.7
Portfolio net	-8,771	164,694	76,269	-35.3	594.4	263.0
Other investment net	-69,889	-68,569	-33,272	-277.6	-246.4	-114.9
	Korea, Malaysia and Thailand					
Total	-3,997	111,880	76,328	-35.8	932.0	610.9
FDI net	7,275	26,014	14,579	64.0	217.4	114.9
Portfolio net	4,101	30,263	52,096	38.0	249.8	411.4
Other investment net	-15,373	55,603	9,653	-137.8	464.8	84.6

Sources: IMF (1985-1999): Balance of Payments Statistics and authors' own computations.
Notes: all values in current US dollars.

Table 2: Financial account of the Balance of Payments for the Czech and Slovak Republics, Hungary and Poland, 1985-1997

	$ million			Per capita $		
	1985-89	1990-94	1995-97	1985-89	1990-94	1995-97
	Czech Republic					
Total	273	10 711	13 663	17.5	1 035.9	1 326.5
FDI net	257	3 155	5 183	16.4	305.1	503.2
Portfolio net	0	2 411	3 084	0	233.2	299.4
Other investment net	16	5 145	5 396	1.0	497.6	523.9
	Hungary					
Total	4 270	10 542	4 658	410.6	1017.6	458.9
FDI net	0	6 375	8 108	0	615.3	798.8
Portfolio net	0	6 383	303	0	616.1	29.9
Other investment net	4 270	-2 216	-3 753	410.6	-213.9	-369.8
	Poland					
Total	-22 077	-20 683	20 193	-581.6	-536.7	523.3
FDI net	-2	4 595	12 925	-0.1	119.2	334.9
Portfolio net	0	-624	3 576	0	-16.2	92.7
Other investment net	-22 075	-24 654	3 692	-581.5	-639.7	95.7
	Slovak Republic					
Total	0	-150	5 074	0	-28.3	943.1
FDI net	0	327	481	0	61.7	89.4
Portfolio net	0	-31	240	0	-5.8	44.6
Other investment net	0	-446	4 353	0	-84.2	809.1

Sources: IMF (1985-1999): Balance of Payments Statistics and authors' own computations.

Notes: all values in current US dollars. The data for the Czech Republic in 1985-9 refers to the former Czechoslovakia .

Figure 1: Cross-section OLS estimates for net capital inflows to the central European transition countries

	model 1	model 2	model 3
FD I [a]			
Intercept	2.514 (1.347; 0.191)		
GROWTH	-0.144 (-1.897, 0.070)		
M2	0.001117 (2.436; 0.023)		
INF	-0.0081 (-1.905; 0.069)		
GDP	-0.00431 (-2.478; 0.021)		
R^2 and Adjusted {R^2}	0.372 {0.262}		
F-test: p-value	0.025		
Portfolio investment			
Intercept	-1.681 (-1.076; 0.291)		
GDP	0.0008882 (1.833; 0.077)		
R^2 and Adjusted {R^2}	0.101 {0.071}		
F-test: p-value	0.077		
Other investment			
Intercept	3.822 (1.757; 0.089)	3.818 (3.340; 0.002)	-4.743 (-2.292; 0.0293)
INF	-0.0212 (-2.672; 001)	-0.208 (-3.459; 0.002)	
MARGIN		-0.190 (-3.008; 0.005)	0.0205 (2.531; 0.017)
M2	0.00783 (2.3518; 0,017)		0.0877 (2.879; 0.007)
R^2 and Adjusted {R^2}	0.422 {0.382}	0.463 {0.426}	0.410 {0.369}
F-test: p-value	0.0004	0.0001	0.0005

Note: T-statistics and p-values (significance levels) reported in parenthesis.

a = time lag one year