

**CENTRAL AND EASTERN EUROPE:
FINANCIAL MARKETS AND PRIVATE CAPITAL FLOWS**

Dorothy M. Sobol

**Federal Reserve Bank of New York
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**Prepared for Study Group on Private Capital Flows
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Council on Foreign Relations**

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CENTRAL AND EASTERN EUROPE: FINANCIAL MARKETS AND PRIVATE CAPITAL FLOWS

The resurgence of private capital flows to developing countries beginning in the late 1980s did not initially benefit the countries of Central and Eastern Europe. With the collapse of Communist governments throughout the region beginning in 1989, most countries in the region were absorbed in a political and economic upheaval unimaginable only years earlier as they sought to undo decades of central planning and transform their economies into ones based more on market principles. In this environment, it is understandable that private foreign capital was slow to enter any of these countries. Not until the efforts of these countries to free up their economies and introduce macroeconomic and structural reforms began to bear fruit did private foreign investors begin to take significant note of this region in their investment decisions.

Today, while the amount of private capital entering Central and Eastern Europe is still a very small fraction of that provided to all developing countries, it has nonetheless begun to flow in (Chart 1, Table 1). Whereas the countries in Central and Eastern Europe as a group were running capital account deficits in the early 1990s, this situation turned around beginning in 1992, as reform programs in a number of countries started to take hold (Chart 2).¹

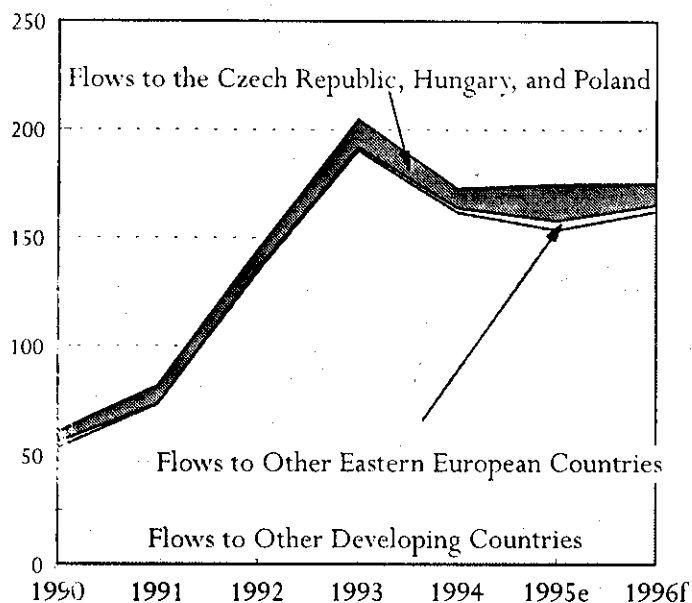
¹For the three countries in this study--Hungary, Poland, and the Czech Republic--the combined capital account swung from near balance in 1990 to surpluses of \$2.7 billion in 1991, \$4.5 billion in 1992, \$14.3 billion in 1993, before falling off to \$10.8 billion in 1994. Poland's surplus beginning in 1991 stemmed from the exceptional financing it received from its official creditors in the Paris Club.

CHART 1

DIRECTION AND COMPOSITION OF PRIVATE CAPITAL INFLOWS

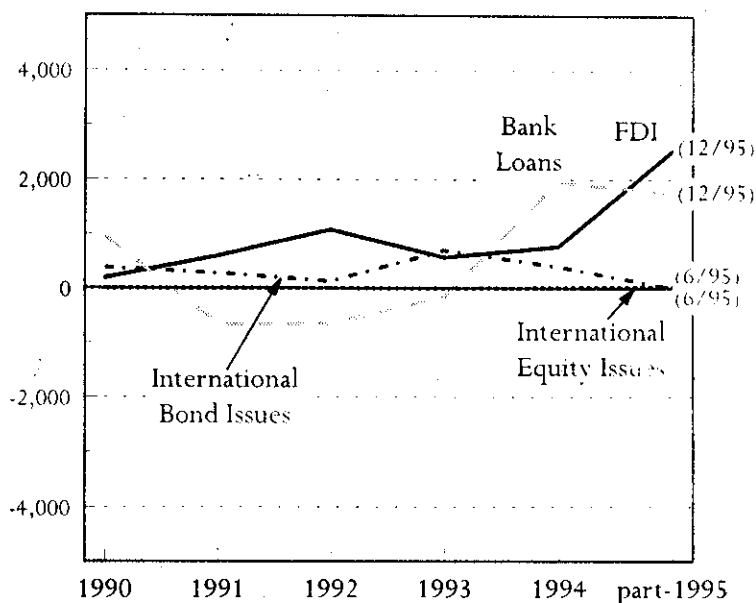
PRIVATE FLOWS TO DEVELOPING COUNTRIES

US\$ Billions



THE CZECH REPUBLIC

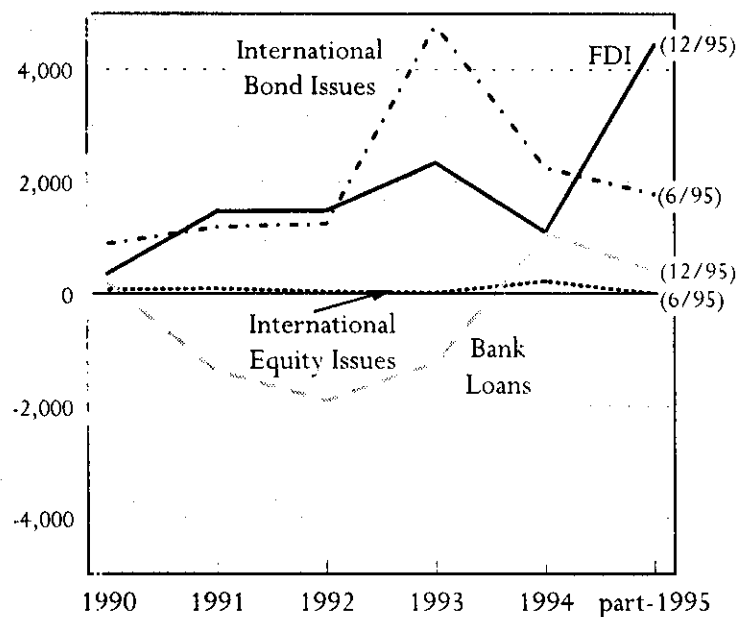
US\$ Millions



Note: 1990-1992 figures are for Czechoslovakia.

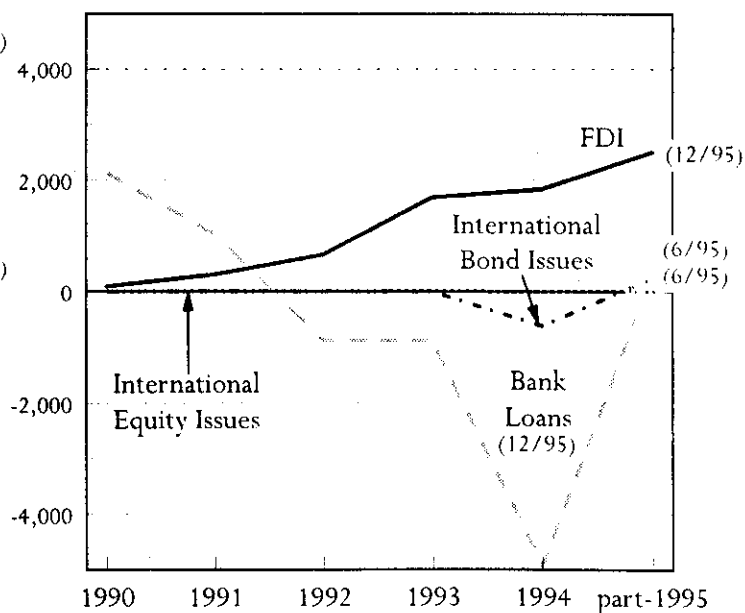
HUNGARY

US\$ Millions



POLAND

US\$ Millions



See Table 1 for the data in the last three charts.

TABLE 1

COMPOSITION OF PRIVATE CAPITAL INFLOWS

(Millions of US\$)

	1990	1991	1992	1993	1994	1995
BANK LOANS						
Czech Republic*	955	-656	-652	-163	1953	1746 (12/95)
Hungary	200	-1395	-1899	-1234	1068	411 (12/95)
Poland	2138	1061	-882	-891	-4929	324 (12/95)
TOTAL	3293	-990	-3433	-2288	-1908	2481 (12/95)
NET FOREIGN DIRECT INVESTMENT						
Czech Republic*	187	586	1073	564	762	2525 (12/95)
Hungary	354	1462	1479	2339	1095	4453 (12/95)
Poland	89	298	665	1697	1846	2511 (12/95)**
TOTAL	630	2346	3217	4600	3703	9489 (12/95)
INTERNATIONAL EQUITY INVESTMENT						
Czech Republic*	0	0	0	0	10	32 (6/95)
Hungary	68	91	33	17	214	0 (6/95)
Poland	0	0	0	1	0	14 (6/95)
TOTAL	68	91	33	18	224	46 (6/95)
INTERNATIONAL BOND INVESTMENT						
Czech Republic*	375	277	129	697	396	0 (6/95)
Hungary	888	1186	1242	4796	2250	1778 (6/95)
Poland	0	0	0	0	-624	250 (6/95)
TOTAL	1263	1463	1371	5493	2022	2028 (6/95)
GRAND TOTAL	5254	2910	1188	7823	4041	14044 (part year)

* Data are for Czechoslovakia from 1990-1992. Bank loans in 1993 are also for Czechoslovakia.

** Foreign Direct Investment figure is gross.

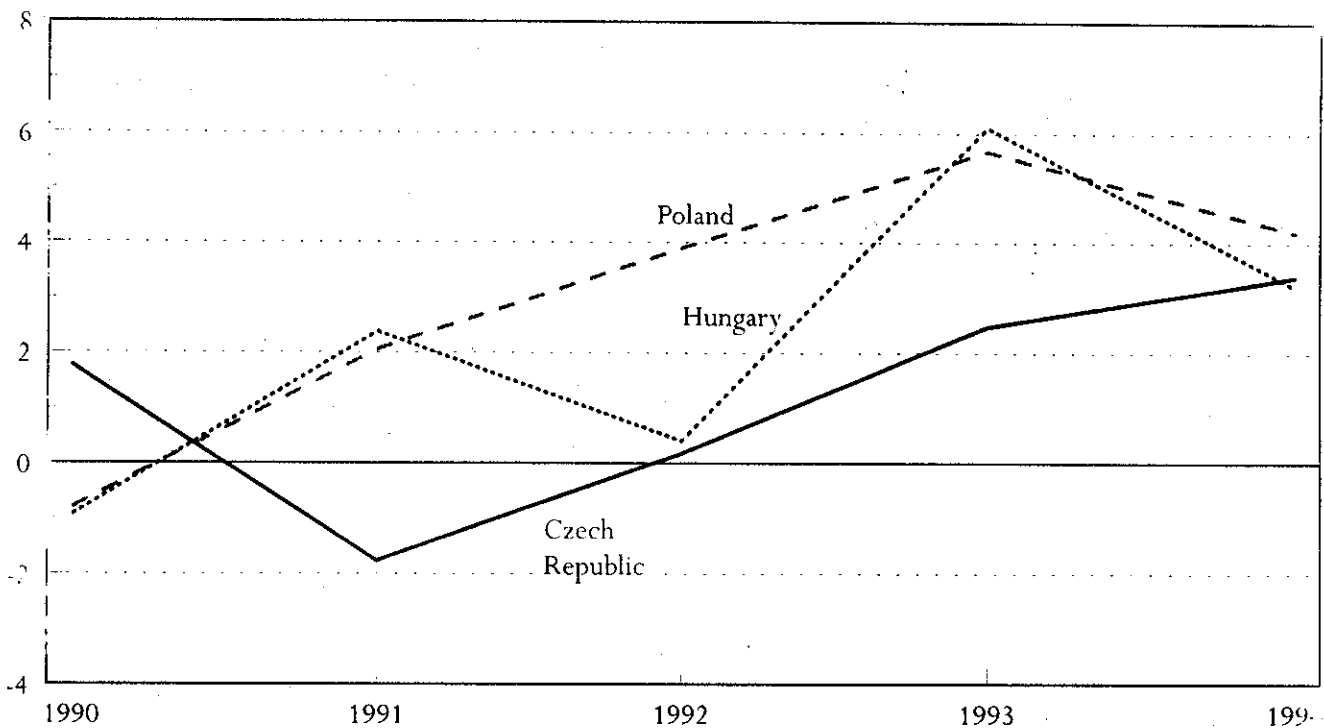
Sources: Balance of Payments Statistics, Bank for International Settlements Semiannual Data, IMF International Capital Markets, IMF Private Market Financing for Developing Countries, Reuter Textline.

CHART 2

CAPITAL ACCOUNT REVERSAL IN THE 1990s

CAPITAL AND FINANCIAL ACCOUNT BALANCES

U.S. Billions



Note: Figures are according to the 1995 Balance of Payments methodology, and include exceptional financing.

There are a few caveats, however. For one, the bulk of the private capital flowing into Central and Eastern Europe in recent years has been concentrated in relatively few countries. Of these, the most important are Hungary, Poland, and the Czech Republic.² These countries therefore form the focus of this paper.

Second, the evidence is as yet only preliminary and the data far from comprehensive. Nonetheless, the findings to date suggest that these three countries, as well as many others in the region, should benefit from private capital inflows for many years. Whether they will be able to do so, however, will be a function of both their ability and their willingness to adhere to market-oriented reforms and carry out often politically difficult restructuring measures. For those able to hold to such a course--and lucky enough to avoid or overcome the political backlashes likely to accompany the implementation of their policies--foreign private capital should be forthcoming. Nevertheless, the competition for capital is fierce. And, in this era of globalized markets, when investment decisions are often made within minutes, markets will not be slow to respond to those who are perceived to lag, falter, or fail in their reform and restructuring efforts.

By focusing on the three major recipients of private capital flows to Central and Eastern Europe thus far, the paper seeks to identify the nature and composition of private capital flowing into the region in recent years and some of the factors driving these flows. In addition, it explores some of the problems these inflows have raised, how policymakers are responding, and what the prospects are for continuing inflows over the coming years. One conclusion seems clear. While some market participants may continue to view the region as a single entity, many increasingly

²By some accounts, these three countries accounted for 90 percent of net capital inflows into Eastern Europe in 1995. United Nations Economic Commission for Europe, Economic Survey of Europe, 1995.

appear to be distinguishing among the countries when making their investment decisions.

COMPOSITION OF PRIVATE CAPITAL FLOWS

In broad terms, private capital flows consist of three basic elements: lending by commercial banks; foreign direct investment (typically defined as an equity investment of 10 percent or more in a foreign firm); and portfolio investment through bonds and equities. Portfolio investment through bonds takes place when foreigners invest in the money and capital markets of another country and when public or private entities, including governments, raise funds in a foreign market or the international markets. Equity flows are generated when foreigners buy shares in firms that are listed on another country's stock exchange and when private or publicly owned firms in one country issue shares in the markets of another country or in the international markets through the use of depositary receipts.

On a net basis, the flow of private capital from these three sources to Hungary, Poland, and the Czech Republic rose from an estimated \$5.3 billion in 1990 to almost \$8 billion in 1993 before dropping off to about \$4 billion in 1994 with the collapse in international bond markets and Poland's agreement with its commercial bank creditors which entailed writeoffs of a portion of its bank debt.³ Inflows in 1995 are likely to total well over \$14 billion, based on partial data for portfolio investment. As elsewhere in the developing world, bank flows ceased to dominate private sector financing to the countries of Central and Eastern Europe in the 1990s. Between 1991 and 1995, Hungary and the Czech Republic combined amortized more bank debt than they took on. In Poland's case, debt was forgiven. Offsetting the declines in bank lending have been

³As part of its agreement with its commercial bank creditors, Poland was granted a 50 percent reduction in the net present value of its bank debt. Although not counted here as such, the debt forgiveness this agreement entailed ought properly to be thought of as a capital inflow.

notable increases for all three countries in foreign direct investment and, for Hungary in particular, portfolio inflows.

Also noteworthy is the extent to which the changes taking place in the composition of private capital flows to these three countries during the 1990s shifted from those considered to be debt-creating, such as bank lending and portfolio investment through bonds requiring repayment, to those considered to be of longer duration and to entail no direct repayment obligation, such as foreign direct investment and portfolio investment through equities. Between 1990 and 1995, the share of bank and bond finance provided to the three countries as a share of their total private sector inflows fell from 87 percent to 32 percent. No country was more affected by these shifts than Poland, which on a net basis saw its non-debt-creating flows as a share of total private inflows fall from 96 percent in 1990 to about 19 percent in 1995, following its 1994 commercial bank debt-reduction agreement and marked increases in foreign direct investment.

These broad patterns, of course, mask important differences among the three countries. The following sections discuss some of these similarities and differences.

COMMERCIAL BANK LENDING

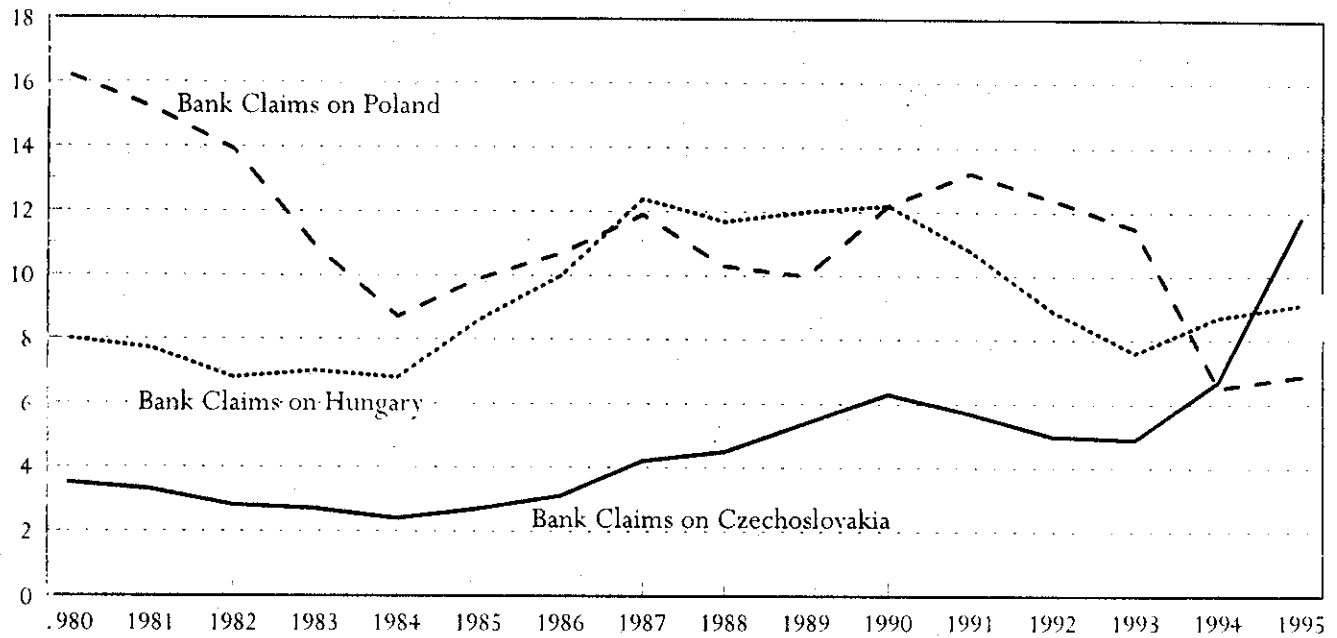
Throughout the 1980s and into 1990, commercial banks continued to lend to many countries in Central and Eastern Europe, including Poland, Hungary and the Czech Republic (Chart 3). Beginning in the early 1990s, however, bank lending to these countries began to slow markedly as economic and financial conditions deteriorated following the collapse of Communist regimes in 1989 and 1990 and amortizations in both Hungary and the Czech Republic began to offset new inflows on a net basis. The falloff in bank lending was, to be sure, most notable in the case of Poland, where new lending net of amortizations fell from an inflow of \$2.1 billion in 1990

CHART 3

ACCESS TO BANK LENDING IN THE 1980s AND 1990s

BIS BANK CLAIMS IN THE 1980s AND 1990s

US\$ Billions



to an outflow of \$900 million in 1993, prior to the country's implementing its commercial bank or so-called Brady agreement in October 1994.

Beginning in 1994, however, bank lending to both Hungary and the Czech Republic began to revive and these inflows continued in 1995, including flows to Poland. In the Czech Republic, net increases in bank flows that started in 1994 have been very pronounced. During 1995, net claims by BIS-reporting banks on Czech borrowers rose by \$1.7 billion (Chart 4). The bulk of these credits have been short-term in nature. The attraction of these credits to Czech borrowers has been their lower interest rates and longer maturities than those available from domestic banks.

Among economists, there is some disagreement about the nature of this increased foreign borrowing by Czech institutions. On the one hand, the increased borrowing may reflect a substitution of foreign for domestic credit, motivated by inefficiencies in the domestic financial system--in particular, wide margins between domestic deposit and lending rates. On the other hand, the increased borrowing may simply reflect a genuine shortage of credit in the economy, despite the fact that interest rate spreads, particularly with respect to the Deutsche mark, though still wide, have generally been declining (Chart 5). To one group of IMF economists, the credit shortage hypothesis is more consistent with the evidence: economic activity has strengthened over the past several years, increasing the real demand for money.⁴

To counter some of the effects of these bank inflows, including the upward pressure they have put on the real exchange rate (Chart 6), as well as to deter those inflows that have been more speculative in nature, the Czech monetary authorities have adopted a variety of measures over the

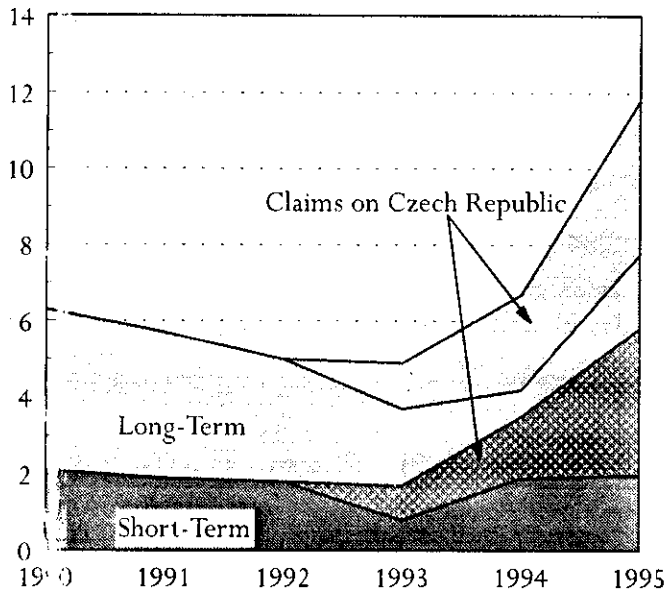
⁴Guillermo A. Calvo, Ratna Sahay, and Carlos A. Vegh, "Capital Flows in Central and Eastern Europe: Evidence and Policy Options," IMF Working Paper WP/95/57, May 1995, pp. 19-20.

CHART 4

MATURITY OF BIS BANK CLAIMS

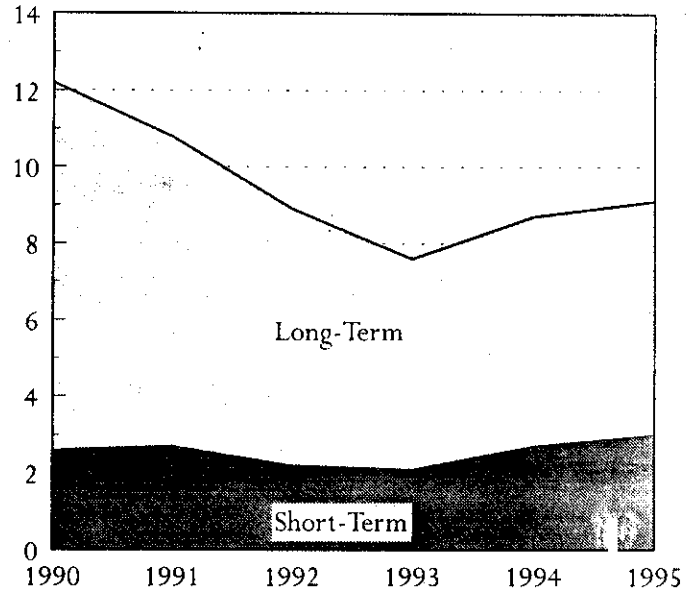
CZECHOSLOVAKIA

US\$ Billions



HUNGARY

US\$ Billions



POLAND

US\$ Billions

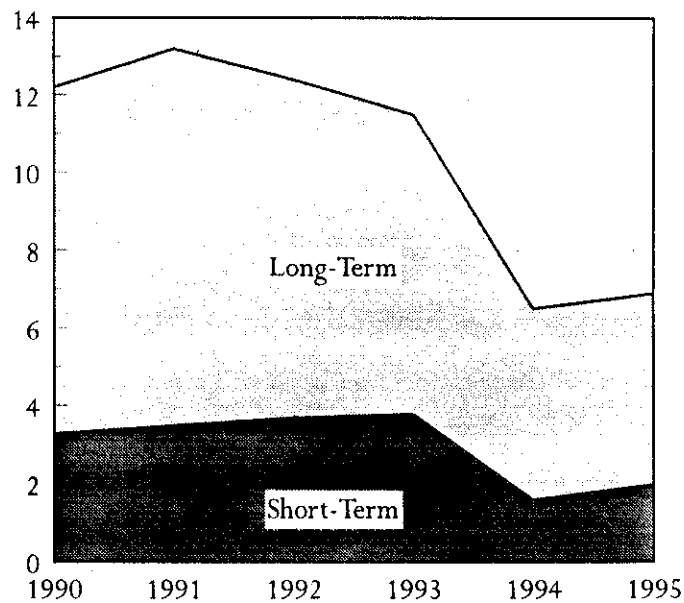
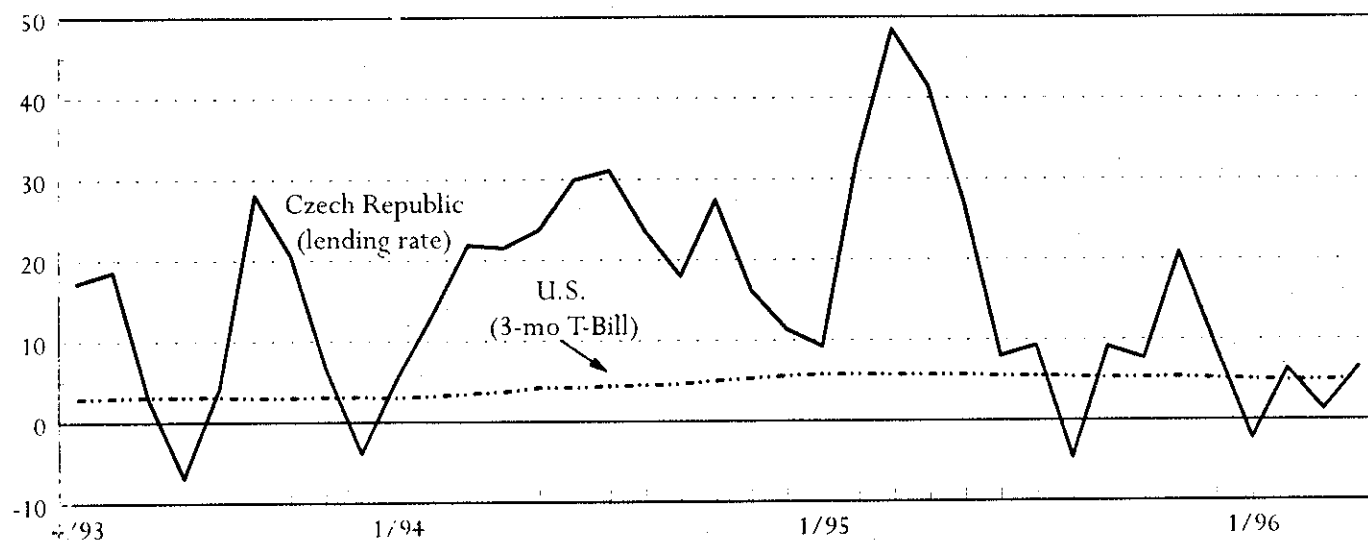


CHART 5

DOLLAR AND DEUTSCHE MARK RETURNS ON LOCAL INVESTMENTS

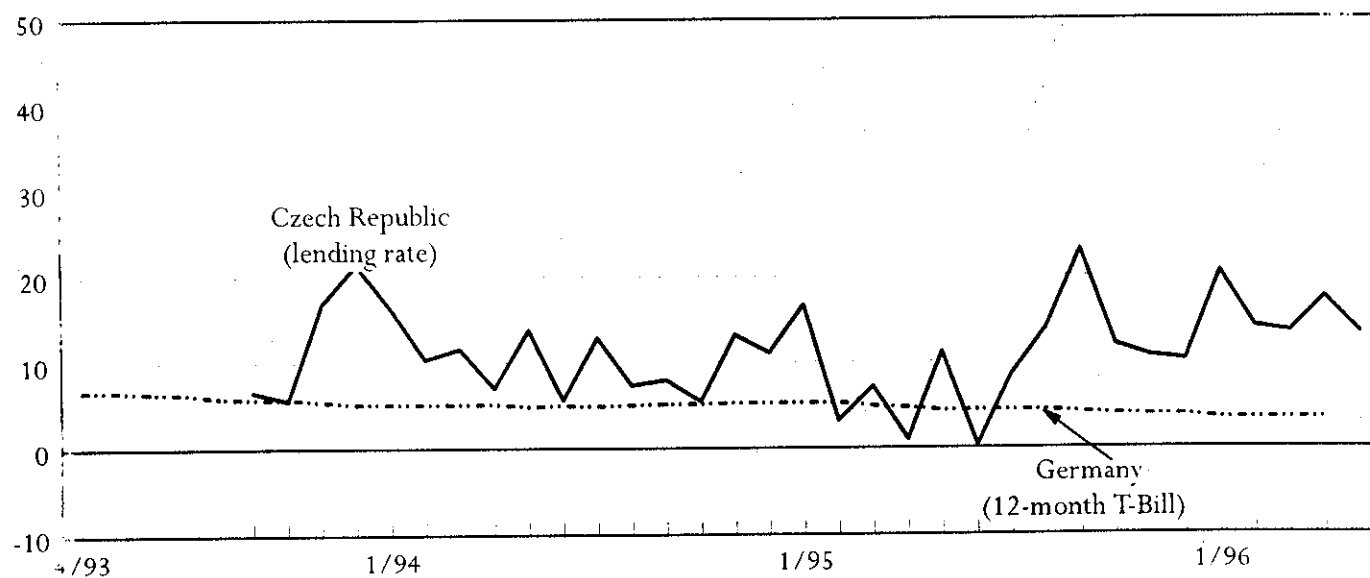
ANNUALIZED DOLLAR RETURNS ON LOCAL INVESTMENTS

Percent per annum



DEUTSCHE MARK RETURNS ON LOCAL INVESTMENTS

Percent per annum



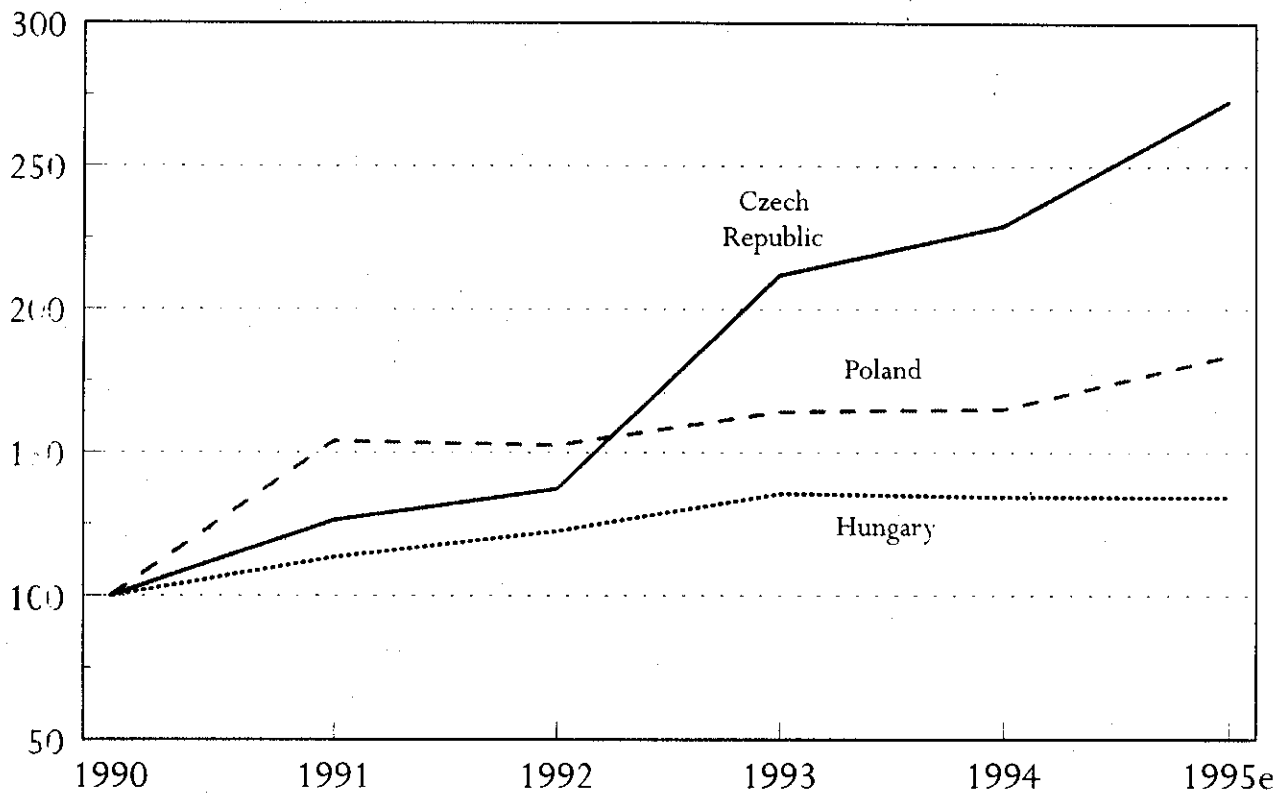
Note: Deutsche mark exchange rates are calculated from exchange rates vis-a-vis the dollar and do not necessarily reflect actual trading prices.

CHART 6

REAL EFFECTIVE EXCHANGE RATES

REAL EFFECTIVE EXCHANGE RATES

1990=100



past two years. Chief among these, the central bank introduced a more flexible foreign exchange policy in February 1996, by widening the band within which the koruna is allowed to fluctuate from ± 0.5 percent to ± 7.5 percent. By bringing a greater measure of risk to the exchange rate, the authorities have sought to reduce speculative inflows and ease growth of the money supply.⁵ This decision followed a series of earlier measures the central bank had put in place for similar reasons.

For example, in April 1995, the central bank announced that it would no longer buy and sell foreign exchange at uniform rates but instead would charge a fee based on a percentage of the intermediaries' exchange rate. Further, in August, it limited commercial banks' borrowing abroad to no more than 30 percent of their short-term assets, or Kc 500 million (\$19 million). At the same time, it unified reserve requirements for sight and time deposits at 8.5 percent (from 12 percent and 3 percent, respectively), raised the discount and Lombard rates, and announced that short-term borrowing by commercial banks would be slowed through administrative procedures.⁶ In October, the government made the koruna fully convertible for current account transactions and partly liberalized capital account transactions by allowing Czech residents for the first time to purchase real estate and make direct investments abroad.

A welcome development for Poland in 1994 was to regain access to the syndicated lending market after years of protracted arrears and debt-servicing difficulties. Following the country's Brady-type debt-reduction agreement with banks in October 1994, which, among other things, reduced the net present value of its bank debt by 50 percent, a state utility company received five-

⁵"Prague eases exchange controls," Financial Times, February 29, 1996.

⁶Girocredit, East European Chronicle, April 1995, p. 41.

year term financing of \$113 million from a syndicate of European banks.⁷

Like the Czech Republic, Poland has also faced mounting inflows of foreign exchange over the past two years. Market participants believe that the bulk of these foreign exchange inflows, which are estimated to have reached \$5 billion to \$6 billion in 1994, represent revenues from domestic sales of goods and services to foreigners, primarily Russians, Ukrainians, and Germans, who come to Poland to shop and benefit from comparatively more attractive prices. Because of Polish balance-of-payments accounting procedures, however, these inflows were not well captured in the data until January 1996.⁸ Although the inflows from this border trade have led to dramatic increases in Poland's reserves and have contributed to strong output growth, they have also put upward pressure on the real exchange rate.

In response to these inflows, the Polish authorities opted in mid-May 1995 to float the zloty by widening the band within which the currency is allowed to fluctuate to 14 percent. The authorities also chose to continue the monthly devaluation rate of 1.2 percent. In the four weeks before the central bank's decision, an estimated \$1.5 billion flowed into the country in anticipation of a currency revaluation.⁹ To discourage further inflows of speculative funds, the authorities lowered interest rates substantially. In addition, on June 1, 1995, the zloty was made fully convertible for current transactions in line with the IMF's Article VIII guidelines. Nevertheless, in

⁷IBRD, World Debt Tables 1994-95, Volume 1, pp.11-12.

⁸Beginning in January 1996, these previously unclassified transactions, notably stemming from cross-border trade, are no longer counted as short-term capital transactions but instead are shown on the current account. Creditanstalt, Central European Quarterly, II/96, p. 33.

⁹Leon Podkaminer et, al., "Transition Countries: Economic Developments in Early 1995 and Outlook for 1995 and 1996," Part II, The Vienna Institute for Comparative Economic Studies (WIIW), July 1995, pp. 32-33.

December 1995, the authorities revalued the zloty by 6 percent and in January 1996 they lowered the monthly devaluation rate to 1 percent.¹⁰

One feature of bank lending that applies particularly in the case of Hungary has been the increasing use banks have made of various risk-reducing techniques in their lending decisions, including co-financing loans with some of the major international financial institutions. In February 1993, for example, Hungary arranged a \$375 million loan facility in connection with a road transport project that was secured by toll revenues together with the participation of the EBRD.¹¹ More recently, in June 1995, MATAV, the Hungarian telephone company, entered negotiations to syndicate a \$300 million loan that was being arranged by the EBRD and the IFC together with Deutsche Bank of Germany.¹²

Finally, it is interesting to note that the Czech Republic has been offered some of the best borrowing terms among developing country borrowers. For example, whereas weighted average spreads for developing country borrowers tended to rise between 1990 and 1994--from an average of 64 basis points over Libor to 100 basis points over Libor¹³--the Czech Republic has seen its spreads narrow dramatically over this period. In 1994, two of the country's major banks, Obchodni and Komerčni, were able to raise funds at 65 to 70 basis points over Libor, well below the average for developing country borrowers. In May 1995, CEZ, the state-owned power utility,

¹⁰Creditanstalt, Central European Quarterly, I/96, p. 37.

¹¹Commission of the European Communities, European Economy, "Private Capital Flows to CEECs and NIS," Supplement A, No. 3, March 1994, p. 3.

¹²"Matav to syndicate \$300 million loan," Financial Times, June 21, 1995.

¹³IMF, International Capital Markets, August 1995, p. 41.

broke new ground by arranging a \$100 million, three-year syndicated credit from Sumitomo Bank at just 25 basis points over Libor when average spreads to developing countries had risen to about 107 basis points.¹⁴ Obchodni Bank achieved comparable spreads in a \$75 million three-year credit it arranged with Societe Generale.¹⁵ By 1996, most borrowers in the region were witnessing a downward trend in margins as well as a lengthening in maturities.

FOREIGN DIRECT INVESTMENT

One of the main factors assisting the transformation of the Central and Eastern European countries has been foreign direct investment. Because it is generally longer term in nature, this form of investment can help to encourage structural change and modernize obsolete production facilities while bringing with it such indirect benefits as the transfer of technology, management, and marketing skills. Practically nil in 1989, foreign direct investment has grown markedly throughout Central and Eastern Europe, almost doubling between 1994 and 1995 to about \$14 billion for the region as a whole,¹⁶ of which two-thirds went to Poland, Hungary, and the Czech Republic. Its rapid rise is not surprising given the sudden opening of the economies in the region and the massive privatization programs initiated by some. A substantial portion of these investment flows, however, has to date been concentrated in one country--Hungary, which has accounted for close to 50 percent of the total net flows to the three countries since 1990.

Generally, direct investment inflows to Central and Eastern Europe have not taken place through "green field" operations, in which new facilities are created from scratch. In fact, the

¹⁴IMF, Private Market Financing for Developing Countries, November 1995, p. 26.

¹⁵The Economist Intelligence Unit, Business Eastern Europe, September 11, 1995, p. 5.

¹⁶"Foreign investment in eastern europe doubles," Financial Times, March 25, 1996.

OECD estimates that investment in this form has accounted for only 20 percent of all such flows to the region. Instead, most direct investment inflows have entailed either taking over existing companies or taking holdings in existing companies. Surveys have shown that investment in the region thus far has been motivated primarily by the desire for access to the domestic markets. Low wages have also been cited as an attractive feature drawing capital to the area,¹⁷ as have such factors as comparative political stability and a skilled labor force.¹⁸

The sectors that have interested foreign investors have varied across countries (Chart 7). In Hungary, manufacturing has played a major role. In the Czech Republic, investments in transport, beverages, and construction have been particularly significant. In Poland, foreign direct investment has flowed largely to the electrical engineering sector, the food industry, and the financial sector.

By virtually all measures, Hungary has surpassed all other countries in the region in attracting foreign direct investment since 1990 (Chart 8). Market-based reforms progressively implemented since 1968 together with its close proximity to Austria have given Hungary an edge and made it a low-cost production site for exports to Western Europe.¹⁹ Between 1990 and 1995, the country accumulated \$11.2 billion in foreign direct investment, almost double the \$5.7 billion for the Czech Republic and well over the \$7.1 billion for Poland. As a share of GDP, these inflows between 1990 and 1995 reached 5.9 percent in Hungary, compared with 2.5 percent in the Czech Republic and 1.4 percent in Poland. In terms of annual flows on a per capita basis,

¹⁷Jan Stankovsky, Direct Investment in Eastern Europe, Bank of Austria, p. 27.

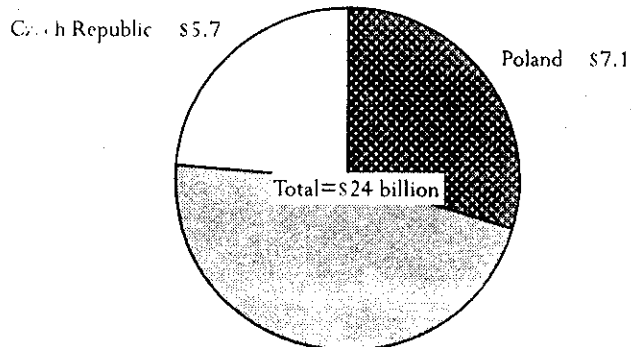
¹⁸"Piling into Central Europe," Business Week, July 1, 1996, p. 42.

¹⁹"All Busy on the Western Front," Business Eastern Europe, October 30, 1995, p. 5.

CHART 7

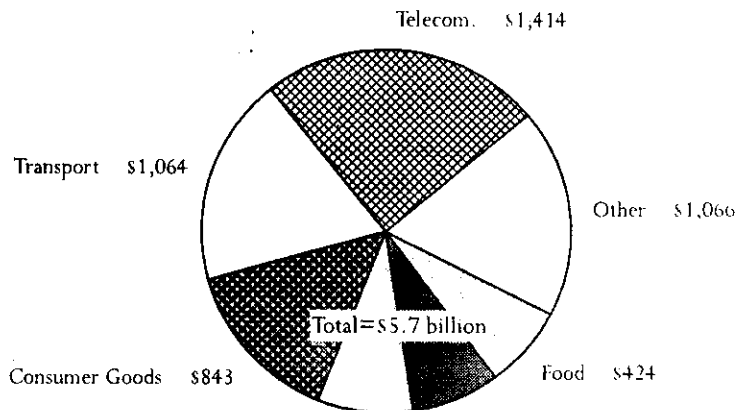
FOREIGN DIRECT INVESTMENT BY SECTOR

**CUMULATIVE FLOWS TO SELECTED
EASTERN EUROPEAN COUNTRIES**



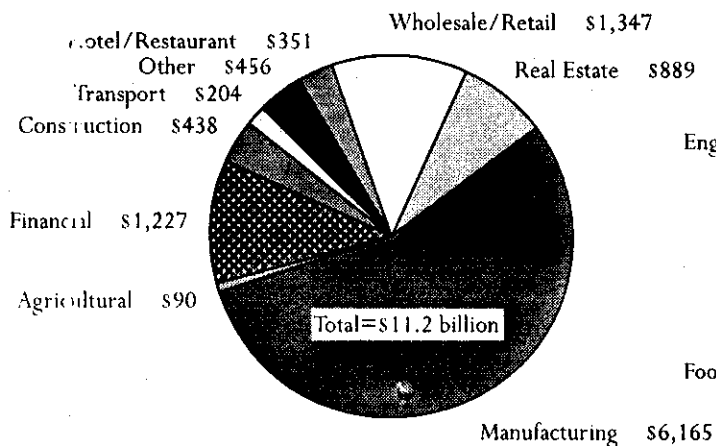
Cumulative flows in US\$ billions from 1990 to 1995

CZECH REPUBLIC



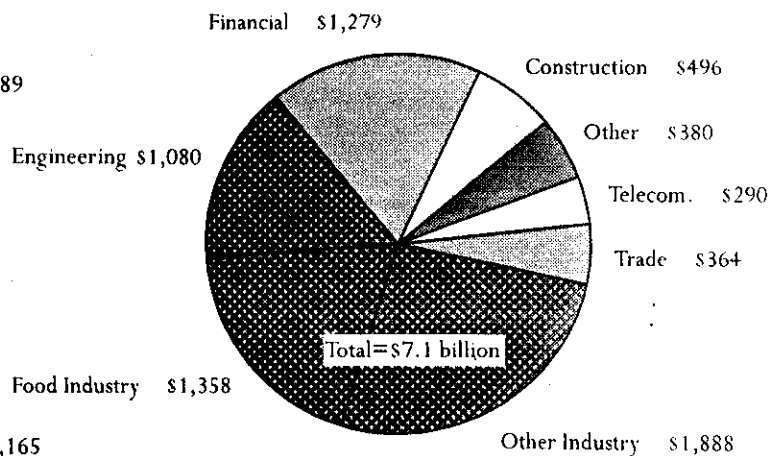
Cumulative FDI in US\$ millions between 1990 and 1995

HUNGARY



Cumulative FDI in US\$ millions between 1990 and 1995.
Breakdown is based on trend between 1990 and 1993.

POLAND

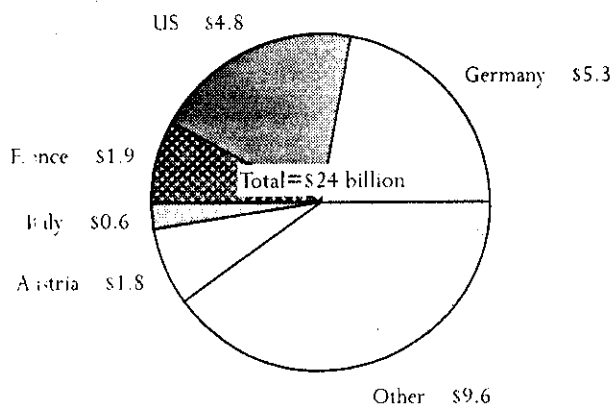


Cumulative FDI in US\$ millions between 1990 and 1995

CHART 8

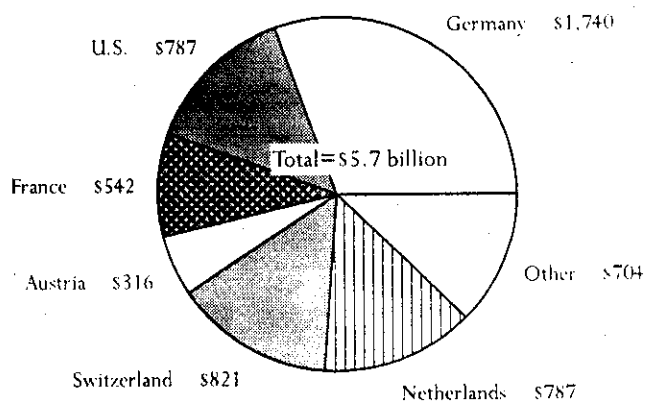
FOREIGN DIRECT INVESTMENT BY COUNTRY OF ORIGIN

CUMULATIVE FLOWS FROM MAJOR INVESTORS



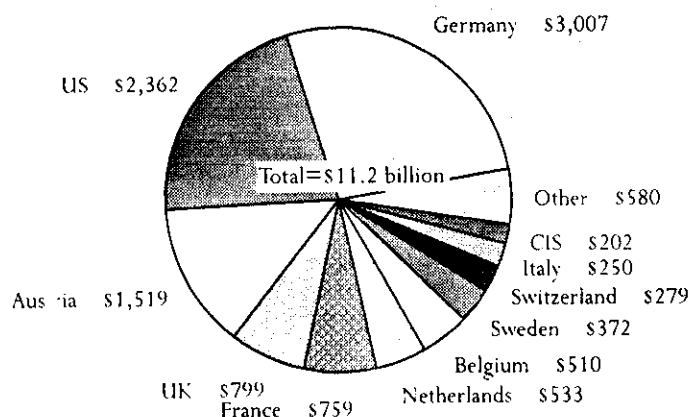
Cumulative FDI between 1990 and 1995 in US\$ billions. This graph is an aggregation of the other graphs on this page.

CZECH REPUBLIC



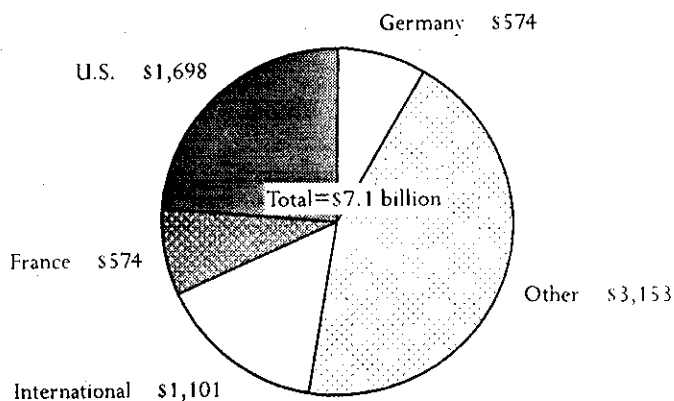
Cumulative investment in US\$ millions between 1990 and 1995.

HUNGARY



Cumulative investment in US\$ millions between 1990 and 1995. Breakdown is estimated based on trend from 1990-1994.

POLAND



Cumulative foreign direct investment in US\$ millions between 1990 and 1995. "International" includes the EBRD, as well as multinational corporations.

Hungary again outdistanced its neighbors, with inflows averaging \$160 a year over the 1992-94 period, compared with \$77 for the Czech Republic and \$36 for Poland. Both Poland and the Czech Republic, however, made considerable strides in attracting new direct investment inflows in 1995. Interestingly, the Czech Republic offers no tax concessions to attract foreign direct investment, whereas both Poland and Hungary do.

Also influencing the levels of direct investment inflows to Hungary, Poland, and the Czech Republic have been macroeconomic developments in each country over the past several years (Chart 9). Hungary, whose reform efforts started as early as 1968, has recorded steady, if sometimes slow, progress in developing a market economy. Despite large fiscal and current account deficits, which the government has begun to address through the introduction of an austerity program in March 1995 coupled with a devaluation and an import tax surcharge, the country has never failed to service all of its external debt (Chart 10). Tight monetary and fiscal policies pursued by the Czech Republic since reform began in 1989 and low levels of external debt have contributed to a domestic environment conducive to long-term economic growth, although significant structural problems remain, for example, in the corporate and financial sectors. After difficulties in some key areas of its economy in the early 1990s, including a sharp run up in inflation following price liberalization, Poland has seen its economy recover strongly over the past three years, fueled by strong export growth and private sector activity as well as by the normalization of relations with its external creditors.

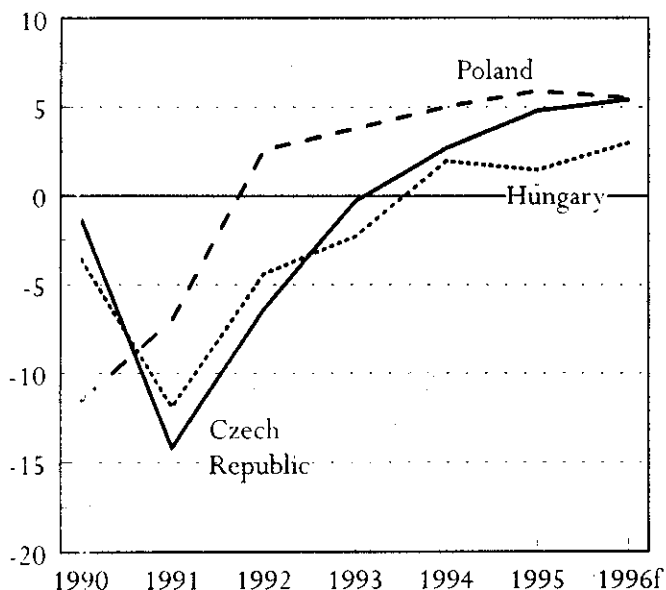
Integral to these broad macroeconomic and structural reforms have been efforts on the part of all three countries since 1990 to reduce the share of state holdings in the economy. The magnitude of the privatization efforts undertaken by each country may be seen by the fact that, as

CHART 9

INDICATORS OF MACROECONOMIC PERFORMANCE

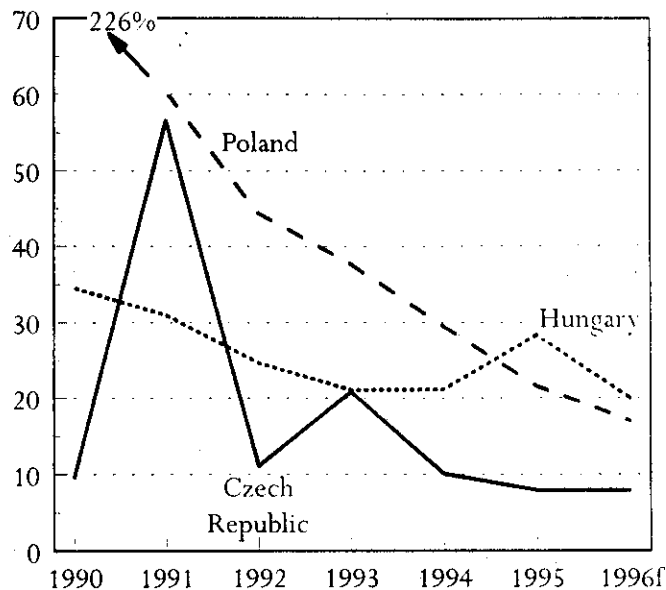
REAL GROSS DOMESTIC PRODUCT GROWTH

Percent change from previous year



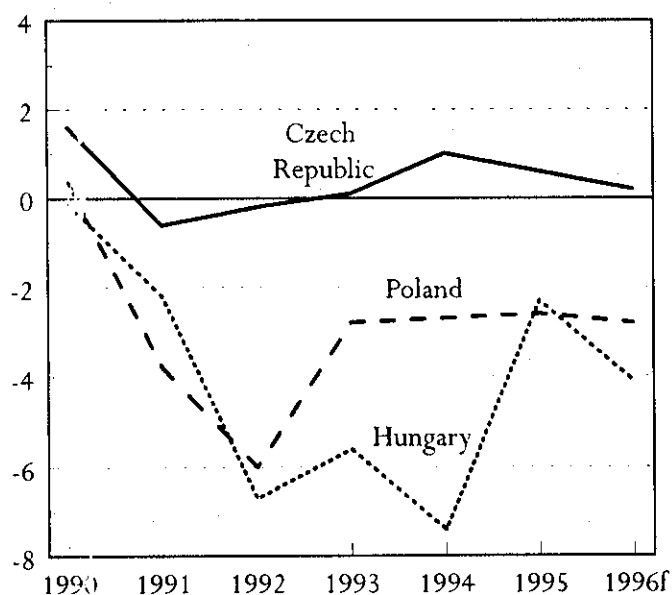
CONSUMER PRICE INFLATION

Percent change from previous year



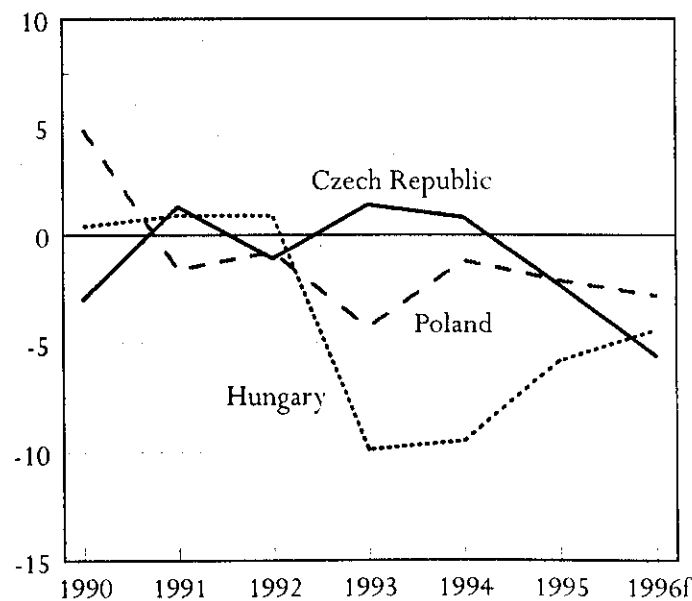
FISCAL BALANCE AS A PERCENT OF GDP

Percent of GDP



CURRENT ACCOUNT BALANCES AS A PERCENT OF GDP

Percent of GDP



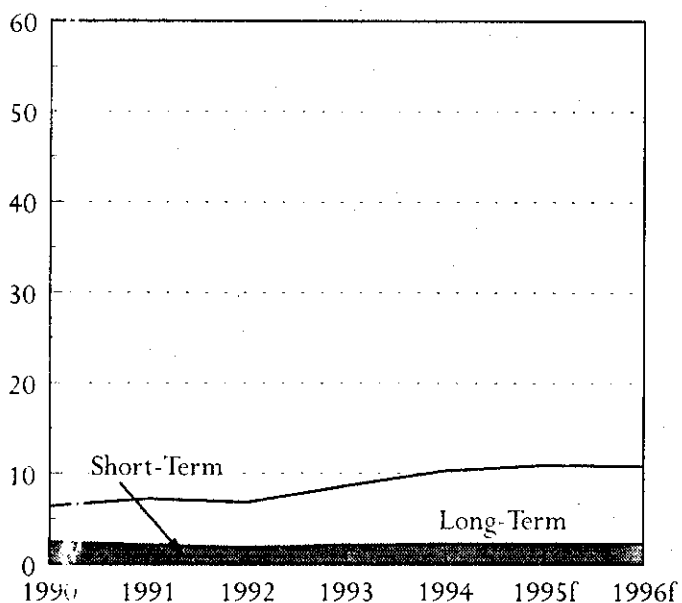
Sources: Economist Intelligence Unit/Datastream (forecasts), International Financial Statistics, National Bank of Hungary, Creditanstalt Central European Quarterly, Czech National Bank, BIS.

CHART 10

EXTERNAL DEBT

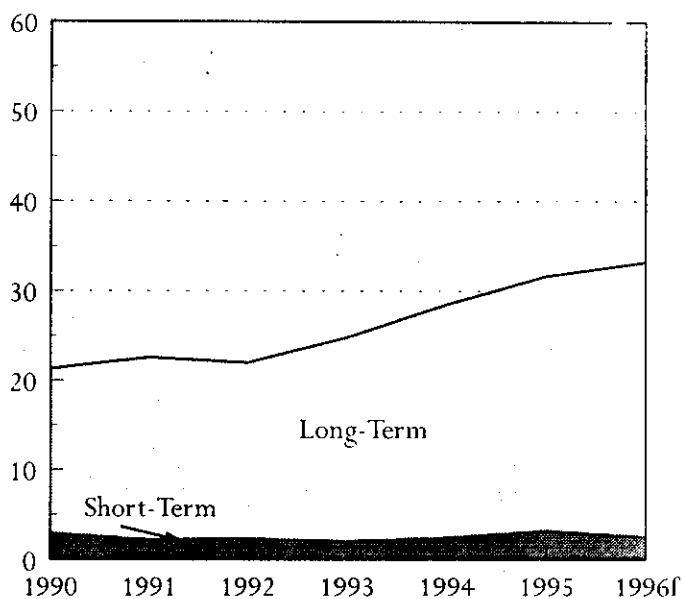
CZECH EXTERNAL DEBT

US\$ Billions



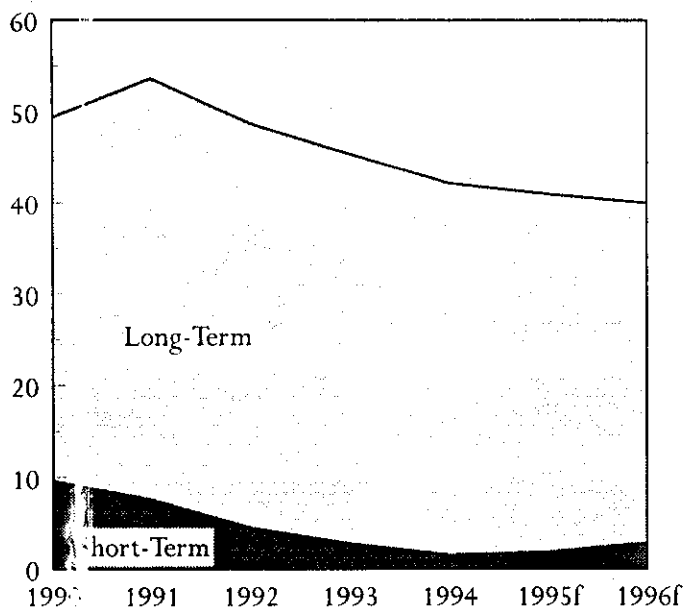
HUNGARIAN EXTERNAL DEBT

US\$ Billions



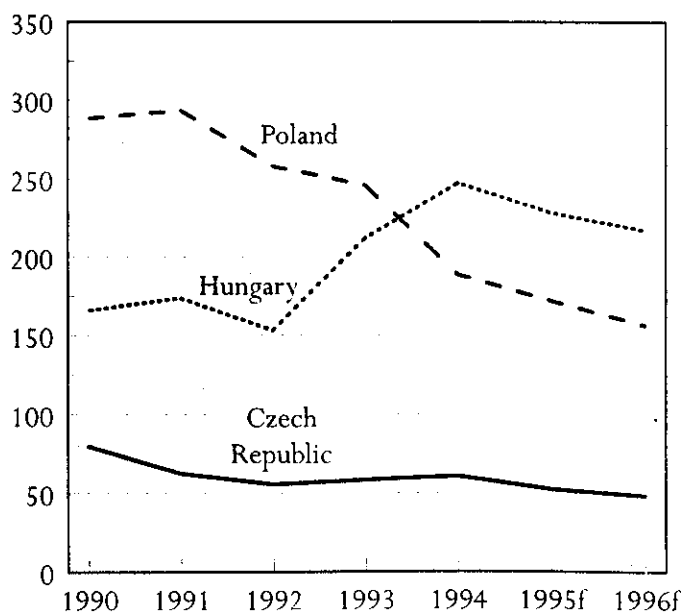
POLISH EXTERNAL DEBT

US\$ Billions



EXTERNAL DEBT AS A PERCENT OF EXPORTS

Percent



of 1995, the private sector contributed 60 percent to the GDP of the Czech Republic, 70 percent to that of Hungary, and 60 percent to that of Poland.

There are clear differences among the countries, however, in the privatization course each has chosen and its implications for the participation of foreign finance. Although the World Bank calculates that foreign participation was most marked in the privatization efforts of countries in Europe and Central Asia, with an estimated 57 percent of sales revenues stemming from foreign sources between 1988 and 1993,²⁰ this finding appears most applicable to Hungary, but considerably less so to the Czech Republic and Poland.

Hungary

Unlike the programs in Poland and the Czech Republic, the privatization program in Hungary has been dominated by sales for cash. When Communism collapsed in 1989, the Hungarian government, which had been introducing many market elements to its economy since 1968, opted for a market privatization program combined with generous tax incentives to attract foreign investors. It opened up large sectors of the economy and sold them primarily to Western firms. General Electric, Unilever, and Electrolux all bought out existing companies. Ford and General Motors built new ones. The drive to sell state assets culminated in late 1993 with the sale of a 30 percent stake in MATAV, the state telephone company, to a German-American consortium for \$875 million, the region's second largest privatization to date.

After having spent most of the 1990s aggressively pursuing privatization and attracting considerable foreign investment inflows in the process, however, the country began to falter in 1994 when it saw its revenue from foreign direct investment fall by more than \$1.2 billion from its

²⁰IBRD, World Debt Tables, "External Finance through Privatization," 1994/5 p. 125.

1993 level. In part this decline is misleading in that almost one-third of the 1993 inflows stemmed from the MATAV sale. Nonetheless, a change in government in March 1994, together with a lack of political consensus on the desirability of foreign participation in the disposition of the government's remaining holdings (valued at roughly \$14 billion) stalled the privatization program considerably in 1994 and much of 1995.

A new privatization law passed in May 1995, however, helped revive activity. The law merged the two existing privatization agencies into the State Privatization and Holding Company (APV Rt) and charged the agency with selling most of the remaining state companies by 1997. Under the new law, the Finance Minister is no longer in control of privatization and parliament is given final say in privatization decisions considered to be "vital to the nation." At the same time, the government committed itself to bringing several medium-sized companies to market over the remainder of 1995, including the oil and gas utility (MOL), five regional gas suppliers, and a major broadcasting company, despite considerable political opposition. The government's success in meeting its goals far exceeded expectations. Initially, the government had hoped for privatization revenues on the order of \$1.5 billion for 1995. Instead, by year end, the government was able to realize a record \$3.5 billion in privatization revenues and a total of \$4.5 billion in foreign direct investment.²¹ The government's successful privatization efforts have continued in 1996.

The Czech Republic

As in Hungary, foreign direct investment flows to the Czech Republic have also been related to the country's privatization program, although in the Czech Republic the relationship has

²¹Creditanstalt, Central European Quarterly, II/96, p. 26.

been somewhat less direct. The Czech privatization program consisted of two waves. In the first wave, which began in 1991, a direct auction method was used for small privatizations. Foreigners were not allowed to bid, at the initial auction, but could do so--and did--if there were no domestic buyers to offer bids. In the second wave of privatization, which was completed in early 1995, the country handed out vouchers to all Czech residents, who could use them to purchase shares either directly on the stock exchange or in newly formed investment funds. Again, no foreign participation was involved in the initial distribution, but foreigners could subsequently purchase shares from Czech residents.

As a result, the Czech Republic has been extremely successful in attracting foreign direct investment inflows, even though it offers no specific tax concessions. Although revenues from foreign direct investment fell rather sharply in 1993, the drop was primarily associated with uncertainties surrounding the country's split with the Slovak Republic on January 1. By 1994, the flows returned such that, by the end of 1995, the country had attracted a total of almost \$6 billion in foreign direct investment since 1990, over 40 percent of this in 1995 alone.

As elsewhere in the region, however, the government continues to retain major stakes in some key sectors of the economy, including the banks, utilities, and oil refineries, but like Hungary, it too has demonstrated over the course of 1995 its commitment to gradually reducing its role in many of these sectors. For example, in late June 1995, it sold a 27 percent stake in SPT Telecom, the telephone company, for which it received \$1.45 billion from a consortium led by a Dutch firm, making this sale the largest privatization in the region since the \$875 million share offering in Hungary's MATAV in 1993.²² In addition, the government has begun to privatize its

²²"Czech telecom stake sold for record \$1.5 billion," Financial Times, June 29, 1995.

oil refineries. Three Western oil companies--Royal Dutch Shell, Conoco, and Agip of Italy--agreed in September 1995 to buy 49 percent of the two main refineries for \$173 million and to invest an additional \$480 million over the next five years. A new state holding company, Unipetrol, retains a 51 percent stake in the refineries.²³

One long-term issue that may discourage foreign investment relates to the ownership structure of Czech enterprises. Although much of the economy is in private hands, a major portion of these ownership rights is concentrated in a comparatively small number of private investment funds created as part of the voucher privatization program. Most of these investment funds, in turn, are owned by the major banks. As a result, ownership of Czech enterprises is not as widespread as had been envisaged. Moreover, this ownership structure raises the potential for conflicts of interest on the part of fund managers who, when faced with market pressures, may be tempted to maximize earnings at the expense of the long-term development interests of their funds' portfolios. The comparatively low unemployment rate in the Czech Republic--2.9 percent in 1995, compared with 10.6 percent in Hungary and 15.1 percent in Poland--suggests that the necessary restructuring of Czech enterprises has not yet been undertaken in part because of these ownership arrangements.²⁴

Poland

In contrast to developments in both Hungary and the Czech Republic, foreign direct investment was slow to get under way in Poland following the introduction of the country's shock-therapy program in 1990. As the economy began to stabilize, with the fixing of the

²³"Czech oil refinery deal signed," Financial Times, June 19, 1995.

²⁴Creditanstalt, Central European Quarterly, II/95, p. 8.

exchange rate in early 1991, foreign investment did flow into Poland. Nevertheless, the amount was relatively modest given the size of the country's economy, by far the largest of the three countries. Although foreign investment has grown steadily over the 1990s, the bureaucratic hassles stemming from the fact that a number of enterprises may report to more than one ministry tended to discourage investors and precluded more substantial inflows.

In addition, the country's privatization program did little until 1995 to promote the inflow of foreign direct investment. Prior to 1995, the Polish privatization program was largely voluntary, relatively slow in implementation, mostly confined to small- and medium-sized businesses, and considerably delayed by a lack of a political consensus on its aims and methods. Of the 8,400 state firms registered in August 1990, only 2,290 small- and medium-sized firms and 135 large firms were privatized by the end of 1994. Of this total, 961 were sold in 1991, compared with only 294 in 1994.²⁵

This situation began to change in the middle of 1995. After a three-year delay, the government agreed in July to launch its long-planned mass privatization program, signing management contracts with fund management companies to manage fifteen National Investment Funds (NIFs). The NIFs, which are partly managed by foreign fund managers and 85 percent owned by the adult population, received 60 percent of the shares in over 500 companies privatized. The government reserved 15 percent of the remaining shares for the employees of the companies; it planned either to hold the balance of the shares or to distribute them to local authorities and suppliers.

Under the terms of the privatization plan, one fund serves as lead manager for each

²⁵"Poland: Set Loose the Dogs," The Banker, May 1995, p. 25.

enterprise privatized, receiving one-third of the shares offered in that company. The remaining shares were then distributed equally among the other funds. Using a lottery system, each fund was allowed to bid on those companies it wished to lead-manage. The lottery took place in early 1996. To encourage the investment funds to take a longer term interest in the enterprises whose shares they hold, the government has allowed them, for a specified time period, to reconfigure their portfolios if they wish.²⁶ In addition, beginning in late 1995, the government allowed all adult Poles, or 29 million people, to purchase at a nominal price of 20 zloty each (\$8) participation certificates that can be converted into shares in each of the fifteen funds. These shares became tradable on an over-the-counter market in early 1996 and were listed on a special market of the Warsaw Stock Exchange in July 1996. This is preliminary to the listing of the individual funds on the Warsaw Stock Exchange in 1997.²⁷

While the mass privatization program may bring little immediate revenue to the country, it holds the promise of attracting foreign investment in the coming years. At the same time, it also permits a rapid selloff of state assets in the face of a shortage of capital among the population. Nonetheless, aspects of the new program continue to be mired in political controversy. For example, parliament and not the privatization minister has the right to veto all privatization decisions involving key sectors of the economy, such as banks, oil and gas, and insurance. The legislation creating the program barely survived the president's veto, which parliament voted to override in October 1995. While Poland's privatization program is likely to remain highly politicized, it does open the way to move the restructuring process of Polish enterprises forward.

²⁶Girocredit. East European Chronicle, July 1995, p. 9.

²⁷"Fibremaker gives dress rehearsal for privatised Poland," Financial Times, July 18, 1996.

Under new government leadership, the privatization program for 1996 appears to be on track, with the government moving forward in its plans to sell a minority stake in Polska Miedz, a copper producer expected to be valued at \$2 billion, which would make this transaction the largest privatization in the region to date.²⁸ In addition, in early 1996, the government announced plans to privatize over seven years most of the country's electrical generating and distribution sector.²⁹ In mid-year, it allowed two foreign banks to take majority control of their respective Polish partners.³⁰ At the same time, the government faced some potential conflicts with foreign investors stemming from the dismissal in May 1996 of two U.S. managers of one of the funds.³¹

PORTFOLIO INVESTMENT

Portfolio investment is undeniably the most significant new development in the provision of private capital to developing countries in the 1990s. Launched by the efforts of pension funds, insurance companies, mutual funds, and other institutional investors located primarily in the United States and the United Kingdom to diversify their portfolios in the late 1980s, portfolio investment has probably grown at a faster rate than any other source of private capital flows to developing countries. The countries of Central and Eastern Europe, however, have only just begun to benefit from inflows from this source. Moreover, the activity that has been reported to date vis-a-vis the region has almost always assumed the form of bond flows and not equity flows, despite the fact that the bulk of emerging market mutual funds' global portfolio investment takes

²⁸"Polish privatization plan survives cabinet changes," Financial Times, February 8, 1996.

²⁹"Poland plans power sell-off over seven years," Financial Times, March 13, 1996.

³⁰"Poland allows foreign buyers for some banks," Financial Times, July 1, 1996.

³¹"U.S. fund managers furious at Polish sacking," Financial Times, May 3, 1996.

place through equity and not bond investment.³² Of the Central and Eastern European countries, Hungary continues to dominate activity in these markets.

One caveat to note in considering portfolio investment to the region is the relative paucity of data and the uncertain reliability of the information that is available. To date, there has been no systematic compilation of statistics on portfolio flows by an international organization. Much of the data that do exist have been obtained from diverse and often inconsistent sources.³³ In addition, balance-of-payments statistics in individual countries often do not distinguish portfolio flows from other capital flows. Moreover, most countries lack systematic methods for recording secondary market transactions in domestic market bonds and equity. Therefore, recorded foreign activity in these markets may be significantly understated.

Bonds

To date, over 90 percent of all private capital flowing into Central and Eastern European in the form of portfolio investment has taken place through bonds. As noted earlier, portfolio investment through bonds occurs in two ways, and both merit discussion. First, public or private entities can issue securities in the domestic market of a foreign country or in the international markets. Thus far, most of the activity concerning the countries of Central and Eastern Europe has taken this form. Second, non-residents can invest in the money or capital markets of another country. This form of bond investment is only just beginning in Central and Eastern Europe. Some data are available for international purchases by these countries in foreign markets, but only anecdotal evidence is possible in the case of foreign purchases in these countries' domestic

³²IMF, International Capital Markets, August 1995, p. 39.

³³European Economy, p. 6.

markets.

Hungarian, Czech, and Polish Bonds Issued in Foreign Markets

Of all the Central and Eastern European countries, Hungary has been the most active participant in the international capital markets during the first half of the 1990s. On average, it raised more than \$1 billion a year in the Eurobond market until 1993 when, taking advantage of favorable market conditions, it raised a spectacular \$4.8 billion. Mounting fiscal and current account deficits prompted its need for finance. According to some estimates, Hungary alone accounted for as much as 83 percent of all international bonds issued by all countries in the region between 1989 and 1994.³⁴

In addition, Hungary has also been able to access the Euroyen or Samurai market and, in 1993, for the first time, the U.S. dollar or Yankee bond market. Although Hungary lacks the investment grade ratings from some of the international credit rating agencies that both Poland and the Czech Republic enjoy,³⁵ the fact that the country has long been committed to market-based reform and has serviced its external debt strictly according to schedule despite some unfavorable conditions has been important to its generally positive reception in the international

³⁴Ibid., p. 5.

³⁵The Czech Republic saw its investment grade ratings upgraded in the fall of 1995 (to Baal in September by Moody's and to A in November by Standard and Poor's). While Poland has had an investment grade from Moody's since June 1995 (Baa3), it was rated below investment grade by Standard and Poor's (BB) until April 1996 when it was upgraded by two notches to investment grade (BBB-). Hungary is rated below investment grade by both these rating agencies (Ba1 by Moody's and BB+ by Standard and Poor's), but was given investment grade status by two other rating agencies in 1996, by IBCA in April and by Duff and Phelps in June. "Credit Rating Boost for Hungary," Financial Times, June 11, 1996.

markets.³⁶

Like Hungary, the Czech Republic began to access the international capital markets before the fall of its Communist government. The amounts the country has raised, however, have been on a far more modest scale than those raised by Hungary, averaging less than \$400 million a year between 1990 and 1994. Following the dissolution of the former Czechoslovakia on January 1, 1993, the Czech National Bank tapped the Eurobond market for the first time in April 1993, issuing a three-year \$375 million Eurobond to help rebuild the reserves depleted by speculation against the koruna in connection with the breakup of the country.³⁷ Notwithstanding the Czech Republic's investment grade ratings, which it received in March 1993, spreads for dollar-denominated issues for both the Czech Republic and Hungary were comparable at about 275 basis points over U.S. Treasuries in 1993 (Chart 11).

Poland, by contrast, was able to access the international capital markets only after it had normalized relations with its commercial bank creditors in 1994. It made its debut offering in the Eurobond market in June 1995, raising \$250 million for five years at a spread of 185 basis points over comparable U.S. Treasuries--a lower spread than that achieved by other comparably rated borrowers (Greece and South Africa).³⁸ The offering followed close on the heels of the country's having been awarded an investment grade rating by Moody's earlier in the month. With some \$15 billion in reserves, Poland mainly sought to test its standing in the international debt markets. In July 1996, following its upgrade to investment grade by Standard and Poor's, the country

³⁶Creditanstalt, Central European Quarterly, III/95, p. 17.

³⁷European Economy, pp. 5-6.

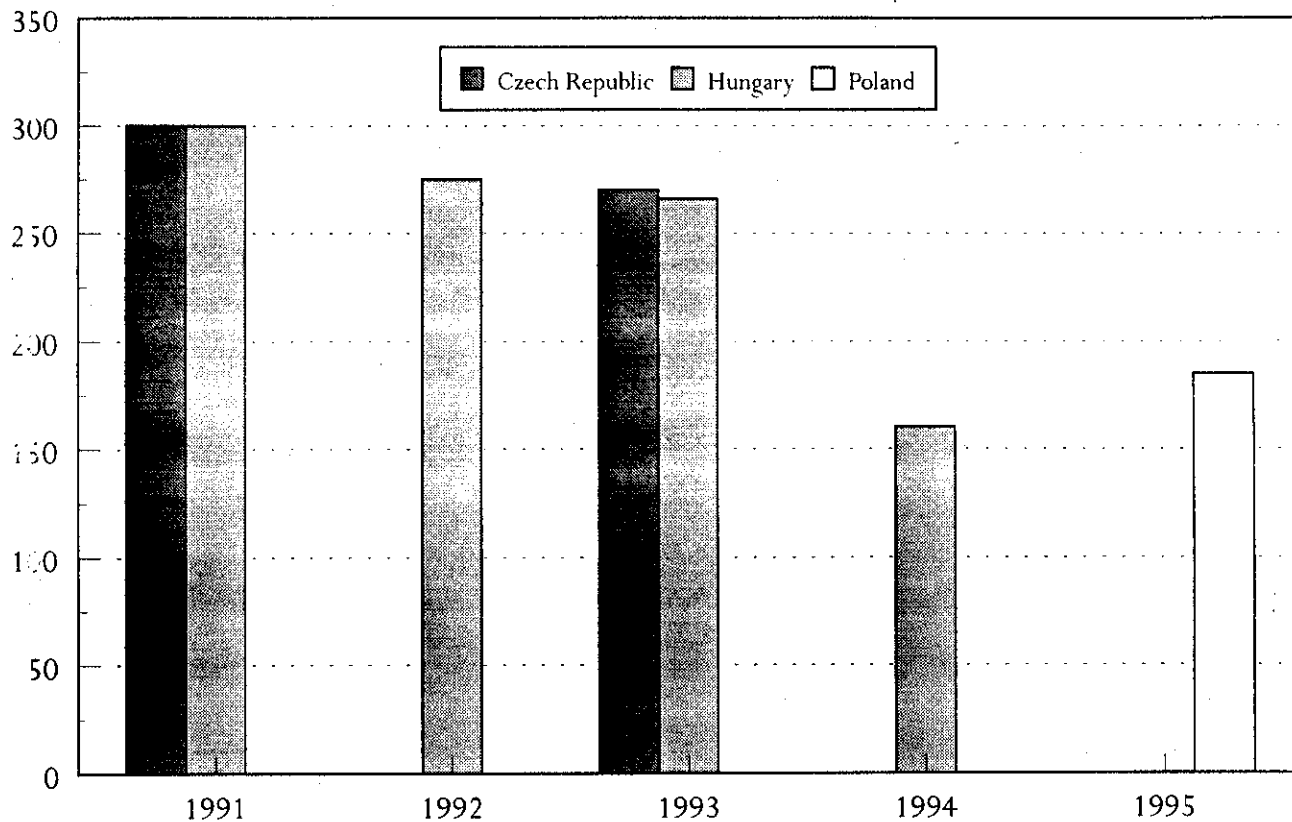
³⁸"Poland's debut meets strong demand," Financial Times, June 28, 1995.

CHART 11

YIELD SPREADS ON SOVEREIGN BORROWING

YIELD SPREAD AT LAUNCH OF SOVEREIGN BOND ISSUES

Basis Points for Dollar-Denominated Bonds Only



further tested the markets by issuing its first Deutsche mark-denominated Eurobond, a five-year DM 250 million (\$165 million) offer at a spread of 65 basis points over comparable German government bonds. This spread was roughly in line with secondary market spreads on its dollar-denominated Eurobond, whose price had risen sharply over the year with the yield spread over U.S. Treasuries falling from 185 basis points to about 70 basis points.³⁹

Although the vast majority of developing country borrowers in the international capital markets during the 1990s were non-sovereigns, all of the borrowing by Hungary and most of that by the Czech Republic between 1990 and 1994 was undertaken by sovereigns.⁴⁰ As privatized companies are restructured, however, and the corporate sector strengthened, some of the major firms in these countries have begun to access the international capital markets. In March 1996, for example, Poland's Export Development Bank (Bank Rozwoju Eksportu) issued a \$50 million three-year floating rate note with a spread of about 150 basis points.⁴¹ In April, the Czech Republic's Komerční Banka raised \$250 million with a spread of 78 basis points over U.S. Treasuries.⁴² And in May, Poland's Bank Handlowy issued \$100 million three-year bonds at 88 basis points over comparable U.S. Treasuries.⁴³

³⁹"Investors snap up DM 250 million Polish eurobonds," Financial Times, July 10, 1996.

⁴⁰In November 1994, CEZ, the state-owned power company, became the first corporation in the region to enter the Eurobond market with a \$150 million issue at a spread of 110 basis points. IMF, Private Market Financing for Developing Countries, November 1995, p. 21.

⁴¹"Polish bank plans \$50 million international bond issue," Financial Times, March 28, 1996.

⁴²"Komerční banka eurobond," Financial Times, April 29, 1996.

⁴³"Bank Handlowy three-year offer heavily oversubscribed," Financial Times, May 1, 1996.

One development of note was that in October 1995 the Czech koruna became the first post-Communist currency in which borrowers can tap the Eurobond market. General Electric Credit Corporation was the first borrower to raise funds denominated in koruna with a Kc 2 billion (\$76 million) issue of three-year bonds. A second issuer, the Nordic Investment Bank, raised Kc 1.5 billion (\$58 million) later in the month. Both these issues followed the decision by the Czech parliament in September to approve the full convertibility of the koruna for current account transactions and a significant liberalization of the currency for capital account transactions. Interest rate differentials enabled these borrowers to fund their operations in the Czech Republic more cost-effectively in the international markets than they could have in Czech local markets.⁴⁴ In December 1995, the World Bank became the largest issuer of koruna-denominated bonds, issuing Kc 2.5 billion (\$96 million) two-year bonds at a spread of 600 basis points over domestic German paper.⁴⁵ The Bank placed a second issue in May 1996 for Kc 1.5 billion (\$54 million).⁴⁶ As of February 1996, borrowers can also tap the Eurobond market in Polish zloty.⁴⁷ The IFC, the EBRD, ING Barings, and British Midland have all issued zloty-linked bonds, in anticipation of the full convertibility of the zloty.⁴⁸

⁴⁴"Czech koruna broadens eurobond currency base," Financial Times, October 10, 1995.

⁴⁵"World Bank launches record Czech koruna issue," Financial Times, December 21, 1995.

⁴⁶The Czech National Bank Monthly Bulletin, June 1996.

⁴⁷"First zloty eurobond," Financial Times, February 7, 1996.

⁴⁸The Polish authorities eased constraints on direct investment flows in April 1996. They plan a further dismantling of controls beginning in January 1997 when they will ease curbs on portfolio investment, allowing Polish citizens to buy stocks on the international markets. "Poland to ease capital flows," Financial Times, March 28, 1996.

Foreign Access to Hungarian, Czech, and Polish Money and Capital Markets.

Evidence of private capital inflows to the domestic markets of countries in Central and Eastern Europe is by necessity anecdotal. Comprehensive data do not exist. Nonetheless, there are indications that foreign investors have begun to take note of both the government securities markets and the corporate bond markets in some of these countries, especially those where regulations affecting foreign access to these markets and the ability to repatriate investment income have been liberalized (Table 2).⁴⁹

Since 1993, Hungary in particular has been easing restrictions on the ability of foreigners to participate in its Treasury markets. In view of its substantial fiscal and current account deficits, it has sought to attract additional funds to help finance these deficits. Foreign participation to date, however, has been modest. For example, in the first Hungarian Treasury issue made available to them in May 1994, foreigners took only HUF 104 million (\$1.02 million) of the HUF 8.8 billion (\$86 million) offered.⁵⁰

Corporate bond markets in both Hungary and the Czech Republic have also begun to attract the interest of foreign investors. The bulk of these investments, however, has been arranged through private placements with the issuers--either local subsidiaries of multinational companies or state-owned firms and banks. As a result, there is virtually no secondary market trading in these bonds. Some market participants estimate that total portfolio investment in koruna-denominated securities amounted to Kc 28 billion (\$10.8 million) at the end of 1994.⁵¹

⁴⁹European Economy, p. 7.

⁵⁰Girocredit, East European Chronicle, January/February 1995, pp. 18-19.

⁵¹Creditanstalt, Central European Quarterly, II/95, p. 9.

TABLE 2

EXCHANGE REGIME AND CAPITAL ACCOUNT RESTRICTIONS

	Exchange Regime	Capital Account Restrictions
Czech Republic	<p>The koruna is pegged to the deutsche mark (65%) and the dollar (35%). The market value of the koruna is established in a daily fixing session by the Czech National Bank and domestic interbank foreign exchange market participants, and is allowed to fluctuate by plus/minus 7.5% around a central rate based on international exchange rates. The band was widened from 0.5% on February 28, 1996.</p> <p>Authorities are working toward full convertibility. The koruna has been fully convertible for current account transactions under the IMF's Article VIII guidelines since October 1995.</p>	<p>INFLOW: There are no restrictions on equity participation in the Czech Republic by non-residents. The authorities allow direct investments by residents of EU member countries without a foreign exchange license, but require that investments be reported. Czech companies may accept credits from non-resident banks. Foreigners may buy up to 10% of Czech banks before obtaining a central bank license. Restrictions remain on purchases of real estate by non-citizens.</p> <p>OUTFLOW: Czechs are allowed to purchase real estate abroad and make direct investments abroad. Remaining restrictions include a ban on the purchase by Czechs of foreign stocks, restrictions on provision of credit to non-residents (outside of credits from the state, those with a term of over five years, for the purpose of direct investment, or between persons), and restrictions on the issue of foreign securities on the Czech market.</p>
Hungary	<p>The forint is pegged to the ECU (70%, to be replaced by the deutsche mark in 1997) and the dollar (30%). As part of an austerity package introduced in March 1995, the forint was devalued by 9 percent and a crawling peg system of devaluation was introduced, devaluing the forint by a total of 26 percent in 1995. The forint is allowed to fluctuate by plus/minus 2.5% around the central rate.</p> <p>The forint has been convertible for current account transactions in line with IMF Article VIII guidelines since January 1996.</p>	<p>INFLOW: Hungarian financial institutions must report foreign short-term borrowing. Foreigners may purchase Hungarian bonds, but licenses are required for original maturities under 1 year. Under the foreign exchange code introduced in January 1996, long-term foreign capital inflow is unrestricted, and non-residents may purchase Hungarian real estate with some restrictions.</p> <p>OUTFLOW: Most credits granted to foreigners are limited to maturities of under six months. Hungarians must obtain a license for direct investments abroad. Foreigners who earn forints from exports of goods or services to Hungary may freely invest their earnings in Hungary or convert them to hard currency and repatriate them. Foreigners may repatriate investments at any time. Some OECD companies may issue equity in Hungary with a Securities and Stock Exchange Commission license.</p>
Poland	<p>The zloty is pegged to the dollar (45%), the deutsche mark (35%), the pound sterling (10%), the French franc (5%), and the Swiss franc (5%). The central exchange rate is adjusted under a crawling peg system, and since May 1995, the zloty has been allowed to fluctuate by plus/minus 7% around the central rate. In December 1995, the authorities revalued the zloty by 6 percent.</p> <p>The zloty has been convertible for current account transactions under the IMF's Article VIII guidelines since June 1995.</p>	<p>INFLOW: As of April 1996, no restrictions remain on foreign direct investment. Foreigners may freely invest in securities with maturities of more than one year, but restrictions apply on shorter-term instruments.</p> <p>OUTFLOW: As of April 1996, no restrictions remain on foreign direct investment.</p>

Were the Czech government to lift its prohibitions against allowing domestic borrowers to issue short-term debt denominated in hard currency, a greater pool of foreign investors might be attracted to the local market, prompting the development of a secondary market.⁵²

Finally, new investment funds geared to attracting foreign investment have been formed in recent years. One such fund in Hungary, capitalized at HUF 330 million (\$2.6 million), was launched by the Austrian bank Creditanstalt Bankverein. In addition, two local Czech brokers have also launched similar funds geared to attracting foreign participation.⁵³ By early 1996, plans were in place by the Templeton Fund to raise \$300 million to invest in Central and Eastern European government debt instruments.⁵⁴

Equities

Portfolio investment through equities takes place when non-residents purchase shares in the stock exchange of a foreign country or when private or publicly owned firms issue shares in the international markets or the domestic market of a single country through the use of global or American depositary receipts. To date, the bulk of activity in portfolio investment through equities for the Central and Eastern European countries has taken place through non-resident direct purchases in the stock exchanges of these countries rather than through the issuance of shares in the international markets by firms in these countries.⁵⁵ As privatization efforts proceed, however, and firms continue their necessary restructuring, equity investment is likely to grow

⁵²Business Eastern Europe, September 4, 1995, p. 7.

⁵³Wall Street Journal Europe, Central European Economic Review, February 1995, p. 32.

⁵⁴"Debt fund planned for central and eastern Europe," Financial Times, January 12, 1996.

⁵⁵European Economy, p. 5.

markedly. A stronger corporate profile will not only enhance the attractiveness of these countries' stock markets to foreign investors but also make firms seeking to issue shares abroad more appealing. Foreign interest in these equity markets has been facilitated by the inclusion of these countries in emerging market indices over 1995 and 1996.⁵⁶

Foreign Purchases of Shares in Czech, Polish, and Hungarian Markets

The striking growth in emerging market mutual funds, which numbered some 900 by the end of 1994, has made direct purchases of shares in developing country stock markets an increasingly important source of portfolio investment over the 1990s. Mutual fund purchases of developing country equities are estimated to have grown from almost \$6.5 billion in 1990 to over \$58 billion in 1994 when despite turbulent market conditions in many developing countries, these funds continued to grow rapidly.⁵⁷ According to market participants, virtually all mutual funds today hold investments in Central and Eastern Europe, compared with only 68 percent in 1991.⁵⁸

As for the countries to which equity funds are directed specifically, the IMF lists only one, Hungary. By the end of 1994, it reports, there were three closed-end equity funds for Hungary with a combined net asset value of \$200 million.⁵⁹ Because many mutual funds combine both equity and bond holdings and are global or regional in focus, it is impossible to reach a

⁵⁶"Emerging-Nation Markets to Receive Big Lift from New Indexes Created by World Bank Unit," The Wall Street Journal, June 20, 1996. "Elusive benchmark of emerging markets," Financial Times, July 15, 1996.

⁵⁷IMF, Private Market Financing, November 1995, p. 26.

⁵⁸Joyce Chang, "Looking for Value Outside of Latin America, Salomon Brothers Emerging Markets Seminar, New York, August 15, 1995, p. 6.

⁵⁹IMF, International Capital Markets, August 1995, pp. 48-51.

comprehensive estimate of the amount of equity they hold in any given country.

Nonetheless, the booms in the Czech, Polish, and Hungarian equity markets, particularly from the second half of 1993 until early 1994 and again in 1996, clearly suggest a significant presence of foreign investors (Chart 12). The Budapest Stock Exchange, for example, estimates that foreigners, mainly institutional investors, account for between 50 percent to 70 percent of the exchange's turnover and investments.⁶⁰ In the Polish market, foreigners are estimated to account for about 25 percent of turnover and 20 percent of market capitalization.⁶¹

Some have argued that increased equity investment in the region largely reflects the resale to foreigners of stocks received by domestic residents during the mass privatization of state enterprises in 1991 and 1992.⁶² This observation appears to be particularly relevant to the Czech Republic, whose stock exchange opened in April 1993, just prior to the completion of the first wave of privatization in May 1993. By the fall, local mutual fund managers reportedly began to offer blocks of shares to international fund managers once it became apparent that the holdings were relatively inexpensive, especially when compared with Polish shares, at a time when prospects for the Czech economy looked relatively favorable.⁶³

The performance of stock markets in these countries to date has been anything but predictable. After registering huge run-ups in 1993, stock markets in Hungary, the Czech Republic, and Poland pulled back, often unevenly, over the course of 1994 as increases in U.S.

⁶⁰Budapest Stock Exchange, "Five Years of the Budapest Stock Exchange," June 1995, p. 6.

⁶¹European Economy, pp. 6-7.

⁶²Calvo, "Capital Flows in East and Central Europe," p. 17.

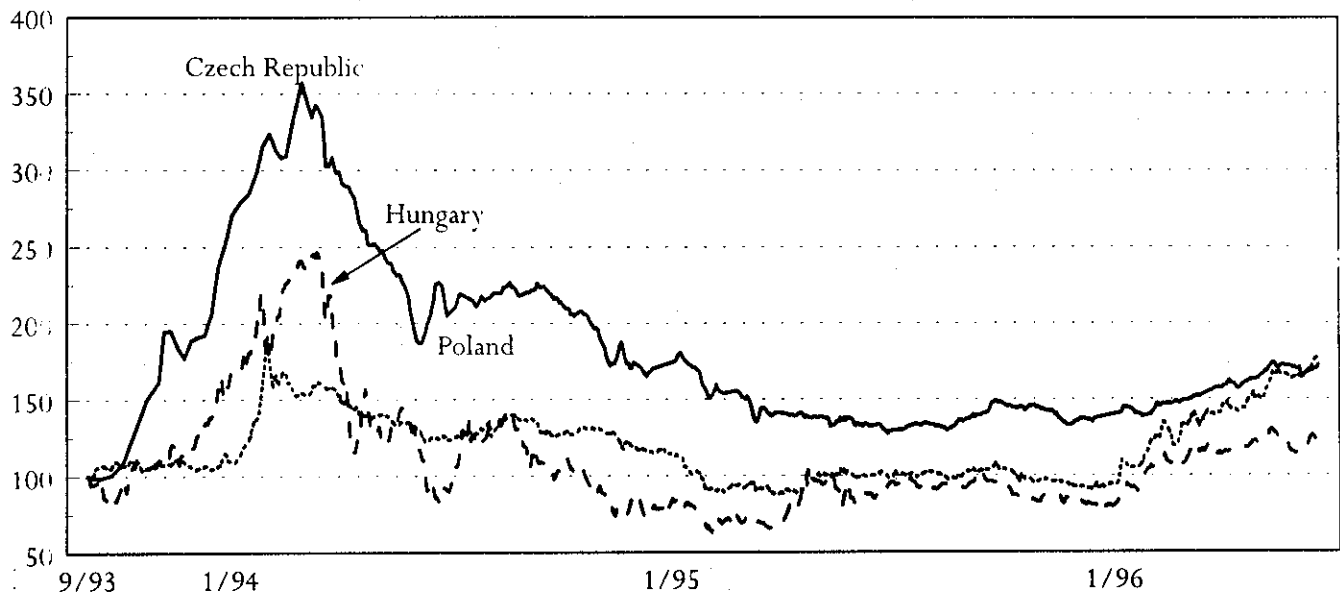
⁶³CS First Boston, Czech Stock Guide 1994, January 1994, p. 5.

CHART 12

INDICATORS OF STOCK MARKET PERFORMANCE

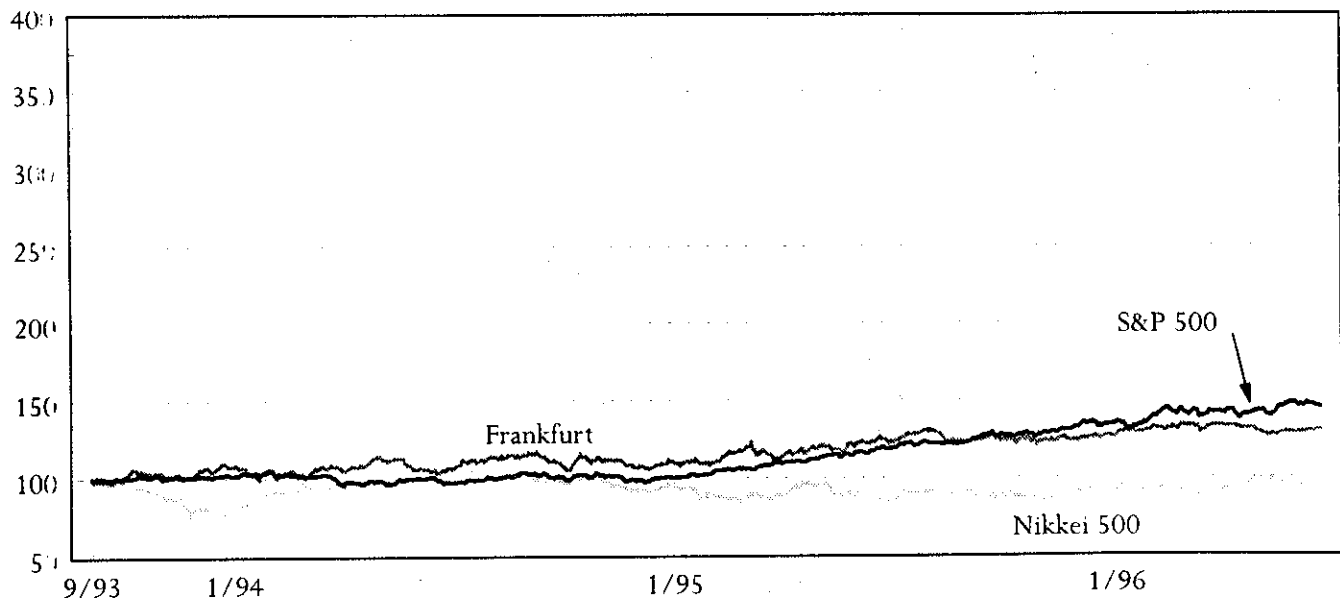
STOCK MARKET INDICES IN DOLLAR TERMS

9/7/93=100



STOCK MARKET INDICES IN DOLLAR TERMS

9/7/93=100



interest rates beginning in February made returns on these investments relatively less attractive and domestic demand slackened. From where it stood in February 1994, the Prague stock market had lost two-thirds of its market value by the fall of 1995, while the Warsaw market also suffered a major decline.⁶⁴ In Budapest, the stock exchange fell to a fifty-two-week low in January 1995 and gradually moved up over the year, but at a considerably reduced level. By early 1996, however, after two years of strong export-led growth and privatization programs actively under way in both Hungary and Poland, most of these markets had begun to turn around, with markets in Poland, Hungary, and the Czech Republic all registering gains ranging from 41 percent to 49 percent in the first quarter of 1996.⁶⁵

The resurgence in equity markets in the region led Europe's largest independent fund manager, Mercury Asset Management, to launch the first equity fund for Central and Eastern Europe in January 1996. The open-end fund, based in Luxembourg, plans a capitalization of DM 30 million-40 million (\$20 million-\$30 million) and to allocate roughly 70 percent of its funds to Poland, Hungary, and the Czech Republic.⁶⁶ In addition, in mid-1996, an affiliate of Deutsche Bank, DBG Eastern Europe, launched a private equity fund, capitalized at Kc 900 million (\$32.7 million), to provide development capital to companies in the region. The aim of the new fund is to provide finance for management buy-outs and buy-ins, acquisitions and joint ventures,

⁶⁴"Eastern European Stock Markets Start to Attract Notice," New York Times, October 6, 1995.

⁶⁵"Market Place," New York Times, April 5, 1996.

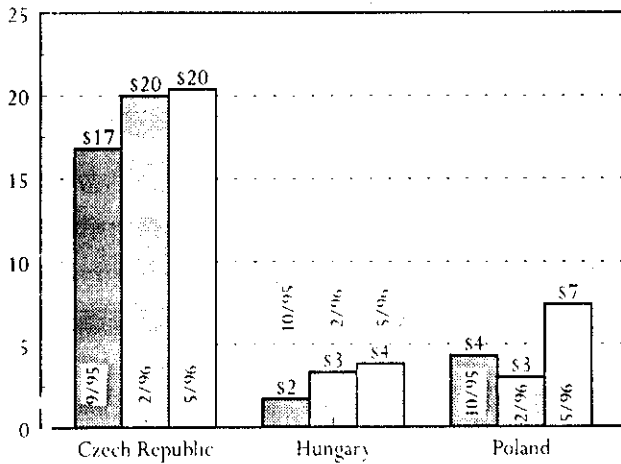
⁶⁶"Eastern Europe fund from Mercury," Financial Times, January 18, 1996.

CHART 13

INDICATORS OF STOCK MARKET PERFORMANCE

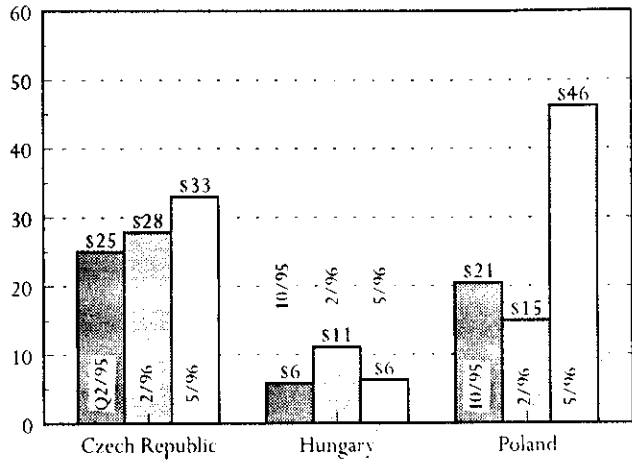
MARKET CAPITALIZATION

US\$ Billions

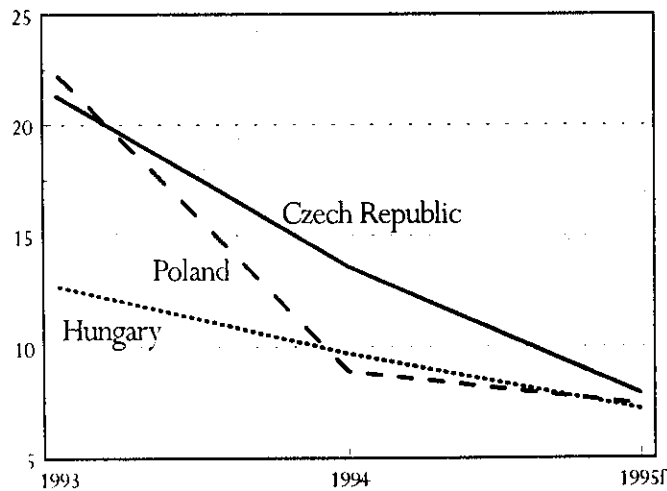


DAILY MARKET TURNOVER

US\$ Millions



PRICE/EARNINGS RATIOS



and improvements in the quality of earnings and management.⁶⁷

In looking at the performance of the equity markets in these countries, it is useful to bear in mind how very recently they have come into operation and how very much still needs to be done to strengthen not only the markets themselves but also the banking and financial systems of which they are integral parts.⁶⁸ The Prague market opened in April 1993, the Warsaw market in mid-1992, and the Budapest market in June 1990. There is little dispute that these markets lack breadth and liquidity, making any large-scale trade impossible to execute without significantly moving the price of the stock. Problems and glitches abound.

Hungary

The Hungarian market listed only forty-eight stocks as of August 1996 and, although in operation longer than either the Czech or Polish exchange, continues to have a smaller market capitalization than either of these countries (Chart 13). Because of political differences surrounding the country's privatization process, only a handful of major privatizations were effected for a good part of 1995, the first major one being the successful offering of shares in July 1995 in OTP Bank, the national savings and commercial bank. However, the government's renewed commitment to an active privatization program in the fall of 1995 and its unexpected success in exceeding its goals led, for example, to a sharp increase in the market capitalization of its stock exchange. This rose from less than \$2.6 billion in October 1995 to \$3.3 billion by

⁶⁷"Fund set up for central Europe," Financial Times, May 17, 1996.

⁶⁸More formal statistical analysis is required to assess the performance of these markets fully. In broad terms, the IMF has found evidence of volatility spillovers from U.S. markets to emerging country stock markets and has determined that these spillovers are strongest when portfolio flows have been most volatile. IMF, International Capital Markets, August 1995, p. 119.

February 1996 and \$3.8 billion by May. Daily turnover also increased dramatically, averaging about \$5 million by May 1996, over four times the average daily figure for 1995.⁶⁹

Over the past two years, the Hungarian government has undertaken some specific steps to help strengthen the country's stock market. In 1994, it established a fully operational clearinghouse and share depository that has reduced settlement time on trades. An efficient settlement system can help to improve surveillance and regulatory control, thereby contributing to investor confidence and increased cross-border transactions.⁷⁰

During March 1995, the government took two additional steps to improve the breadth and transparency of the Budapest Stock Exchange. First, it opened an unregulated market (UM) that is able to use the regular stock exchange facilities after official trading hours. The UM market, which was formed by the agreement of thirty-three stock exchange members, is not official; listing, disclosure, and trading requirements do not apply to the stocks traded there. Since opening, eleven stocks have been admitted and trading has been sporadic. Second, the government allowed trading in certain derivative products to take place on the Budapest exchange, with a total of five contracts made available.⁷¹

Investor confidence in Hungary has been boosted in 1996 not only by the measures the government has taken to improve the country's stock exchange but also by the improved performance of the economy, including renewed growth and declining inflation, the introduction of currency convertibility in January, the approval of an IMF \$387 million standby in March, and

⁶⁹Creditanstalt, Central European Quarterly, II/96, p. 30.

⁷⁰IMF, Private Market Financing, March 1995, p. 32.

⁷¹Creditanstalt, Central European Quarterly, II/95, p. 19.

acceptance as an OECD member at the end of March, the second ex-Soviet bloc country to be admitted. Continued strengthening of the stock market is likely with the privatization of TVK, a chemical producer, which is expected to be the largest equity offering from the region after MOL, the Hungarian oil producer, and the decision by Cofinec, a central European packaging company, to become the first non-Hungarian firm to seek a listing on the Budapest Stock Exchange. Both of these equity issues promise to attract a wide range of investors, boosting the Hungarian market even further in 1996.⁷²

Poland

Like its Hungarian counterpart, the Polish stock exchange has also suffered from comparative thinness. As in Hungary, this situation has begun to change in 1996, driven by strong economic growth, the persistent influx of foreign capital, and the implementation of the mass privatization program in mid-1995. With only forty shares listed in October 1995 and a market capitalization of roughly \$4.3 billion, the Polish stock exchange had fifty-eight companies listed by August 1996 and a market capitalization of over \$7.0 billion. Still, the size of Poland's stock exchange is almost three times smaller than that of the Czech exchange while the size of its economy is almost four times larger. After almost four years of trading, there are few open-end mutual funds, the main one being the Boston-based Pioneer Group's Pioneer First Polish Trust Fund, which began operations in July 1992.

Domestic restrictions on fund activities--rather than market concerns--have tended to hold back the development of funds. Until 1996, Polish residents were prohibited from holding any investments abroad. This meant that mutual funds could invest only in domestic securities, which

⁷²"Hungarian share issue well-received," Financial Times, July 9, 1996.

until the end of 1995 comprised fewer than fifty stocks and a small array of government debt issues. Moreover, a regulation requiring trust funds to employ at least two licensed investment advisers in a country where only twenty-two had been licensed as of early 1995 made new applications for setting up funds scarce.⁷³

Further, until the middle of 1995, the Warsaw Stock Exchange tended to be dominated by retail investors, who began to leave the market after heavy losses in 1994. Domestic institutional investors, such as banks and insurance companies, were mostly absent, as were foreign investors, who were largely deterred from entering the market between 1994 and mid-1995, owing in part to uncertainties stemming from political tensions between the president and the parliament.

With the government's decision to implement its mass privatization program in May 1995, these factors began to change. By year-end, shares in over 400 companies were added to the Warsaw Stock Exchange, a development that clearly contributed to improving the market's liquidity. Driven by strong foreign interest, in part resulting from 7 percent real growth in 1995 as well as sharply declining inflation, the Warsaw exchange saw its average daily turnover catapult from as low as \$21 million in late October to over \$46 million by May 1996. Moreover, the National Investment Funds are expected to help stimulate corporate restructuring by deepening the stake each fund has in the success of the companies in its portfolio. This too should add to foreign interest in Polish equities. In addition, Poland has the most stringent disclosure requirements of all countries in the region, obliging companies listed on the exchange to report not quarterly, as is typical elsewhere, but monthly. A new securities law in 1995, which

⁷³Wall Street Journal Europe, Central European Economic Review, February 1995, p. 32.

establishes strong penalties for securities offenses, such as the falsifying of information in prospectuses, has also helped improve investor protection rights.⁷⁴

Foreign involvement in the Warsaw Stock Exchange should deepen further by the decision of the government in early 1996 to allow foreigners to sell investment fund units, stocks, and securities with a maturity of more than one year up to an overall total of ECU 200 million (\$250 million) after obtaining permission from the Polish Securities Commission.⁷⁵ In addition, domestic residents are expected to be able to widen their portfolios, particularly toward the manufacturing sector, as soon as their certificates have been exchanged for shares in the fifteen National Investment Funds in 1997 and traded in an organized market.⁷⁶

The Czech Republic

The Czech stock market, by contrast, faces a rather different set of problems as it struggles to cope with over 1,700 listed stocks as of March 1, 1995, following the completion of the second wave of voucher privatization in February. With a market capitalization of over \$20 billion by May 1996--the region's largest--and an economy whose performance would suggest that the stock market should be strong, the Prague Stock Exchange faced notably slack demand for most of 1995. This was true as well for the market created at the same time for small investors, called the RM system. In large part, the sluggishness of these markets stemmed from the absence of a significant foreign presence in an environment characterized by inefficiency, fragmentation, and a lack of transparency. This situation began to change in 1996, as foreign

⁷⁴IMF, Private Market Financing, March 1995, p. 32.

⁷⁵"Poland to ease capital flows," Financial Times, March 28, 1996.

⁷⁶Creditanstalt, Central European Quarterly, II/96, p. 37.

investors returned to the stock exchange and were mainly responsible for the market's upward surge in the first half of 1996.⁷⁷

Nonetheless, market activity continues to be dominated by a handful of regularly traded companies--CEZ, SPT Telecom, and Komerční Banka--which account for more than 55 percent of the market's turnover (bonds account for 25 percent) and 57 percent of its capitalization. On average, only 677 issues trade daily, which is no more than 40 percent of the total 1,700 companies listed.⁷⁸ Added to these difficulties is the fact that voucher privatization basically created a large and fragmented body of shareholders but no active investors. The fifteen largest investment funds manage an estimated 40 percent of the assets distributed; many of these funds are owned by the country's major banks, which remain largely state-owned.⁷⁹

In addition, the bulk of share trading, 80 percent by some estimates, takes place outside the organized exchanges in over-the-counter markets, in part because settlement time is faster and in part because prices on the official exchanges are not allowed to fluctuate by more than a specified amount on any trading day.⁸⁰ Thus, public prices bear little relation to over-the-counter trades, leading to a serious lack of transparency that keeps away many domestic as well as foreign investors.

⁷⁷Creditanstalt, Central European Quarterly, II/96, p. 25.

⁷⁸Creditanstalt, Central European Quarterly, III/95, p. 11.

⁷⁹Pier Luigi Gilibert and Alfred Steinherr, "Changing Investor Base, New Instrument and the Adjustment Process in the Emerging Markets Crisis of 1994-95," Conference on Private Capital Flows to Emerging Markets after Mexico, Institute of International Education and the Oesterreich National Bank, September 7-9, 1995, p. 7.

⁸⁰Czech National Bank, The CNB Monthly Bulletin, No. 8, 1995, p. 4.

These weaknesses have convinced market participants and the authorities of the need for changes. In a fall 1995 initiative, intended to encourage market transparency, a group of brokerage firms agreed on a voluntary code committing them to report over-the-counter trades on a daily basis. In addition, in September 1995, the authorities introduced new measures to limit the number of stocks that can be listed on the main exchange and to improve disclosure requirements for all traded stocks. The plans call for a primary and a secondary exchange for listed stocks, plus a third exchange to function as a free market. Whether a company is listed on one of the main exchanges depends on the volume and amount of its shares that are traded publicly. Investment funds, too, are subject to similar requirements. Reporting requirements are far stricter for companies and funds that trade on the primary exchange, although disclosure requirements are imposed on all. Any company that fails to fulfill these conditions may be transferred to the free market.⁸¹

The authorities put in place two additional initiatives in early 1996. The first was the introduction of continuous trading on the Prague Stock Exchange of the exchange's five most liquid shares (SPT Telecom, Komerční Banka, CEZ, Česká Sportovní, and Komerční Banka Investiční Fund). This measure, which had been planned for over a year, is intended to facilitate market liquidity and may be followed by continuous trading in other issues before year end.⁸²

In addition, planned improvements in investor protection laws, which, among other things, require disclosure of those holding more than 10 percent in any company were also put in place in

⁸¹Creditanstalt, Central and Eastern Europe, Monthly Market Review, July 1995, pp. 2-3.

⁸²Creditanstalt, Central European Quarterly, II/96, p. 25.

April, when parliament approved an amendment to the country's securities act. Among its other provisions, the new legislation requires companies listed on the Prague exchange to publicize their annual results within three months after the end of their fiscal year at the latest as well as to provide semi-annual reports. Broadly, the legislation is intended to strengthen foreign confidence in the Czech markets and boost their transparency, which has lagged that of both the Polish and Hungarian markets.⁸³ Still left unaddressed, however, is the fact that most trades on the Prague Stock Exchange continue to take place outside the official markets, so that prices on the exchange often vary widely from those investors are paying.⁸⁴

In addition to its disclosure and investor protection requirements, the new securities legislation also provides for the possibility of transforming investment funds into different types of companies. Investment funds may not hold more than 20 percent of their assets in any one company. But if these funds elect to become managerial companies, which they may now do with the consent of three-quarters of their shareholders, they may be permitted to acquire majority stakes in Czech companies and, for the first time, to manage the assets of pension funds. This means as well that they are no longer subject to investment fund regulations and oversight by the ministry of finance. The new legislation took effect July 1.⁸⁵

As early as the fall of 1995, it was clear that foreign investors had begun to take note of some of these prospective stock market changes. In October, a U.S. investor opted to invest

⁸³Ibid., p. 25.

⁸⁴"Czech capital markets performed," Financial Times, April 26, 1996.

⁸⁵"The Czech Republic, The Second Time Around," The Banker, February 1996, p. 43; "Czechs plan tighter bourse rules," Financial Times, April 9, 1996.

\$140 million through a newly created investment fund, the Stratton Fund, which contributed importantly to the market's liquidity and was intended to give fresh impetus to corporate restructuring.⁸⁶ Moreover, in December, Bankers Trust, in an arrangement with Ceska Sporitelna, bought a forty percent stake in two Czech voucher funds, paying Kc 6.7 billion (\$252 million) in notes due in 2000, making this investment the largest single investment in the region's equity markets.⁸⁷ Finally, two principal U.S. investors in the Czech market agreed in July 1996 to create a joint investment vehicle targeted not just at Czech companies, but also at others in the region. With a net worth of roughly \$1.4 billion, the new company, Daventree, plans to seek stakes of more than fifty percent in companies in the region, before restructuring and selling them.⁸⁸

Issues of Czech, Polish, and Hungary Shares in Foreign Markets

Another source of equity flows, although far more modest than direct purchases by foreigners, has been the issuance of shares in foreign markets by Hungarian, Polish, and Czech firms between 1990 and 1994. Available IMF data show that Polish firms raised \$1 million in 1993 and Czech firms \$10 million in 1994.

Hungarian firms have been far more active. They issued shares abroad totaling over \$400 million between 1990 and 1994, roughly half of which were placed in 1994. The greater amount of share issuance abroad by Hungarian firms is explained in large part by the fact that

⁸⁶"U.S. investor revives Czech stocks," Financial Times, October 23, 1995.

⁸⁷"Bankers Trust to sell Czech shares to Western funds," Financial Times, December 18, 1995.

⁸⁸"Bermuda businessmen link to fund Eastern European groups," Financial Times, July 9, 1996; and "Investment marriage made in the Bahamas," Financial Times, July 10, 1996.

most securities listed on the Budapest exchange also trade in markets outside Hungary, primarily in Austria, Germany, and the United Kingdom. Of the forty companies listed on the Budapest Stock Exchange in March 1995, twenty-eight were also listed on foreign exchanges, accounting for 91 percent of the Budapest exchange's total capitalization at the time. In addition, foreign ownership accounted for 57 percent of the capital held by these twenty-eight companies, and in some of these companies it exceeded 90 percent. A few Hungarian shares also trade in the United States.⁸⁹

As for recent activity, the Czech Republic's Komerční Banka offered \$32 million in non-voting depositary receipts to international investors in May 1995,⁹⁰ and made available a second tranche a year later, bringing to \$140 million the total of the bank's shares held in global depositary receipts.⁹¹ Another Czech bank, Ceska Sporitelna, raised \$48.5 million in early June 1996.⁹² Two large Polish companies, Optimus and Mostostal Export raised \$14 million in the first half of 1995 by these means, while Bank Gdanski became Poland's first financial institution to offer shares to foreign investors through global depositary receipts as part of its privatization.⁹³ In July 1995, Hungary's OTP Bank completed an international private placement for 20 percent of its shares.⁹⁴

⁸⁹"Five Years of the Budapest Stock Exchange," June 1995. p. 6.

⁹⁰The Czech National Bank Monthly Bulletin, Number 8, 1995. p. 4.

⁹¹"Komerční banka in further GDR issue," Financial Times, May 13, 1996.

⁹²"Ceska Sporitelna raises \$48.5 million with GDR issue," Financial Times, June 3, 1996.

⁹³"Polish bank makes its debut in London," Financial Times, December 20, 1995.

⁹⁴"Stake Placed in Biggest Hungarian Bank," American Banker, July 10, 1995, p. 16.

CONCLUSIONS

It is not surprising that private capital has only recently begun to flow into the countries of Central and Eastern Europe. After all, 1994 was the first year since 1989 that all three of the countries examined here--Hungary, the Czech Republic, and Poland--began to see some of their liberalization and restructuring efforts bear fruit as each registered significant gains in real growth. Private inflows allowed the three countries to incur a combined current account deficit of \$16 billion over the 1990-95 period and to accumulate \$35 billion in reserves (Chart 14). By enabling these countries to run larger current account deficits than would otherwise have been possible, the capital inflows contributed to an improvement in the countries' living standards, "directly through a greater variety (and higher quality) of imports of final goods and indirectly through imports of high quality capital and intermediate goods."⁹⁵

Nevertheless, as has been widely noted in the literature, capital inflows also bring with them concerns, one of the most important of which is a potential loss in competitiveness in global markets owing to real exchange rate appreciation. Of course, countries have a variety of policy options to mitigate the effects of capital inflows on their domestic economies, but none is without drawbacks, whether sterilizing inflows, reducing fiscal deficits, or imposing temporary capital controls.

What is of fundamental concern is how the imported capital is ultimately being used. If the capital goes to finance current consumption, it fails to contribute to the productive capacity of the economy and therefore cannot promote growth in the long run. But if the capital goes primarily to finance investment, there are few reasons for concern, assuming the investment is

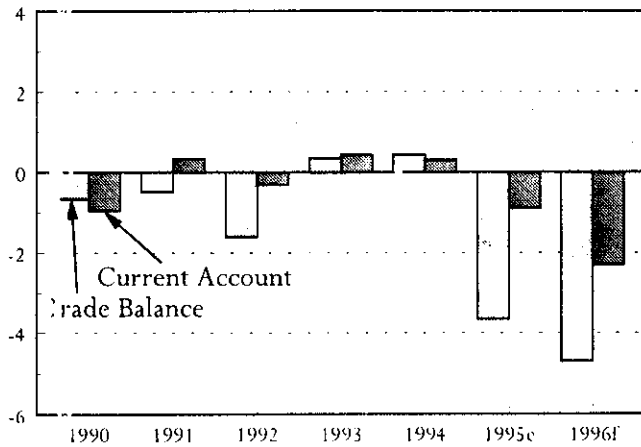
⁹⁵Calvo, "Capital Flows in East and Central Europe," p. 23.

CHART 14

EXTERNAL POSITION OF EASTERN EUROPEAN COUNTRIES

CZECH REPUBLIC

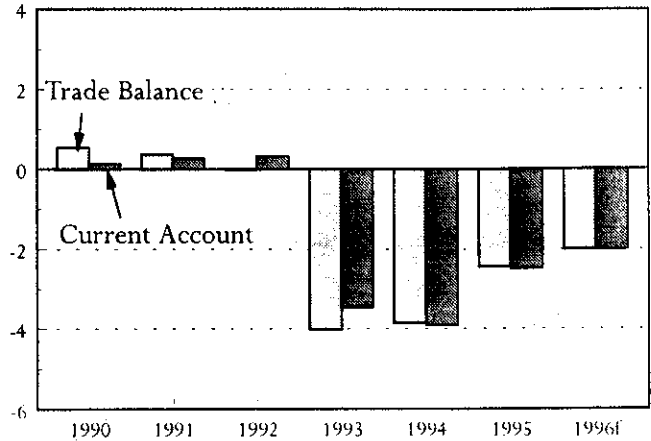
US\$ Li lions



Not: 1990 and 1991 data are for Czechoslovakia.

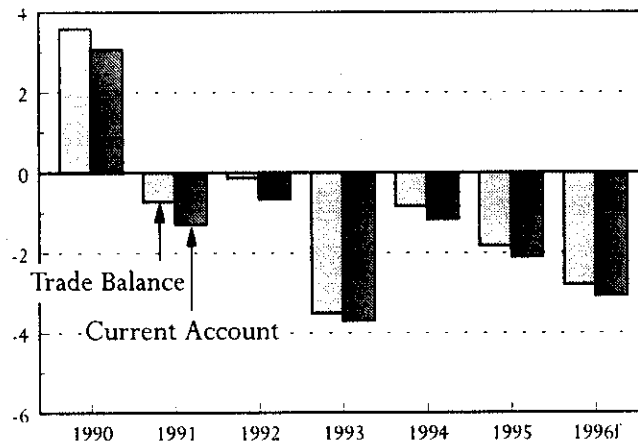
HUNGARY

US\$ Billions



POLAND

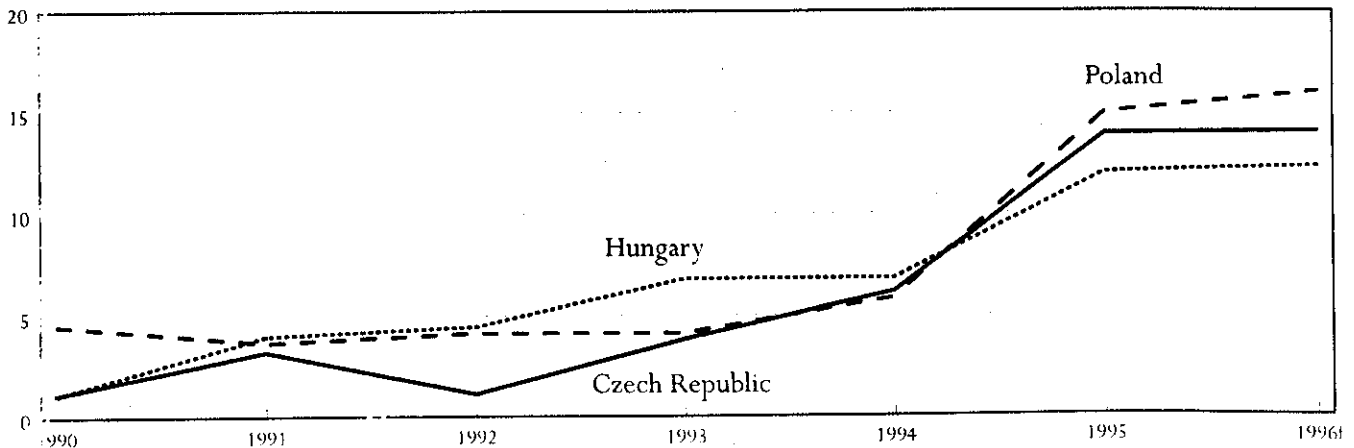
US\$ Billions



Trade figures exclude cross-border trade. If included, Poland's 1995 trade and current account balances are in surplus.

INTERNATIONAL RESERVES

US\$ Billions



Sources: Balance of Payments Statistics, Czech National Bank, National Bank of Hungary, National Bank of Poland, Economist Intelligence Unit/Datastream (forecasts).

productively used and improves export-earning capacity. By this means, countries are able to earn the necessary foreign exchange to service their ongoing borrowing.

To date, the evidence on the uses of imported capital by the Central and Eastern European countries is mixed. Saving and investment rates clearly fell in all three countries in the early years of the post-Communist economic transformation (Chart 15). This is to have been expected, as households were obliged to draw on savings to maintain consumption levels or avoid seeing too sharp a falloff in consumption in the face of widespread cutbacks in state subsidies.

There are indications that investment is beginning to increase, although the levels are still far below those that prevailed before the transformation process got under way, particularly in the Czech Republic and Poland. While all three countries currently face gaps between saving and investment levels--the current account deficit that must be financed with foreign funds--the gap for Hungary is the most pronounced.

What then should countries do if they wish to preserve the benefits of continued private capital inflows at the same time as they minimize the costs? The basic policy prescriptions are no less relevant for the countries of Central and Eastern Europe than they are for other developing countries. Avoidance of large external debt positions as well as attention to other aspects of macroeconomic stability reduces the risks of investing in these countries. To the extent that these reduced risks result in favorable credit ratings, countries may find their access to private capital eased and the price they must pay for it lower.

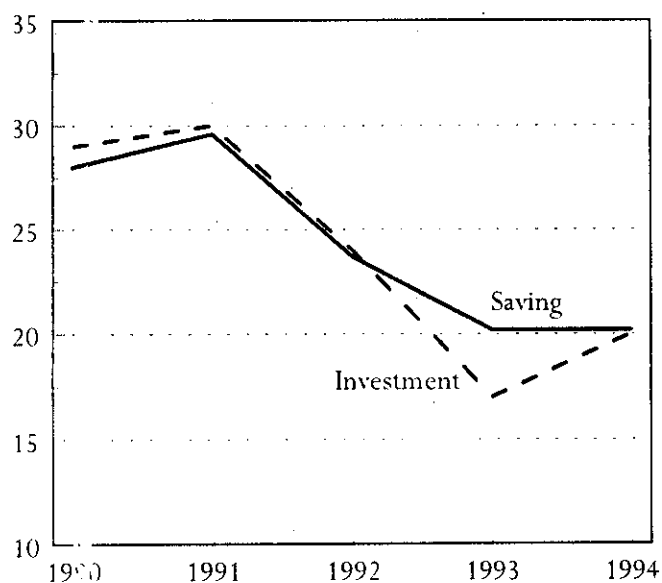
Structural reform remains crucial as well. Only with an infrastructure provided by a well-functioning banking and financial system will capital be allocated efficiently and money flow to its most productive uses. The amount of work that lies ahead for all countries in Central and Eastern

CHART 15

SAVING AND INVESTMENT RATIOS

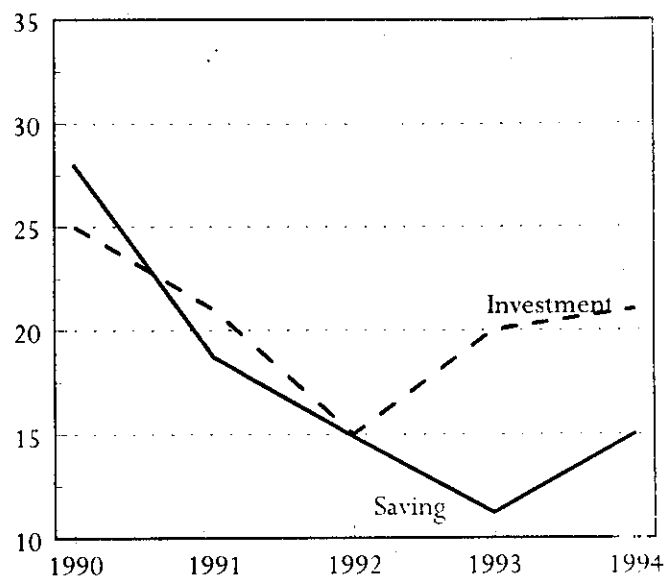
CZECHOSLOVAKIA

Percent of GDP



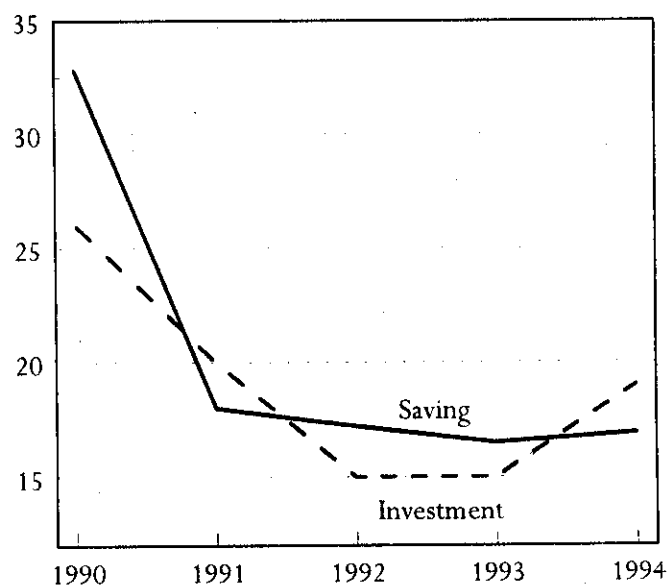
HUNGARY

Percent of GDP



POLAND

Percent of GDP



Europe in these respects will be a challenge for many years. Progress will require, among other things, modernization of telecommunications facilities, more efficient payment and settlement systems, recapitalization and privatization of the banking system, clarification of property rights, improvements in accounting and disclosure standards and investor protection laws, and development of sound supervisory and oversight institutions. Measures to boost labor mobility and improve pension systems are also needed.⁹⁶ All of these reforms of necessity require time. What is most significant is that for Hungary, Poland, and the Czech Republic, the initial steps seem to be well under way.

The fact that private capital has begun to flow into these countries, despite the many challenges that they yet confront, is a market vote of confidence in the potential these countries offer. If the countries, in turn, are able to hold firm to their course and not be swayed or felled by political backlashes, they stand to be the beneficiaries of potentially substantial inflows of private capital from abroad for many years to come.

⁹⁶See World Bank, From Plan to Market, World Bank Development Report 1996, June 1996.

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