Zur Homepage der Dissertation

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External Factors of Economic Growth in the Transition Economies of the Baltics and Central Asia

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Zusammenfassung

Im Kontext der zunehmenden Verflechtung von Volkswirtschaften können Außenhandel und Kapitalströme von besonderer Bedeutung sein, wenn die Wirtschaftswachstumsperspektiven der Länder in Betracht gezogen werden. Diese Aussage findet ihre Bestätigung in entgegengesetzten Wachstumsentwicklungen der baltischen und zentralasiatischen Transformationsökonomien, welche seit den frühen 1990er Jahren bedeutsame Änderungen hinsichtlich Wirtschaftsstruktur und Handelsmuster erfahren haben.

Unterschiedliche Wachstumsraten aufweisend, divergierten die Ökonomien dieser zwei Regionen in ihrer Entwicklung. Momentan beobachtete Variationen in Wachstumsraten sowohl zwischen als auch innerhalb der beiden Regionen dienen als Motivation für den Vergleich dieser Ökonomien, was deren Wachstumsdynamik, Außenhandel und Investitionsleistung anbelangt.

Diese Arbeit untersucht, welche Rolle externe Faktoren im Wirtschaftswachstumsprozess in den Transformationsländern des Baltikums (Estland, Lettland und Litauen) und Zentralasiens (Kasachstan, Kirgisistan und Usbekistan) spielen. Dementsprechend lautet die Leitfrage dieser Untersuchung: Sind die betrachteten Wachstumsratenunterschiede in den Transformationsländern des Baltikums und Zentralasiens auf unterschiedliche Entwicklungen in ihren externen Sektoren zurückzuführen?

Um diese Frage entsprechend zu beantworten, werden die Länder hinsichtlich der einzelnen zum Wachstum beitragenden Komponenten verglichen. Diese werden empirisch durch das Anwenden des Modells des durch die Zahlungsbilanz beschränkten Wachstums ermittelt. Mit der einfachen Version des Modells lässt sich die Wachstumsleistung der betrachteten Ökonomien mit deren Handelsverhalten, d.h. Exportkapazitäten und Importzwängen verbinden. Die erweiterte Version des Modells ermöglicht, die Wachstumsraten in deren Komponenten – den Effekt des realen Tauschverhältnisses, den Effekt des Exportwachstums und den Effekt der Kapitalzuflüsse – zu zerlegen.

Aus den empirischen Ergebnissen kann geschlossen werden, dass die höheren zu beobachtenden Wachstumsraten der baltischen Ökonomien – verglichen mit denen der zentralasiatischen Ökonomien – in der Periode von 1994 bis 2005 auf höhere Werte der Gesamtheit von Exportwachstum, Kapitalzuflüssen und relativen Preisentwicklungen zurückzuführen sind. Die Wachstumsunterschiede innerhalb der betrachteten Regionen können analog erklärt werden.

Ferner, ist davon auszugehen, dass die unterschiedlichen Ergebnisse hinsichtlich der angestrebten regionalen Integration bei der Erklärung der unterschiedlichen Wachstumsleistungen des Baltikums und Zentralasiens in Betracht gezogen werden sollten. Das Baltikum war erfolgreicher nicht zuletzt dank der geglückten Integration mit den Ökonomien der Europäischen Union. Zentralasien hat diesbezüglich hingegen weniger erreicht.

Abstract

In the context of increasing interrelatedness of economies, foreign trade and capital flows may prove crucial when considering their growth perspectives. This assertion is corroborated by contrasting growth experiences of the Baltic and Central Asian transition economies, which have undergone significant transformations in terms of their economic structure and trade patterns since the early 1990s.

Exhibiting different growth rates, the economies of these two regions have diverged from each other. Currently observed variations in growth rates both across and within the regions in question provide a rationale for comparing these economies in terms of economic growth dynamics and foreign trade along with investment performance.

This dissertation inquires into the role external factors play in the process of economic growth in the transition economies of the Baltics (Estonia, Latvia and Lithuania) and Central Asia (Kazakhstan, the Kyrgyz Republic and Uzbekistan). Accordingly, the main research question is whether observed differences in growth rates across the transition economies of the Baltics and Central Asia may be attributed to diverse developments in their external sectors.

To provide a proper answer to the above question, the economies are compared in terms of their growth constituents' contributing shares. These are defined empirically through employment of the 'balance of payments constrained growth' model with its basic and extended versions. The basic version of the model enables to link growth performance of the considered economies with their trade behaviors, embodied in exporting capacities and necessity to import. The model's extended version makes possible to break down growth rates of the economies into their constituents – the effect of real terms of trade, the effect of exports growth and the effect of capital inflows.

Deriving from empirically obtained results, it may be inferred that higher growth rates observed in the Baltic economies – compared to those in the Central Asian economies – in the period from 1994 to 2005 are due to larger values of a compound of exports growth, capital inflows and relative price developments. Growth differences within the regions concerned are explained in a similar manner.

Moreover, it is suggested that contrasting outcomes of their endeavors in fostering regional integration processes should be taken into consideration, when explaining differences in growth performance of the Baltics and Central Asia. The former performed well, not least due to its succeeded integration with the economies of the European Union. The latter has attained rather negligible results on this front.

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Acronyms

ADB	Asian Development Bank
BFTA	Baltic Free Trade Agreement
BPCG	balance of payments constrained growth
CAEC	Central Asian Economic Community
CAP	common agricultural policy
CAREC	Central Asia Regional Economic Cooperation
CAU	Central Asian Union
CBA	currency board arrangement
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
COMECON	Council for Mutual Economic Assistance
EAEC	Eurasian Economic Community
ECA	Europe and Central Asia
ECO	Economic Cooperation Organization
ERM	European Exchange Rate Mechanism
EU	European Union
EU-15	European Union before the 2004 enlargement
FDI	foreign direct investment
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IMF	International Monetary Fund
ISI	import substitution industrialization
MFN	most favored nation
NEG	new economic geography
R&D	research and development
RTA	regional trade agreement
SCO	Shanghai Cooperation Organization
SDR	special drawing rights
SPECA	Special Program for Economies of Central Asia
TFP	total factor productivity
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

Introduction

In the field of economic research, the place of issues related to economic growth and development has always been a special one. Currently dominating theoretical approaches emphasize various aspects of growth and development. For instance, the neoclassical growth model stresses the importance of accumulation of production factors along with an exogenous nature of technological progress (e.g. Solow, 1956). Theories of economic development set a stress on structural characteristics of an economy, which determine its growth perspectives and resulting character of its interaction with other economies via trade (Prebisch, 1950; Singer, 1950). Models of endogenous growth in their turn emphasize the innate trait of technological progress in the process of accumulation of factors of production, where human capital's role is deemed essential (Romer, 1986; Aghion and Howitt, 1998).

In view of growing interrelatedness of economies, special attention should be paid to an element of their openness, which is apt to influence their growth dynamics and development paths (Romalis, 2005). Interacting in numerous ways, economies may exert influence upon each other's growth patterns through trade links (Ventura, 1997; Arora and Vamvakidis, 2004) or other channels, which may comprise capital movements (Borensztein et al, 1998; Cuadros et al, 2001), migration of labor resources along with technology and knowledge flows (Kuznets, 1966). This implies that an economy's external sector may be of great significance, when its growth prospects are drawn into consideration.

Since the onset of transition processes across the region of Central and Eastern Europe and the Former Soviet Union in the early 1990s, the issues related to economic growth and its external determinants have come to the fore anew, for this economic transformation implied a reintegration of these economies into the world trading system (Michalopoulos, 1999) along with significant changes in terms of their external sectors (Sachs and Warner, 1995).

Thus, significant alterations in terms of their output composition, economic structure and, therefore, geographical distribution in conjunction with structural make-up of trade flows in the countries of Central and Eastern Europe (Caetano, 2005) and the Former Soviet Union (Havrylyshyn and Al-Atrash, 1998; Elborgh-Woytek, 2003) have occurred throughout transition period. These two country groups have proved

rather heterogeneous in terms of the economies' performance since the onset of transformation (Svejnar, 2001).

The regions of the Former Soviet Union have performed differently throughout transition in terms of the pace of implemented reforms (De Broeck and Koen, 2000). For instance, the Baltic states have been quick in overcoming numerous shortcomings in their economic structure and stood out for a rapid pace of implemented reforms (Shen, 1994) setting on the course of accelerated reorientation of its trade flows and attracting foreign investment from abroad (Sorsa, 1994, 1997).

Differing considerably in terms of transformation paths, the economies of Central Asia, in contrast, have attained rather moderate results since they have embarked on their transition (Åslund, 2003). The region's performance stands in rather stark contrast to that of the Baltics in many respects. In terms of the pace of implemented reforms, output recovery and institutional transformation the countries of Central Asia are second to those of the Baltics (Berg et al, 1999).

Observed differences across these two regions in their initial conditions, taken paths in reforming their economies along with attained results throughout transition may prove a sensible rationale for a comparison at both regional and country levels. What is more, thorough consideration of their contrasting growth patterns may help shed light upon significant determinants of growth. Among determinants of the two regions' economic growth external ones should be considered important in view of the small sizes of the economies concerned.[1]

Furthermore it may be assumed that observed differences in the growth performance of the Baltic and Central Asian economies are to some degree attributable to their external sectors' differing performance. Therefore, one of the principal objectives of the work is to reveal the contribution of external factors into economic growth of the Baltic and Central Asian economies. To put it differently, this work will inquire into the question, whether existing differences in growth rates of the Baltic and Central Asian economies may be explained through differing outcomes of their foreign trade and investment activities.

To provide an appropriate answer to the above stated question, a suitable method is to be employed. It is suggested that the so called 'balance of payments constrained

[1] This feature has been proponed and thoroughly discussed by Kuznets (1966).

growth' framework would deliver well in this case, since it enables to take a closer look at the workings of growth in conjunction with foreign trade and capital flows.

The present thesis touches upon an array of diverse aspects, which include – but are not limited to – growth and development, economic transition, importance of an economy's external sector and integration issues. It provides a review of theoretical fundamentals of growth and development concepts, covers an array of issues related to foreign trade and openness. In addition, these issues are investigated in the context of transition economies.

Furthermore, an application of the 'balance of payments constrained growth' framework to the realities of transition economies may be considered as another unassuming contribution of this work.[2] In addition, it expands by this time large and diverse literature on the importance of external conditions for an economy's growth dynamics, economic growth in the context of transition economies, comparison of economies' growth performance at both country and regional levels.[3]

The thesis has got a somewhat unconventional structure (See Figure 0.1), which is yet subordinate to the main logic of the material that is to be covered to attain the main objective of this inquiry.

Thus the work is organized as follows. *Chapter 1* focuses on theoretical basics of growth and development (section 1.1), the role of trade in the process of development (section 1.2) and economic growth in an open economy (section 1.3).

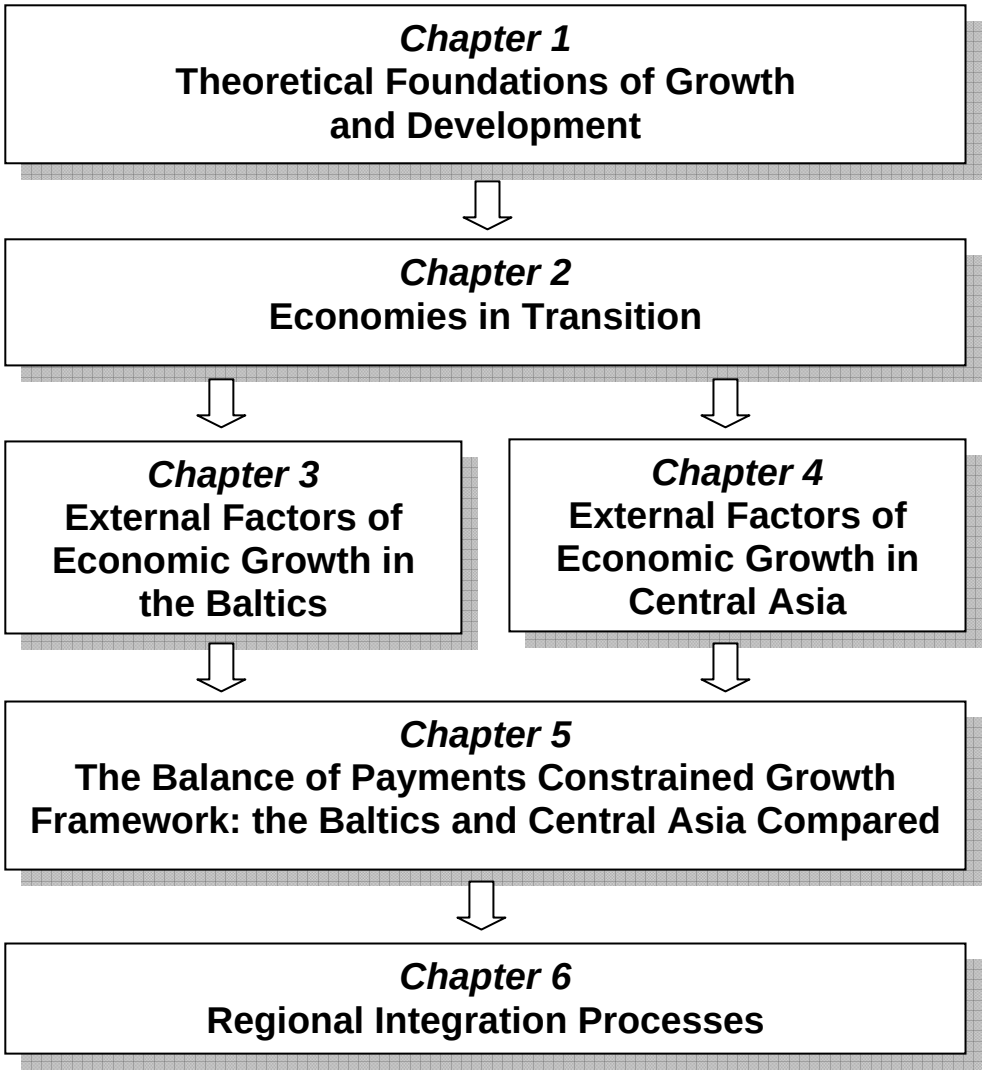
Chapter 2 first deals with the issues related to economic transformation in the countries of Central and Eastern Europe and the Former Soviet Union (section 2.1); it then shifts the focus to the economies of the Baltics (section 2.2) and Central Asia (section 2.3).

Chapter 3 narrows the scope of inquiry further and provides a comprehensive description of external determinants of growth in the economies of the Baltics – Estonia (section 3.1), Latvia (3.2) and Lithuania (3.3). Each of the sections depicts in details external factors such as trade, capital flows along with other external factors of economic growth in the countries concerned.

[2] Thus far primarily due to data issues, most of the works have focused on developed and developing countries. See, for instance, McCombie and Thirlwall (2004).
[3] This method was favored by Kuznets (1949) when considering determinants of and explaining differences in growth rates.

Chapter 4, being identical to the preceding one in terms of its structure and content, shifts the focus to the economies of Central Asia. The chapter first considers external factors of economic growth of Kazakhstan (section 4.1), then moves to those of the Kyrgyz Republic (section 4.2) and closes with a detailed description of Uzbekistan's external sector developments (section 4.3).

Figure 0.1 Structure of the work



Chapter 5, while drawing into consideration the 'balance of payments constrained growth' framework, aims at providing a comprehensive comparison of the economies of the Baltics and Central Asia both at country and regional levels in terms of their external factors' contribution to economic growth. Presentation of theoretical foundations of the 'balance of payments constrained growth' framework (section 5.1) is followed by an empirical part (section 5.2). A comparative analysis (section 5.3) along

with policy implications of the economies of the regions (section 5.4) make up the concluding part of the chapter.

Chapter 6 concentrates on integration processes in both regions. Integration of the Baltic economies with those of the European Union is covered first (section 6.1); these are then followed by a part devoted to the regional integration processes in Central Asia (section 6.2).

Conclusion provides a concise outline of the issues discussed in the chapters of the work.

Chapter 1 Theoretical Foundations of Growth and Development

The present chapter covers an array of issues related to theoretical underpinnings of economic growth and development. Its opening part focuses on theoretical concepts of growth and development (section 1.1), which is then followed by a part devoted to a set of issues of trade and development (section 1.2), whereas matters related to growth issues in the context of an open economy are covered in the chapter's closing part (section 1.3).

1.1 Growth-theoretical approaches

1.1.1 General background

The world economic system is to be considered as a patchwork rather than a picture comprising relatively uniform elements, for it is made up from countries that differ from each other in many respects. Presently, economies exhibit fairly diverse characteristics, as regards their structure, supplying capacity, participation in the international labor division, etc. Living conditions have diverged greatly across countries over time not least due to a stubborn work of the compounding effect resultant from output increments.

Numerous theorists of the past epochs have been trying to solve the puzzle of the determinants of human-being's welfare. In the course of recent decades the term of economic growth has become a catchphrase among economists and practitioners. This fact is to be considered as no wonder for the phenomenon of economic growth exerts direct influence on the living conditions of the people dwelling in all countries irrespective of their current state of development. Thus, developing economies, which make up about four-fifth of the world's population, see economic growth as an indispensable means of improving the well-being of their residents. In addition, experience of many developed countries shows once anew that economic growth has been the main source of welfare growth, which has taken place in these economies in recent decades.

The body of this research field has expanded rapidly especially in the last two decades. An impressive amount of works of scholars devoted to the issues of growth and development prove the statement yet again that these issues occupy one of the central stages of economic theory and praxis. Since the phenomenon of economic growth is rather multifaceted containing a variety of aspects, it is no surprise that there are numer-

ous approaches to the issues related to it. In fact, each of these approaches stresses one of many aspects of economic growth. Thus, there are schools of economic thought that stress, for instance, the importance of accumulation of factors of production (e.g. physical capital or labor resources) (Solow, 1956), another school would emphasize an important role human capital plays in the process of economic growth (Romer, 1986; Aghion and Howitt, 1998); yet another school would highlight the importance of institutions and geographical issues (Acemoglu, 2003).

Significance of economic growth may be inferred from the fact that it is considered as one the principal objectives of economic policy due to its capability to facilitate easier attainment of other goals, such as higher employment rates or lower inflation. What is more important, however, is its ability to improve living conditions and increase the level of well-being of people in poverty-stricken areas. Not coincidentally, the notions of sustainable growth and development have lately got much attention. These imply that economic progress is achieved only then, if growth is brought about in line with social and environmental concerns.

Growth and development

A clear distinction is made between growth and development in the economic literature. This distinction whereby growth is to be considered as a quantitative increase of income (usually expressed either in GDP or GNP) per capita, whereas development has a qualitative dimension and is associated with institutional and structural changes.

However, numerous economists, mainly representing the modern mainstream, do not draw a clear dividing line between these notions and are often inclined to treat these as conceptually interchangeably. In their works, for instance, Rostow (1953) and Kuznets (1966) held these two concepts synonymous. This fact is to be explained by the focus of the neoclassical methodology primarily on the static character of analysis, in accordance with which a considered economy is deemed stable with relatively stable variables. Hence, it becomes evident that static analysis is concerned with transformations within a structure but not with structural changes, whereas dynamic analysis, in contrast, focuses rather on the progression of structural transformation, the process during which one structure gives way to another (Brinkman, 1995).

Furthermore, Ray (1998) points to a wider scope of ‘development’ compared to ‘growth’. According to his view, most of the developing economies are trying to accomplish their development what most of the developed countries have already done.

Development, therefore, implies structural evolution of an economy, where primarily qualitative aspects of this process are stressed. By contrast, the term of economic growth emphasizes nominal increments of a county's output and income.

Definition and measurement

Economists habitually use real per capita income to measure how well off residents of a given country are. No doubt, people also are inclined to care about other matters besides the income at their disposal, which secures certain level of their consumption. These typically include democratic liberties, education and health issues, environmental concerns and patterns of income distribution within the country concerned. Therefore, a fine yardstick of living standards has to account for a rather wide array of aspects. However, most of them would be hard to measure and prove rather cumbersome.[1] Therefore, economists use for the most part real per capita income, although it is itself an aggregate indicator that is incapable of displaying subtler details of life quality of a country's residents.

Income levels and income growth rates

How fast the well-being of residents in a given country changes across time is also a matter of concern to economists. In this case the growth rate of per capita income is apt to give a clear picture. This is the very place where economic growth wields direct influence upon living conditions of the country's residents, since it is defined by the rate of change of real per capita income. As stated earlier, even very small differences in rates of per capita income growth lead to quite impressive differences in their levels over time.

To capture the workings of compounding effects, economists often use the so called 'rule of 70', with the help of which it is possible to calculate the time required for an economy's per capita figure to double. For instance, if per capita income grows steadily at the rate of 2 percent annually, it will take approximately 35 years this economy to double the existing incomes of its residents; whereas a country growing twice as faster would double the incomes in just 17 to 18 years. This diminutive description makes evident that even quite small differences in growth rates could change over time the welfare landscape drastically.

[1] For instance, the United Nations Human Development Index (HDI) represents a compound of equally weighted income, health and education (Mazumdar, 2003).

1.1.2 Concepts and approaches

The classical school

Currently dominating theoretical approaches have been developed upon the concepts put forward by scholars of the past. These concepts, building the bedrock of today's theory of growth and development, reflect general economic developments of the time, as they had been developed. Being in one or another manner related to the mechanics of economic growth, their insights continue to shape modern research in this very field.

Smith (1776) was one of the first scholars to stress the importance of competition and division of labor as needed requirements for accumulation of physical capital, leading towards higher productivity (either through employment of a more advanced technology or increase of efficiency in using the present one). Furthermore, he emphasized the importance of institutional frame (e.g. property rights on the means of production, certain degree of property protection, etc.) in the process of development and growth.

Other scholars (e.g. Malthus, 1798; Ricardo, 1789; Marx, 1867) paid increased attention to an important role distribution of material affluence (embodied in produced goods and means of production) may play in the process of economic growth and development. Furthermore, with their concepts of absolute and comparative advantage, Smith (1776) and Ricardo (1789) accentuated the importance of international trade for nations' growth dynamics. Hence, foundations of the theory of growth and development have been laid by a number of distinguished scholars representing the classical school of economic thought.

Neoclassical growth models

With the onset of the neoclassical (marginalist) revolution in the last quarter of the nineteenth century, scholars shifted their attention from ample macroeconomic issues of growth and development towards narrower problems of efficient utilization of resources within a given institutional organization. This far-reaching shift of focus induced the issues of growth and development to disappear from the central stage of economic research, until they got once anew plenty of attention from a number of leading economists in the second third of the twentieth century. Upon assisting economies to abscond from quagmires of the Great Depression, economists started again to focus on a wide array of issues related to growth. The growth model forged by Harrod (1939) and Do-

mar (1946) along with the growth theoretical framework conceived by Solow (1956) and Swan (1956) became an outcome of these endeavors.

Harrod-Domar model

In the 1940s, Harrod (1939) and Domar (1946) independently from each other offered their explanations of the cumulative growth process. Since then this model has been extensively utilized by economists active in development economics to explain an economy's growth rate in terms of the level of savings and capital productivity (Hosseini, 2003). Although the model was first devised to analyze business cycles, it was later adapted to explain the workings of economic growth. The following statements express the model's main implications: i) economic growth depends on the abundance of labor and capital, and ii) higher rates of investment lead to capital accumulation, which in their turn trigger production growth.

The model envisaged that the equilibrium growth rate was very instable. Once the economy does not grow at exactly the rate anticipated by investors, who in their turn depend on the savings within the economy, then it is inclined to grow either too fast, causing higher inflation rates, or too slow, resulting in increased underutilized capacity and higher unemployment rates.

To fix this kind of problems, the government intervention in form of state indicative planning and built-in stabilization measures is required. The main policy implication was to thus to increase the level of saving and investment[2] and place investment efficiently to further technological progress. The Harrod-Domar model was the forerunner to the exogenous growth model, devised by a number of economists representing the neoclassical school of thought.

Solow-Swan model

The exogenous growth model, which aims at explaining economic growth in the long run, has become a result of contributions of a number of neoclassical economists who intended to fix a few irregularities envisaged by the Harrod-Domar model's framework. The exogenous growth model, elaborated primarily by Solow (1956)[3] and Swan (1956), has become a workhorse model for numerous empirical studies devoted to the issues of growth in the long term.

[2] It is alleged that all savings are transformed into investment.
[3] In 1987 Solow was awarded a Nobel Prize in Economics for his contributions to the theory of economic growth.

The model has embraced its predecessors' features and offered a number of improvements in its theoretical body. In contrast to the Harrod-Domar model's framework, the Solow approach has introduced labor as an additional production factor, and implies that returns to labor and capital diminish, and the state of technology varies over time. While considering the bedrock of the Solow model, the following points should be mentioned: in the long run growth rate of an economy is determined exogenously and is supposed converge to its steady state, which depends upon the rate of technological progress and the growth rate of its population.

One of the main inferences to be made is that economies less well endowed with physical capital per capita are likely to exhibit higher growth rates of income in comparison with nations possessing large stocks of physical capital, provided rates of saving and investment along with growth rates of population remain invariable over the considered period.

Theories of economic development

Most of the previously devised models aspired to focus on the issues of growth in the capitalist economies with their already established and well functioning institutional framework. However, with the reconstruction in Europe in the 1950s being completed and the emergence of the new independent states in Africa and Asia, more and more economists began raising issues of development in the underdeveloped part of the world.

In the wake of such developments, Rosenstein-Rodan (1943), Nurkse (1949), Hirschman (1958), Lewis (1949) and Rostow (1960) were among the first economists to embark upon the 'quest for growth' in the less developed world. Being for the most part of practical character, their theoretical works put an emphasis on the more practical and historical approach towards the issues of growth and development in the less developed regions of the world.

Generally, these theoretical frameworks reckoned that the workings of growth were not that difficult and catching up of the less developed parts of the world with its richer ones was supposed to be a matter of time. In the course of their development societies were deemed to go through certain stages, which included 'preconditions for take-off', the take-off, 'drive to maturity' and 'the age of affluent consumption' (Rostow, 1960).

Furthermore, industrialization was reasonably assumed to be the force capable of triggering and sustaining the process economic growth along with required structural changes. One of the ways to implement such changes was the scheme of 'big push' (Rosenstein-Rodan, 1943), which envisaged large-scale industrialization via parallel implementation of copious investment projects capable of furthering synergetic interaction between and across affected sectors. In this process, state was supposed to coordinate the increase of capital invested and utilized in an array of industries and provide further support, for instance, in form of 'infant industry' policies (Nurkse, 1949). Thus, via proposed balanced growth these schemes aimed at attaining a match of supply of a significant number of industrial branches with a large-scale increment of demand initiated by this expansion.

A slightly differing approach has been offered by the so called 'unbalanced growth' option, which implied creation of disequilibria in the economy by redistributing resources across its sectors (Hirschman, 1958). This should lead to bottlenecks, which, in general, generate incentives for investments into disadvantaged sectors. In this context, the workings of backward and forward industrial linkages[4] are supposed to facilitate of intended attainment of the intended structure of an economy, the former of which implied linkages of a sector to its suppliers, the latter meaning linkages of a sector to sectors demanding its output.

Furthermore, implementation of structural changes along with economic development are in part favored by the dualistic character of the economies of the developed world. The dualistic character of developing economies, implying the existence of relatively weakly interacting sectors (agriculture and industry), harbored certain opportunities for an appropriate implementation of structural changes required for the take-off of these economies (Lewis et al, 1949). Reallocation of labor resources from agriculture to industry suggests that with costs and prices for industrial products remaining low, further accumulation of physical capital in the industrial sector seems no difficult task. This scheme is considered to be an appropriate way to escape poverty and attain higher living standards.

[4] Backward linkages are linkages of a sector to its suppliers, whereas forward linkages represent its ties to sectors demanding its output.

Institutionalism

Representing another approach to the issues of economic development, institutionalism emphasized the importance of institutional constituents (embodied in the form of production organization, legal framework, educatiosn, culture, etc.) of the process of economic development. In general, these constituents were seen as determinants and outcomes of the development process at the same time. In addition, development was seen to be interrelated with diverse aspects of societal life.

Against this background, being closely linked to the character of social stratification, distribution patterns of affluence in societies was inclined to influence the demand structure prevalent in the economy. This in turn determined behavioral along with consumption patterns and, hence, gave further impetus and directions of production patterns (Veblen, 1915). In addition, the nature of interaction between economic actors was deemed crucial for further paths of economic development. Defined by institutional arrangements, such interactions determined final outcomes of individual or cooperative endeavors (Commons, 1934).

Such differences across regions in terms of their institutional frame are to be seen as main determinants of existing differences in economic development. In the course of time, gaps between regions may increase or decrease depending whether spread or backwash, effects stemming from their interaction with each other, are in place (Myrdal, 1949). Transformation of 'attitudes and institutions' is considered as one of the surest ways to accelerate development in poor regions. This is attainable through fundamental institutional transformation. This kind of institutional transition has to be accompanied, however, by appropriate changes in knowledge and technology, what presupposes a proper expansion of education capable of increasing the stock of human capital[5] (Ayres, 1944).

Theories of endogenous growth

In the 1980s the emergence of the so called endogenous growth theories proved to be natural, since previously devised theoretical frameworks could not explain starkly differing patterns of economic development of the economies of South-East Asia and Latin America. Aspiring to cope with this task, theories of endogenous growth shifted focus to a number of other important aspects of economic growth.

[5] The new growth theory has extensively stressed this feature.

Thus, these models put an emphasis on the innate character of technological progress in the growth process, in which the role of human capital is deemed essential (e.g. Romer, 1986; Lucas, 1988; Aghion and Howitt, 1998). Furthermore, while rejecting the neoclassical assumption of diminishing returns to capital and labor, the endogenous growth theories posited that a larger share of investment in human and, in part, physical capital was likely to bring about externalities and synergies leading towards higher growth rates. Consequently, physical capital accumulation was not seen as a dominant determining factor of economic growth. Therefore, an appropriate expansion of education along with R&D was considered as a required condition for sustaining appropriate high growth rates in the long-term perspective, which would enable to sustain growth rates in the long run, while setting free spillover effects and, thus, obviate diminishing returns.

1.2 Concepts of trade and development

> The causes which determine the economic progress of nations belong to the study of international trade…
>
> Marshall (1890)

1.2.1 General background

Throughout history trade has been playing an indispensable part in the process of economic growth and development. Rich countries of nowadays owe a good deal of their affluence to the trade they used to conduct and continue doing so with other regions of the world. No rich nation of nowadays has become such without undergoing the industrialization process and being involved in international trade. Due to differences in resource and factor endowments, nations always had and have to conduct trade to keep their welfare levels higher than they otherwise would have been.

When considering the development issues, one naturally takes into consideration the countries that underwent substantial transformations in terms of their economic structure. This is valid for the earlier stages of what is now developed world presently comprising industrial countries of Western Europe and, slightly later, its offshoots, Pa-

cific Rim, most of today's transition economies (formerly COMECON economies), and most recently in China, Vietnam and South Asia.

At the outset of the nineteenth century the industrializing countries managed to trade their industrial products in exchange for cheaper primary products (food, raw materials, etc.) and further develop their production facilities. Providing an outlet for their abundant resources and agricultural products, the regions constituting the periphery of that time have also benefited from the very exchange and maintained relatively high per capita incomes.

It is also apparent that trade facilitated and contributed substantially into an establishment of currently existing patterns of production and specialization. By and large, in line with these patterns economic structure and the make-up of exports in developed countries are dominated by industrial goods and services, whereas developing countries' economic structures are still dominated by primary products (Grilli and Salvatore, 1994). This notwithstanding, poor economies should not give up their trade links with other economies, but instead try to rearrange their currently existing trade patterns to be able to accrue gains from their participation in the international labor division. Therefore, developing economies should not seek answers to the question whether to trade or not to trade. Instead they should be concerned with the question in what and how to produce and trade.

Furthermore, it is manifest that in the process of industrialization international trade is assumed to have played a significant role, since it would have been impossible to increase substantially productivity levels of newly established industrial sectors just orienting to domestic markets. There is a significant rationale for changing an economy's structure and trade profile (Grilli and Salvatore, 1994). As a matter of fact, countries that produce and export predominantly goods of primary sectors and, therefore, have to import a set of industrial goods tend to experience instabilities in their terms of trade. Consequently, industrialization should be seen as a means to achieving and creating a more robust economic structure with trade patterns capable of securing higher income levels of an economy's residents.

In general, development implies a significant transformation of the economic structure. A general scheme implies that the agricultural (primary) sector gives way to the industrial (secondary) and services (tertiary) sectors in terms of value added and employment. Consequently, this process is accompanied by an appropriate migration of

labor from the country side into urban sites. Successfully completed industrialization is supposed to induce productivity gains in all sectors implying higher incomes and improved living standards. Further transformation of an economy leads even to higher paths of development implying further reallocation of resources in favor of the tertiary sector. To maintain that an economy undergoing such kind of transformation processes is secured from adverse price developments of its exportables and importables, appropriate alterations in its patterns of production and exports seem expedient.

It would be shortsighted to reckon presently existing export structure of trading countries to be unchangeable and perpetual reflecting an optimal organization of and participation in international labor division, as envisioned by Ricardo (1789) in the theory of comparative advantage. Instead, the existing patterns of trade links are to be considered as just one state of affairs in a long series of actions.

As shortly mentioned in the previous section, it was the rural migration that enabled to foster industrialization and establish tight links between economy's formerly non-interacting sectors. Since most of developing economies were dominated by the traditional sector with substantial labor reserves, there were impressive potentials hidden within these economies, which could be naturally freed and realized through the intermediary of international trade. Trade was supposed to assist developing nations to create dynamic comparative advantage in labor-intensive manufacturing based on their lower wage levels (Lewis et al, 1949).

1.2.2 Industrialization and trade

The above described scheme reveals the workings of a tense interaction of trade and industrialization occurred in an evolutionary manner (i.e. happening 'naturally' through market mechanisms). Most of Western European economies along with their off-shoots got industrialized in this manner (Kuznets, 1973). By contrast, the experience of newly industrialized economies of South-East Asia provides an example of such transformation implemented via wide state engagement. This in turn implies that industrial transformation may be conducted at a rapid pace (e.g. Kuznets, 1994).

In general, the process of industrialization may be implemented in accordance with certain schemes, which, as a rule, comprise several stages. Hence, an appropriate timing and right sequencing of these stages are indispensable if an economy's industrialization endeavor is to prove successful.

Nations that successfully pursued industrialization made use of import substitution industrialization (ISI) measures to expand their domestic industrial sectors.[6] With this strategy in place, domestic production replaces a number of imported goods. Typically, in the initial stages ISI touches upon the production of fairly primitive non-durable items requiring undemanding technologies (Alavi, 1996).

Since employed technologies in such sectors are deemed unchallenging and relatively labor-intensive, no significant obstacles are likely to hinder the process of absorption of labor force from rural areas. Therefore, the initial stage of ISI should be viewed as a start in creating new comparative advantage in more promising kinds of production, which would bring certain gains in productivity and income growth.

Hence, ISI brings the transforming economy into a stage, where higher standards of living may be attained due to ever evolving industrial structure, significant changes in the employment of labor resources and altering patterns of exports and imports (Kuznets, 1973). To establish new comparative advantages in certain types of production, any society has an array of inputs at its disposal, which make up resource endowment of a given economy.

Furthermore, every nation is able to increase the stock or upgrade the quality of its reproducible factors of production. This is valid, in particular, for human capital, technology and physical capital, whose structure, quality and quantity are exposed to permanent changes. It is also quite obvious that the government policy may exert certain influence upon the evolution of the resource endowment of a nation (Weiss, 1994). Therefore, it is a high priority of public policy to maintain appropriate composition and quality of inputs that would enable to attain and retain the competitive edge in certain types of production and, thus, secure higher living standards. When implementing policies of industrialization based on import substitution, countries often employ a number of instruments to manage and sequence the process of transformation. These may include tariff protection, undervalued exchange rates, managed credit allocation, planned government procurements, tax incentives for training and investment, etc.

The first stage of ISI itself brings potential gains that could pave the way for further steps on the transformation path of an economy. Thus, this stage of ISI facilitates job creation and assists in upgrading human capital, which could prove crucial for fur-

[6] Great Britain that was the first nation to industrialize was an exception, since there were no economies from which the newly established industries were to be protected.

ther positive externalities across various sectors of the economy. What is more, throughout this phase of industrialization indispensable entrepreneurial skills are acquired, which in their turn may positively influence business ethics and habits.

The first stage of ISI enables countries to move to a higher level of economic development. Upon completing the initial stage of industrialization an economy reaches a point, after which there are two different paths. One of these paths promises greater potentials for further dynamic effects resulting from physical and human capital accumulation. The other path lessens such potentials for continued and sustainable economic development. It is worth noting that this stage provides only limited opportunities for development, since diminishing returns in the sectors affected by import substitution policies pose constraints for further expansion of an economy. In this case, industrial expansion, which is required for further economic development, is likely to be just limited to the population growth and its purchasing power expansion.

In addition, during and immediately after the first stage of ISI, the composition of imports changes in favor of more sophisticated investment products, which an economy cannot produce yet but needs them to have its industrial sector run. Therefore, the dependence of an industrializing economy on trade with other nations is deemed even more intensified. With this necessity to switch to imports of more capital-intensive products, an economy undergoing industrialization deals with foreign exchange shortages. Either because of rather instable prices of their primary commodities or due to steadily unfavorable development of their terms of trade, the exports revenues of these economies are not likely to cover the whole scope of imports that the economy requires for sustaining its further development.

It is possible to do away with the shortage of foreign exchange either through first-stage export promotion or second-stage import substitution. Either of the ways taken leads to fairly different outcomes in terms of a country's industrial structure, patterns of its exports and imports, the 'balance of payments' issues, and long-run development perspectives. It should be also noted that almost all economies that successfully completed their industrialization and development processes went through both of the proposed strategies. It's expedient to find an optimal sequencing of both.

Upon elimination of infant-industry tariffs, formerly infant industries can opt to export their products. This endeavor is often supported by government measures, such as slightly undervalued exchange rate, international marketing activities, education sub-

sidies, etc. (Amsden, 2000). Such steps aim at earning additional foreign exchange to maintain appropriate development of the domestic economy via importing more capital-intensive products required for deepening its industrialization. What is even more noteworthy is that exports composition is changed in favor of industrial goods, thus, decreasing dependence on revenue originating from exports of primary goods.

Increased exports might also bring further positive effects in terms of productivity and employment. Rising exports will doubtlessly assist in maintaining high growth levels. Operation in foreign markets brings further experiences that would further augment the knowledge stock, which can be transferred to other domestic sectors via spill-over effects. Therefore, there emerge favorable conditions for both forward and backward linkages in new types of industries enhanced by further deepening. In short, during the first stage of export promotion an economy manages to transform its export profile. Exports of manufactures appear to be more than just an addition to the primary product export base.

It is essential that a country produce such goods for which there would be an expanding demand over extended periods of time, what would secure ample of value-added for its domestic economy. All in all, while aspiring to dynamic (created) comparative advantage, economies ought to find an export composition comprising goods with positive and, preferably, greater than unity income elasticity.

Well arranged and successfully implemented industrialization strategy in a number of East Asian economies including Japan confirms that an appropriately devised and realized sequencing of industrialization from the first stage of import substitution to the second phase of export promotion enables to develop additional dynamic comparative advantages.

Unlike the economies of East Asia, most Latin American countries moved from the first stage of ISI straightforwardly to its second stage, discarding the first-stage export promotion pursued by the East Asian economies. The second stage of ISI is assumed to further domestic industrialization by expanding the scope of importables to be substituted, which, as a rule, include durable consumer items, intermediate products, equipment and the like (Alavi, 1996).

The move to this stage of industrialization is motivated by two intertwined facts. Firstly, the previous stage has already exhausted its potentials to maintain further development. Secondly, steadfast trade deficits lead to the balance-of-payments difficulties.

Therefore, the intention to reduce the import bill through further measures of import substitution seems quite reasonable. The logic behind this step is founded on the assumption that the amount of foreign exchange saved by a deepening of ISI equals to the amount of foreign exchange earned thanks to export promotion measures.

However, there are also other issues and aspects that are to be taken into consideration. In the long run, the second stage of ISI may prove a shortsighted step, if launched prematurely, in view of an abundance of gains its alternative – first-stage export promotion – secured for the economies of South-East Asia.

These two different paths taken have brought contrasting results, which in their turn determined further development trajectories of the economies concerned. Letting alone potentially attainable gains, the path taken by Latin American economies prevented them from exploiting the scope of advantages and gains brought about during the first stage of ISI (Corbo, 1994). A swift shift from labor-intensive to more capital-intensive kinds of production undermined further absorption prospects of labor moving from the country side to cities. Furthermore, economies could not have exploited potentialities of the formerly emerged entrepreneurs who would have definitely brought in a great number of positive externalities provided the first stage of export promotion had been in place.

In contrast to the experience of Latin American economies, the East Asian economies have undergone transformations of another type (Bradford, 1994; Hong, 1993). The first stage of export promotion enabled these economies to further absorb large volumes of labor force from the country side, while fostering additional accumulation of physical along with human capital and, thus, reaping benefits and creating new comparative advantage from operation in international markets.

Producers in a large number of Latin American countries, India and a few other countries during the second stage of ISI started ‘benefiting’ from high levels of protection of industry from foreign competition, what prevented them from growing and enhancing their competitive edge (Corbo, 1994; Dubey, 1994; Kiely, 1998).

However, in the 1970s, there has been one more switch in strategies both in the economies of South-East Asia and Latin America. This strategy change once again led to slightly differing development paths. In the economies of South-East Asia, with substantial government guidance the strategy of second-stage import substitution has been fairly implemented. These economies succeeded in establishing new production lines

and industries now putting out more sophisticated and capital-intensive products that they had to import previously. All the process has been accompanied by well-rounded indirect support of the government, with an intention to even further expand the stock of knowledge (through R&D activities) and foster the process of physical and human capital accumulation. Once the newly established firms reached the needed productivity levels, the infant industry tariff protection was to be lifted. With enhanced stocks of inputs, these economies could already successfully compete both in the domestic and foreign markets.

Upon implementing the second stage of ISI aimed at solving the balance-of-payments difficulties, most of the Latin American economies saw their imports rise too, as the economies were not capable of producing all needed products in demanded quantities or qualities. Therefore, to be able to earn additional foreign exchange, they had to start pursuing the strategy of export promotion. The strategy of export promotion, unlike that of export substitution, had to just add some additional items to the list of exportables. This type of export promotion was implemented rather in form of particular subsidies provided to multinational corporations residing in the economies of Latin America to sell part of their products in international markets.

Timely well arranged and rightly combined, import and export substitution policies enabled the East Asian economies to climb up the technology ladder by moving towards industries that bring even higher value added in the production activities employing both knowledge- and capital-intensive technologies. These industries, involving cutting-edge technologies, provide good opportunities for future development.

These experiences of structural transformation evince the ability of small economies to undergo industrialization, while focusing just on a small number of importable items to be substituted and consequently switching to exporting as productivity rises to appropriate levels. Therefore, regional trade arrangements would provide smaller economies with ample opportunity to get access to regional markets and, thus, attain economies of scale and reap benefits stemming from learning-by-doing effects. Larger economies with greater domestic demand are inclined to have better prospects for strategies of import substitution and export promotion, facing, however, also more difficulties, particularly if they are abundantly endowed with land and natural resources.

1.2.3 Trade, resources and institutions

Gains from trade

As already discussed in the previous section, a country's development patterns are subject to the influence of trade, the character of which is to a great extent determined by its endowment with factors of production (e.g. workforce, physical capital, natural resources). Economic development, implying an increase of a given society's welfare, is sustained by increments of goods and services available for consumption. This augmentation of products is due to growth of domestic production capacities or imports from abroad, both of which are subject to the influence exerted by trade's static and dynamic effects. Increased domestic production implies, among other things, increased revenues from exports allowing for more imports. This chain of events is well explained by the interplay of effects of trade resulting in gains. In theory scholars distinguish between the two main types of gains (or effects) stemming from conducting trade. These are static and dynamic gains from trade.

Static gains are the benefits that a trading county accrues from exploiting its already established comparative advantage. It is assumed that this sort of gains stems primarily from inter-industry specialization (Grimvade, 2000). Economies being variously endowed with production factors will find themselves better off, if they specialize in goods they can produce with lower costs to trade them in exchange for goods they themselves would have to produce with higher costs. Specialization in line with the foundations of comparative advantage enables to make the most of the given resource and factor endowments, and results in welfare gains of trading economies. This type of gains is rather obvious: their effect is seen right away in the increased level of welfare. However, these static gains do not make up all benefits a country is capable of reaping from conducting trade with other nations. In addition, there are also some other gains that ensue from trade.

Dynamic gains provide another rationale for conducting trade, even if there are no static gains in place (Thirlwall, 2003). Dynamic gains are the benefits to be accrued from the impact of trade on an economy's production structure and possibilities and contribute to the establishment of incremental comparative advantage. Dynamic gains appear to be somewhat latent, since they provide an economy with an impetus to adjust and, thus, induce it to undergo needed transformation and changes. It is the workings of these dynamic gains that play a significant role in the development process, since

through trade economies may more easily accumulate resources. This is valid particularly for small economies that are incapable of accumulating enough capital as specialization is limited by the extent of their domestic markets. Briefly, dynamic effects enable countries to expand their production possibilities and modify their comparative advantage, for instance, through industrialization based on import substitution and export promotion policies. Thus, benefits gained from static and dynamic effects provide a rationale for conducting trade.

In addition, there is another kind of benefits that can be accrued, when trade is to be considered as a '*vent for surplus*'.[7] The existence of the 'vent for surplus' gains are ascribed to the fact that regions are unevenly endowed with resources and inputs. This type of gains imply benefits ensuing from exports of excessively available resources that would otherwise lie idle and not be used altogether if demand were limited to domestic consumption only.

Revenues yielded from these exports can be easily spent for imports required by the economy. The 'vent for surplus' approach to trade and development focuses on the essential insight that trade is capable of triggering growth and putting an economy on an appropriate development path. In addition, it is suggested that the scope of welfare gains stemming from appropriate expansions of exports of primary goods and mobilization of previously idle resources may exceed that of benefits originating from a reallocation of presently given and previously entirely utilized resources (Ros, 2003). Being apt to widen the market, trade fosters further labor division and increases the level of productivity.

Natural resources and development

The 'vent for surplus' approach implies primarily trade with resources, which are obviously distributed rather unevenly among regions. What role should be ascribed to resources in the process of development? Theorists are not unanimous in providing their answers to this question, which range from facilitating growth to impeding it. Against this background, the 'staples thesis' states that exports of resource-intensive goods may prove indispensable for further economic development, whereas 'Prebisch-Singer thesis' states that specialization in resource-intensive exports may hamper economies' growth prospects (Ros, 2003).

[7] The concept has been originally formulated by Smith (1776) and thoroughly developed by Myint (1958).

Other approaches point to further important aspects of the link between trade in resources and development patterns. Sachs and Warner (1997) along with Arezki and van der Ploeg (2007), for instance, argue that resource abundance, measured by the stock of natural capital, is apt to slow down economic growth and, hence, development. This notwithstanding, it would be shortsighted to ascribe success or failure in economic performance of countries only to their resource endowment.[8] Since resources and raw materials of one country demanded elsewhere could become a good source of foreign exchange, it is up to a nation to either dissipate the earned windfall or smartly allocate it by investing in establishing new production facilities or modernizing the existing ones.

Deriving from fairly positive experiences in development through trade in primary products of countries, such as Canada, Argentina, South Africa, Australia and New Zealand,[9] one must note that this kind of trade with the then industrializing Europe paved the way for productivity growth in mining and agriculture, and a bit later also in labor-intensive industries.

The 'staples thesis' corroborates the aforementioned. Initiated in the work of Canadian economic historians, the staples thesis postulates that exports of resource-intensive goods may serve as an engine of development and transformation by inducing manufacturing industries and transport networks to expand, which are supposed to have important linkages with other domestic industries, a scheme *à la* Hirschman, implying potentials for backward and forward linkages (Ros, 2003).

As already shortly mentioned, the virtue of abundantly available natural resources demanded by other regions can, in fact, quickly turn into curse. Excessively large revenues from exports may deluge domestic economy and induce the exchange rate to rise, what leads to the loss of competitiveness of local manufacturing industry both within the country and abroad. This phenomenon has been dubbed *'Dutch disease'* in the literature, after the Dutch manufacturing industry suffered from adverse effects triggered by the real currency appreciation as a result of the natural gas discoveries in the 1970s. During the same decade, after the oil price shocks, a number of oil-exporting economies have been adversely affected by analogous 'disease'. This shows that there is a trade-off between the exports of resources and successful performance of an industrial sector.

[8] There is definitely another variable making the difference in the outcome, namely institutions in its broadest sense; Arezki and van der Ploeg (2007) state that allowing policies aimed at more trade openness and establishing good institutions may diminish the negative 'impact of resource curse'.
[9] These countries were among the richest at outset of the 1900s.

The successfully undergone processes of industrialization in the offshoots of Europe before the 1930s were to a certain degree conditioned by favorable price developments for primary products and high demand for them, enabling them gradually to accumulate required inputs and, later, switch to needed substitution patterns. Therefore, the main points of the 'staples thesis' approach seem plausible at earlier stages, when countries were much more involved in the inter-industrial type of trade exchanging industrial products and primary goods. Currently, the bulk of international trade is conducted between developed countries and is in fact of intra-industrial type. By and large, the resource intensity of goods has declined persistently, what has led to the decreased demand and lower prices; whereas skilled-labor intensity increased considerably, what makes this input more demanded and more expensive. This circumstance leaves small room for today's developing economies intending to develop through trade in resources.

Production and trade patterns, being closely interlinked constituents, have led to the currently existing economic order, on the origins of which a number of theorists tried to provide their explanations. In fact there are several approaches that tackle the issues of development and trade as tightly interrelated phenomena. For instance, Prebisch (1950) and Singer (1950) offered their view on the backwardness nature of developing economies in a theoretical framework what is now called 'Prebisch-Singer thesis'. In line with their concept, the world consisting of two groups of countries – industrial core and traditional periphery – engaged in trade was not allegedly able, so goes the argument, to fairly distribute gains from trade. Less developed countries are inclined to suffer from steadfast decline of their terms of trade (due to their production and trade specialization in primary products, whose prices are supposed to continually fall). The way out is seen in import substitution industrialization, the main workings of which have been mentioned afore.

Bhagwati (1958) also cast doubt on the consistency of strategies based upon exports of primary goods and put forward the notion of immiserizing growth, which implied that a growing economy exporting primary goods might find itself worse off despite or, to be more correct, because of growth of commodity exports, so that their prices would plummet down. This case is valid for countries possessing large shares in international commodity markets.

The framework of an 'export model of regional growth rate differences' combines insights of Prebisch (1950), Seers (1962) and Myrdal (1963) on trade and devel-

opment patterns by outlining the workings of growing disparities among countries engaged in exchange of products. According to this approach, trade is alleged to set off progress, since once one region gets developed, it will impede the development of other regions by attracting required inputs to further sustain its growth.

In this context the workings of Verdoorn's Law[10] are of primary significance. Growth in output in a trading country induces productivity growth that in turn is apt to generate further increases of exports. Therefore, this sequence of events deprives less developed economies of their possibilities to get to higher paths of development by setting their 'hidden potentials' free. Structural changes in the composition of exports, attained first by import and, then, export substitution strategies, were proposed to break up the existing constraints on growth and development.

Institutions and development

The aforementioned makes obvious that despite a large number of approaches concerned with the interplay of resource endowment and development, it is still not so clear whether being rich in resource is a virtue or a curse. Therefore, there must be something else in place, what contributes to the successful outcome of this endeavor – getting rich through utilization of available resources.[11]

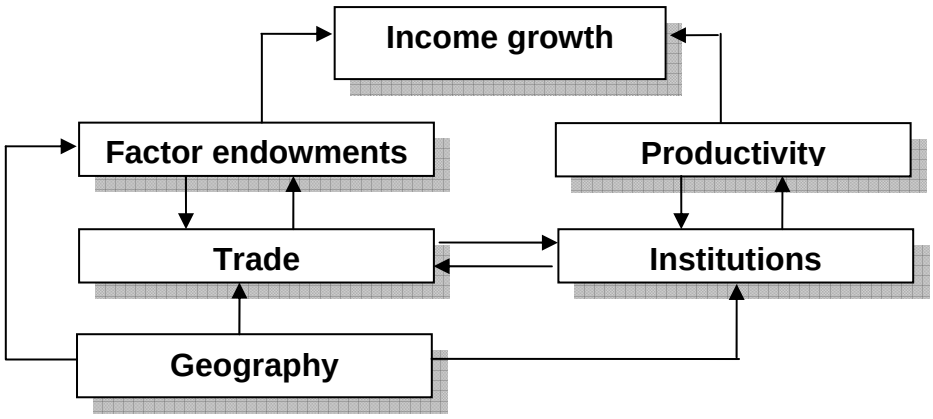
Geography[12] and institutions make up important fundamentals exerting strong influence on countries' long-run growth and development (Acemoglu, 2003). Both of these constituents are tightly intertwined with the stage of development of a country. Some scholars adhere to the view that both institutions and resources to certain extent influence each other, and their joint interplay determines the pace of economic development.[13] In this context, embodied in a wide array of arrangements, laws, norms, behavior patterns, attitudes, and the like, institutions are believed to matter for the process of economic development (Olson, 1982). In general, natural resources are believed to exert influence upon growth through 'positive' and 'negative channels' (Stijns, 2005). The main channels of such influence are depicted in Figure 1.1, which shows the way the fundamentals of geography and institutions, while interacting with the so called

[10] The law, named after Dutch economist P.J. Verdoorn, reveals the long-term positive relationship between the rate of output growth and productivity growth due to increasing returns.
[11] Diverging paths of rich in resources Canada, Australia, New Zealand, the American West, on the one hand, and Argentina along with other regions of Latin America, on the other, point to the existence in this setup of another variable capable of making the difference along the path of development.
[12] In this context the notion of geography implies natural resources.
[13] North et al (2000) argue that institutional framework influences the pattern of region's specialization to a great extent.

proximate determinants of growth – factor endowments (labor force and physical capital) and productivity – exert influence upon income growth. In addition, it must be noted that in this context the role of trade is an essential one.

Proper institutions are believed to facilitate growth and development, being at the same time their 'by-product'. A comparison of East Asia's economic performance with that of Latin America stresses the importance of sound congruence of public policies with long-term interests of the private sector's agents. Thus, institutions, seen as an important complement to the constituent of resources, do matter a lot for the process of economic development.

Figure 1.1 Growth, trade, resources and institutions



Source: Rodrik (2003: 5)

These two constituents of the development process can be hardly modified within a short time span. However, gradual but persistent changes favored by external conditions may lead to substantial improvements in country-specific policies and institutional framework. In the form of trade, external conditions, for instance, may set free and bail out regions, whose development was previously limited by the locally prevailing discouraging institutions, since these may specialize in sectors least exposed to 'bad policies'. It must be emphasized, however, that such kind of seemingly obvious links between international trade, institutions and economic growth are currently not proved empirically or in a more formalized way due to numerous difficulties in specifying determinants and resultants (Dollar and Kraay, 2003).

This notwithstanding, as Belloc (2006) argues, international trade and institutions are reasonably assumed tightly interrelated, where the latter should be seen as a determinant of an economy's competitiveness and trade patterns. These features are deemed essential for a country's sustainable economic growth that presently further en-

hanced by the exchange of produced items and factors of productions. The issues of economic growth in an open economy are the subject of the next section.

1.3 Growth in an open economy

> The possibility of foreign trade and other peaceful international flows increases the variety of choices available as to the sectors and means by which the modern economic growth of a given nation will be induced...
>
> Kuznets (1966: 293)

Due to achievements of modern technology and its impact on the means of communications and infrastructure, modern economies, interacting with each other in a number of ways, have become more interdependent. The term 'globalization' has become central in the recent time, which signifies this process of economies' ever increasing dependence on what happens internationally. In addition, there is also a process of regionalization in place that leads to increased integration of the economies intending to form an integration bloc. Such endeavors are aimed at facilitating the trade in goods and services along with flows of capital, labor and know-how.

Significant volumes of products and inputs flowing between economies are straightforward consequences of this process. However, countries are to different degree engaged in these exchanges of goods and services, as well as factors of production. Therefore, it makes sense to identify different groups of economies in line with their openness. Using a number of indicators, one distinguishes between autarky and openness. The former implies that an economy is completely closed and does not have links with the rest of the world and is rarely encountered in economic reality. The latter suggests that an economy is linked with other regions either through trade or input flows or both.

Open economies may be linked to other economies in two forms of interaction, the first of which is trade embodied in the exchange of goods and services, and the second is the flow of factors of production. These forms of interaction are supposed to contribute to the income levels of economies' residents as well as their growth rate either directly – through the workings of factor accumulation – or indirectly, i.e. through changes in productivity. This in turn enhances processes of convergence across the economies, which, for instance, participate in an integration grouping.

Therefore, it is to infer that growth in an open economy is subject to the factors stemming from its environment. Among external determinants of economic growth it is expedient to accentuate the following:

> […] first, the worldwide stock of useful knowledge, to which the given nation may have contributed but necessarily only in part; second, the various international flows of economic resources or goods, either in exchange as in the case of foreign trade, in borrowing and lending as in the case of capital flows, or in unilateral receipts or payments as in the case of grants or, more important, immigration and emigration; third, acts of aggression by the given nation against some other part of the world, whether such acts constitute extraction of special privileges, exercise of colonial domination, or outright annexation.
>
> Kuznets (1966: 285)

From the abovementioned it becomes evident that a country's growth is influenced through numerous ties with other countries, what implies its higher dependence upon the dynamics of the rest of the world.

Measurement of openness

Hitherto scientists have produced an abundance of theoretical and empirical works devoted to the issues of openness and growth. Most of these works, being supported with a rich variety of empirical methods, corroborate the view of favorability of openness for growth. However, the things are not as clear as they might seem to be presented due to the existence of a lot of unresolved issues.

Among these unresolved issues is the measurement of openness. In this context, one may employ one of the two main approaches to the measurement of openness of economies. Some economists focus on the volumes of goods (or inputs) flowing in and out of an economy to measure how open it is in terms of the exchange of products (or production factors).[14] However, countries might be open and pursue fairly liberal trade policies and still don't conduct trade because of the absence of incentives to do so. This case made the present approach void.

This shortcoming may be overcome with the help of another approach. This one is based on the workings of the law of one price, which suggests that the less the prices of two economies differ, the more open the economies should be considered. In this

[14] In this case, the volume of trade turnover (exports plus imports) is related to GDP.

case prices signify prices of goods and services, factors of production, interest and exchange rates. If these differences in prices of the economies exceed trade costs, then there appear incentives for conducting trade.

Openness and size

What is more, the degree of openness may also vary across economies due to their sizes. *Ceteris paribus*, larger economies tend to trade less than smaller economies. Hence, there is a negative link between foreign trade proportions and the size of an economy measured by its GDP. For instance, it is quite natural that small economies, aspiring to maintain certain level of consumption of a fair variety of goods, have to rely more on trade than large economies would have to. Therefore, it is quite understandable that…

> […] small countries can attain economic growth only through heavy reliance of foreign trade, as indicated by high proportions to national product – although clearly this is a necessary but not sufficient condition; whereas the larger countries can attain economic growth with much lower foreign trade proportions, so that reliance on proportionally large material flows to and from the rest of the world is not a necessary condition, although it may occur…
>
> Kuznets (1966: 302)

Openness and factors of production

As already stated above, economies may be open to trade with goods and to the exchange with factors of production. These types of openness are closely interrelated through the mechanisms of factor price equalization. This implies, in accordance with the main inferences of the Heckscher-Ohlin model of international trade, that even if a country is relatively closed to the exchange of inputs into production, after engaging in trade and continuing conducting it, an economy would come to roughly similar results in terms of compensation of employed factors of production, if it had been also open to the exchange of factors of production.

Furthermore, the basic models of economic growth have also their own implications, when analysis is directed to an open economy. For instance, within the frame of the neoclassical approach with its workhorse model, where the rate of saving and the rate of population growth are of significance, the flows of capital (or of population) would lead to a new unified steady state.

Accordingly, in one of his works Ventura (1997) continued along this path in order to validate the ever increasing interdependence, which was essential for explanation of the existing differences in the growth performance of various countries. He exemplified the experiences of South-East Asia to support the idea of the possibility to obviate potential losses stemming from diminishing returns on capital. Hence, the economies of this region had an opportunity to either start exporting capital or shift into more capital intensive types of production.[15]

In the case of endogenous growth models, there is an effect in place that justifies the involvement of an economy into international trade. Since this type of models dismisses the assumptions of the neoclassical growth model of perfect competition and diminishing returns on reproducible inputs concentrates on the externalities that enable to neutralize the effect of diminishing returns on reproducible factors of production, it is evident that increases of the market size – an indispensable outcome of the involvement in trade – would lead to the augmentation of positive externalities, which would lead to higher welfare levels either through higher quality or larger variety of products to be consumed.

Additionally, there is an array of further effects stemming from the involvement of an economy into international trade, which are well devised by endogenous growth models. Omitting details, involvement in trade could also produce positive spillovers across export industries, which could then be embraced by other industries of an economy. Often, trade leads also to reallocation of resources within economies causing over time transformations in their specialization patterns.

Despite all the brought about justifications of openness as a virtue for growth, there is an implication that the more open an economy, the more volatile it becomes. For instance, Calderón et al (2004) argue that greater openness to trade and capital movements entail higher vulnerability degrees for an economy. Di Giovanni and Levchenko (2006) point to a few channels, through which trade openness (causing greater specialization and higher exposure to external shocks) results in the increased volatility of an economy open to international trade. Furthermore, if a small economy with a fairly developed R&D sector opens itself to inter-industry trade; it will run a risk of losing its competitive edge in favor of bigger economies with already well estab-

[15] Here the interplay of the two sources of growth is evident: on the one side, accumulation of inputs (labor and capital), and on the other, productivity resulting from higher quality of inputs (higher educated labor force, better technologies) and efficiency (superior institutional frame).

lished R&D activities (Feenstra and Hanson, 1996). This could result in lower growth rates of a small economy but higher welfare.

Trade, liberalization and transport

The incentives of nations to trade are determined by an array of factors, among which are transportation costs. The flow of goods and services are subject to trade policies of economies involved in the exchange of products and factors of production with each other. This kind of regulation may in fact substantially exert influence upon the movements of goods and services across countries.

As a number of economies of the present and of the recent decades ascribe part of their fortune to the successful performance in international markets, theorists and policymakers turned their attention to the issues of trade liberalization. These aspirations go presently along the GATT/WTO initiatives aimed at reducing trade barriers and facilitating trade across regions.

However, liberalization itself is not to be seen as an end but rather as a means enabling to increase welfare through exchange of goods and services. Measures directed at trade liberalization are not that easy to implement without causing negative effects, since trade is assumed to exert a considerable influence upon the income levels (Berg and Krueger, 2003; Brunner, 2003). However, despite all possible effects caused by trade liberalization, an overwhelming majority of works devoted to this issue favors this measure since its positive effects are alleged to be dominant.

For instance, Edwards (1992) in his work on thirty developing economies considered during 1970-1982 concludes that trade openness is to be seen as a mechanism facilitating technology transfer across nations. Frankel and Romer (1999) provide empirical evidence and state that during the observed period the increase of income and its growth rate is due to greater openness (measured as the ratio of trade to GDP) caused.

Clemens and Williamson (2001) confirm this fact as well, but stress that presently developed economies owe their rise to protectionist measures rather than free trade encouraging policies. A detailed description of the workings of protectionism and transformation of economies has been provided in section 1.2. The vivid examples of the rise of High Performing Asian economies demonstrate that openness to trade is not favorable during the ‘infancy of industries’ that are being established. Trade policy’s toolkit comprises instruments widely ranging from tariffs and quotas through voluntary export restraints and anti-dumping duties to other kinds of non-tariff restrictions.

An earlier made distinction between large and small economies stressed the importance of trade for economic growth of the latter, since their producers are deprived of opportunities to make the most of the effects, which are in place in the larger economy, such as economies of scale or spillover effects, where both of them lead to faster accumulation of required factors of production and higher productivity growth. However, there is an opportunity (Ventura, 1997) for a small economy (whose terms of trade are assumed fixed) to augment exports without having to suffer from rapid price drops of its exportables (Young, 1992), as it is to be anticipated in the case of a larger economy, which would just depress the price of its exportables by expanding the supply (Acemoglu and Ventura, 2002).

In this context, terms of trade represent 'an important mechanism for the international transmission of growth effects' (Helpman, 2004: 59). Its workings resemble a zero-sum game, in which an expanding economy transfers gains to countries importing its products. The deterioration of terms of trade of an exporting country implies terms-of-trade improvement for its trading partners. The presence of such transfer mechanisms were empirically confirmed in a study by Arora and Vamvakidis (2004), in which they corroborate the argument that trade partners' growth matters for the growth dynamics of a country.

Obviously, the favorable influence of trade partners' growth dynamics is expressed in increased opportunities for exports into the economies of trading partners. The character of such trade links is often subject to the influence of the structural characteristics of economies conducting trade. The trade pattern is closely linked with the economic structure of the country, hence its growth rate would be 'pegged to that of the rest of the world' (Wong and Yip, 1999: 537).

Differently structured economies conducting trade with each other are to encounter changes in their terms of trade over time as they develop. These changes in terms of trade are apt to bring about balance of payments difficulties for an economy with a less favorable structure of its economy. An economy experiencing terms-of-trade deterioration has to either (depending on the character of its importables) descend to a lower growth path (thus obviating the rise of its balance of payments deficit) or attract foreign capital to keep financing increased imports from the rest of the world.

Therefore, it is not abnormal that countries face difficulties because of the composition of trade they conduct with other countries to sustain current levels of consump-

tion. If, as noted earlier, a country opts to keep present or even attain higher imports, while not upgrading its exports composition, the balance-of-payments constraint would prevent from ascending to higher growth paths, since current-account deficit is to be covered by additional capital inflows.

These issues have been brought to the fore by the Post-Keynesian school. For instance, Kaldor (1966) emphasized that it was imperative to take into account an economy's trade performance with special attention paying to exports growth when considering its growth perspectives. Furthermore, the so called 'balance of payments constrained growth' framework, proposed by Thirlwall (1979), devises a mechanism enabling to link growth rates of an economy engaged in international trade with characteristics of its exportables and importables.

Resembling the theoretical construct of the trade multiplier developed by Harrod (1933), where increments of GDP were determined by the ratio of exports increase to marginal propensity to import., the balance-of-payments constrained growth framework considers these sequences in a dynamic perspective implying that these increments tend to move constantly. Over time even small increments' changes could produce significant differences between potential and factual output levels. The model envisages that a country's growth rate is determined by the ratio of exports growth to its income elasticity of demand for imports: $y=x/\pi$, where y stands for output growth, x represents exports growth and π denotes income elasticity of demand for imports.

This approach suggests that a country, engaged in international trade, aspiring to attain higher growth rates should either increase the value of the first constituent, which is real exports growth (e.g. by making exports more demanded using price and non-price tools), or reduce the second one, that is income elasticity of demand for imports (e.g. through gradual substitution of horizontal and/or vertical nature), or both. This theoretical framework provides a wide-front research opportunity, since it may encompass an array of aspects related to economies' growth and trade performance.

Exchange of factors of production

Parallel to trade in goods and services, nations are involved in a fairly intense exchange of factors of production. This type of exchange is also of relevance, when matters of growth in an open economy are considered, since existing differences in output and its growth rates are due to factor accumulation (capital and labor) and/or productivity

(technology and efficiency). In line with the growth accounting principles, an increment in output is attained by appropriate increases in inputs – capital, labor and knowledge.

Capital, being the most mobile factor of production, is supposed to flow from countries abundantly endowed with capital to economies where it is scarce, other things being equal. This was one of the implications of the Solow-Swan model devised to explain growth differences across countries. Return differences as a result of different capital endowment across regions is assumed to cause capital movements: higher returns on capital in countries poorly endowed with capital would attract it.

However, in a rather complicated economic reality other things are not equal. International capital flows, whose main sources are savings and investments, "arise from the movements of merchandise, bullion and species, services (business and personal, such as tourism), immigrant remittances and funds, and factor incomes…" (Kuznets, 1966: 321). Hereby these kinds of capital flows can take various forms, which may include foreign direct investment, portfolio investment, remittances from migrant workers, grants and lending from financial institutions and international agencies.

There can be a wide array of incentives for countries to borrow capital, which comprise, for instance, investment in new infrastructure facilities, coverage of an outstanding trade-balance deficit, service of foreign debt, etc. To somehow determine the needed volumes of capital to be borrowed, practitioners may make use of the so called three-gap approach. In a nutshell, the main focus is made on three deficits that may arise and need to be covered by borrowed resources from abroad. Implied are investment-saving gap, current account deficit and budget deficit. The largest outstanding gap is to be financed by borrowing to loose the constraint on the demand side that presently prevents an economy from growing at a higher rate. However, it must be noted that borrowed capital is to be repaid with interests some day (certainly, unless they are written off!), thus, diverting resources required for further growth in the future.

A number of theorists raised this sort of issues related to the link between foreign debt and growth prospects. For instance, recent studies of Lin and Sosin (2001) and Pattillo et al (2004) reveal a significant negative link between high indebtedness and attained growth rates. This impact is supposed to be channeled both through factor accumulation and total productivity growth.

Lately the capital flows in form of FDI have become ever momentous. Hence, there is an abundance of works devoted to the links between growth and FDI.[16] FDI is alleged to bring about positive effects that in turn favor growth of an economy either through enhanced capital accumulation and/or productivity growth due to better technology and expertise. There is no absolute unanimity in the literature on the role of FDI in enhancing growth, however the studies advocating their positive role in the growth process of a receiving country are rather dominant. For example, Khavar (2005) corroborates in his cross-country empirical study the existence of a positive relationship between foreign direct investment and economic growth. Furthermore, Borensztein et al (1998) in their comprehensive work on developing economies suggest FDI facilitates technology transfer from industrial to developing economies, while being often more influential than domestic investment. They stress the importance of an economy's absorptive capability for its growth.

Moreover, Busse and Groizard (2006) emphasize the significant role of an institutional framework capable of attracting FDI. Furthermore, Cuadros, Orts and Alguacil (2001) ascribe augmentation of trade volumes and increase of growth rate of Latin American economies to the effects ensuing from FDI. Bitzer and Görg (2005) point to the positive impact of FDI inflows on productivity growth in industrial countries. However, despite the predominant position that FDI's positive influence is clear-cut, there are yet papers denying this legibility. For instance, Carcovic and Levine (2002), having reassessed the link between growth and FDI, conclude FDI is not apt to "exert a robust, independent influence on growth".

International capital flows may also take the form of financial aid, as a rule, provided by developed economies or international institutions on concessional terms mostly to developing countries for solving their capacity-bottleneck problems. These transfers are usually complemented by loans and credits with favorable for the recipient conditions of repayment.

Remittances of migrants make up another form of financial flows bringing about significant effects by, for instance, substantially expanding import capacities of an

[16] Along with portfolio investment, FDI is one of the forms of capital movements across regions and implies an acquisition or a construction of a production facility in a country through a foreign firm. Portfolio investment assumes just an indirect control over a company through foreign investors by purchasing its bonds or stocks.

economy.[17] As already shortly stated, the phenomenon of remittances is closely intertwined with migration of labor and human resources. Irrespective of the relatively high mobility degree of capital, one ought to pay much attention to the flow of labor and human resources, which in their turn are indispensable inputs into production as well. Generally, migration of labor, caused by differences of its reward across regions, is deemed to be highly regulated. Although presently migration trends are not of the scope of the several decades preceding World War I, they cannot but be taken into account due to their implications for the workings of international economic links.[18]

Since labor and human resources possess a certain stock of knowledge, the size and character of which are determined by cultural and education background, the transfer of knowledge – that is embodied in mores, values, professional skills, etc. – ensues migration.

In general, migration causes both positive and negative effects for countries, depending on the type and quality of human resources migrating. For instance, a sending country may benefit from remittances sent by migrants, but simultaneously have outgoes resulting from the absence of required labor or human resources; many developing countries have, thus, to bear rather high costs of the brain-drain effect that deprives them from the necessitated proficiency and expertise of high-skilled workers.

However, as already pointed out, there are some other channels for knowledge transfer along migration of labor force. These comprise – among other things – FDI, trade in intermediate and final products, trade in patents and licenses, what once anew stresses that international links among economies are rather multifaceted. Therefore, it is not that easy to take them apart to study them in details. Nonetheless, it is commonly accepted that an economy substantially gains from its access to the universal stock of knowledge (Kuznets, 1966; Pasinetti, 1993).

Unlike capital and labor, knowledge, being an indispensable input into products an economy puts out, is generally assumed non-rival. Its central role in the recently devised models of endogenous growth is ascribed to this very feature of non-rivalry enabling to emulate growth by rightly fitting it in the set-up along with other variables. Given that differences across countries in income levels are just up to one third due to

[17] Kireyev (2006) and Chami et al (2003) point to an ambiguous impact financial inflows originating from migrants' remittances exert on the domestic economy.
[18] In particular, since the break-up of the COMECON bloc, migration movements have gained in their intensity, thus, wielding direct influences upon the economies of both receiving and sending states. For details see Mansoor and Quillin (2006).

factor accumulation and the rest is owed to productivity,[19] it is no doubt essential to influence this variable, if paths with higher growth rates are to be attained.

Summary

Thus, taking stock of the chapter, the following should be mentioned. Existing differences in living standards across countries are primarily ascribed to varying rates of economic growth. Accumulation of inputs (labor and physical capital) and productivity growth are main constituents of economic growth, which in turn may often be subject to the influence of external factors. Therefore, in the process of economic growth and development an important role is ascribed to international trade. In addition, the rationale of openness, expressed in accruable benefits, motivates economies to engage in the exchange of factors of production along with international trade in products.

[19] For growth rate variations the dominance of productivity is even more significant with the ratio of 0.1 to 0.9 (Helpman, 2004: 33).

Chapter 2 Economies in Transition

This chapter covers general issues related to the process of economic transformation. Its first part sets forth the process of economic transition in the countries of Central and Eastern Europe (CEE) and the Former Soviet Union (FSU) (section 2.1). Subsequent parts are devoted to an array of issues related to the processes of economic transition in the regions of the Baltics (section 2.2) and Central Asia (section 2.3).

2.1 Transition in Europe and Central Asia

2.1.1 Transition and its meaning

Shortly before the outset of the 1990s, a rather vast region of Europe and Central Asia (ECA)[1] comprising more than two dozen of countries have taken their first steps on their path from command to a market economy. Inconsistent and half-heartedly implemented economic reforms of the 1960s and 1980s in a number of CMEA economies were insufficient to fix the fundamental cruxes, i.e. slow pace of productivity growth and indicators related to it, and create needed incentives for an intensification of production processes.

Guided by plan mechanisms, these economies had failed to maintain sustainable growth increments called for improving living standards of their residents. This made the rationale behind the 'change of tracks' palpable. The market system was in that context a viable option, which was to fix most misconducts of the command economy and, thus, bring about further development. Therefore, through adoption of completely different methods of running their economies, these nations had to define anew *what*, *how* and *for whom* to produce goods and services.

The whole process of this large-scale economic transformation in the region has been accompanied by numerous reforms of all spheres, which have been implemented fairly differently across countries in question. The changes stretched far beyond the economic field and involved often grand shifts in political and institutional spheres.[2]

[1] This region encompasses all formerly communist countries of Central and Eastern Europe and the Former Soviet Union.

[2] The processes of political reorganization of a number of states have been in place since the onset of transformation. While the Soviet Union was succeeded by fifteen newly established states and formerly federal states of Yugoslavia and Czechoslovakia underwent the process of dissolution, East Germany was reintegrated with West Germany.

Therefore, transition should be seen as a set of interrelated reforms called for establishing new institutions, which would resemble the ones of market economies.

2.1.2 Initial conditions

In spite of exhibiting a number of similar traits in their economic systems and fairly high rates of human capital development, the transition economies differed considerably right from the outset of the transformation process. There were differences throughout the whole ECA region as well as in their parts – Central and Eastern Europe and the Commonwealth of Independent States (See Table 2.1).

Table 2.1 Transition economies: initial conditions (selected indicators)

Country	Per capita GNP at PPP, US dollar 1989	Average % growth, 1985-89	Foreign debt in pre-transition year (in percent of GDP)	Share of agriculture, 1989	Distance from Brussels, km	Endowment with natural resources
			CEE			
Albania	263	3.0	36.9	26	1588	poor
Bulgaria	4712	4.1	50.6	11	1698	poor
Croatia	5295	n/a	74.7	10	1024	poor
Czech Republic	8460	2.0	12.2	7	718	poor
Estonia	5237	2.2	0.0	20	1599	poor
FYR Macedonia	4514	n/a	0.0	12	1632	poor
Hungary	6155	1.2	64.0	14	1129	poor
Latvia	5105	3.5	0.0	19	1454	poor
Lithuania	5523	7.4	0.2	27	1457	poor
Poland	4718	3.1	63.4	13	1160	moderate
Romania	4043	-1.8	2.9	14	1770	moderate
Slovak Republic	6680	2.7	6.3	7	971	poor
Slovenia	9384	n/a	6.8	5	916	poor
			CIS			
Armenia	5345	n/a	0.0	11	3298	poor
Azerbaijan	3412	-3.0	0.0	22	3662	rich
Belarus	5365	6.1	0.1	22	1601	poor
Georgia	4865	-0.7	0.0	22	3224	moderate
Kazakhstan	4380	1.0	0.0	29	4528	rich
Kyrgyz Republic	3220	3.9	0.0	33	5218	poor
Moldova	3384	2.8	0.0	32	1830	poor
Russia	6300	n/a	12.1	15	2259	rich
Tajikistan	2534	2.6	0.0	27	5097	poor
Turkmenistan	3675	3.4	0.0	29	4414	rich
Ukraine	4581	3.2	0.0	21	1836	moderate
Uzbekistan	2860	6.1	0.0	31	4949	moderate

Sources: Falcetti et al (2005: 26); Fischer and Sahay (2000: 36).

Before the onset of transition in the early 1990s, the countries of both regions exhibited differences in terms of per capita income, rates of economic growth, structure of their economies. Income levels (measured in GNP in PPP terms) differed across both regions. Among countries of Central and Eastern Europe Slovenia (9384 US dollars) was the richest country, whereas Albania (2163 US dollars) was the poorest one. Other countries of the region were placed somewhere in between. Across the CIS region, in terms of per capita income, Russia (6300 US dollars) exhibited highest income per capita, whereas that of Tajikistan (2534 US dollars) was the lowest.

Across the ECA region, there have been noteworthy disparities in terms of economic growth rates. Some countries (e.g. Lithuania, Belarus, Uzbekistan and Bulgaria) had been experiencing solid growth throughout several years prior to transition, while other economies exhibited either moderately positive or even negative (e.g. Azerbaijan, Romania, Georgia) growth rates. In general, external debt was no big issue for most transition economies, although some countries of CEE had substantial debts on their accounts. Since Russia was the prime successor of the full scope of foreign debt and claims all other successors of the Former Soviet Union CIS countries embarked on reforms with clean sheets.

Regarding endowments with natural resources, it may be inferred that on the whole the CIS were better positioned when compared to the region of Central and Eastern Europe. In this context, four economies, namely Azerbaijan, Kazakhstan, Russia and Turkmenistan stood out for their rich oil and gas reserves.

Furthermore, the countries of the ECA region varied notably in terms of their economic structure. Against this background, certain countries (e.g. the Czech Republic, the Slovak Republic and Slovenia) exhibited rather small shares of agriculture in their economies. Conversely, there was a group of countries (e.g. the Kyrgyz Republic, Moldova and Uzbekistan), in which the share values of agriculture were quite significant. On this account, Gylfason (2000) provided arguments that transition economies strongly depending on natural resources and agriculture were likely to be adversely affected, since this reliance tended to foster rent seeking and red-tape and, thus, undermine external trade and investment activities.

In terms of their geographic location, the CEE economies were certainly better positioned than most of the CIS countries. This circumstance favored the prospects of

CEE economies to make the most of their spatial closeness to the rich countries of Western Europe by extending their trade and attracting foreign investment.[3]

2.1.3 Reform strategy

Since the point of destination of transformation, namely market economy with well developed institutions, was clearly defined from the outset, the definition of the way and methods became a matter of concern. As usual, one goal may be attained through various methods. The transition countries had the choice between rather radical and gradual types of reforming.

As the field of economic research in the 1980s was dominated by supply-siders representing rather liberal views on economic issues, the package of reforms, implemented in most of the ECA transition economies, was to a significant extent influenced by this school of thought. It must be noted that the radical way of reforming has been christened "*shock therapy*" or "*big bang*" (Marangos, 2004). Initially this set of measures was agreed upon and suggested by the *Washington Consensus* for implementation in a number of Latin American economies (Marangos, 2007).[4]

Thus, in line with the recommendations put forward, the following outcomes of reforms were envisaged: tighter fiscal discipline, liberalized prices and exchange rates, higher degree of openness to trade and capital flows, privatized production facilities and decentralized distribution of resources (Rodrik, 2006). These measures were to be implemented in a short time span, while amendment and adjustment of imbalances were left to the market mechanism. Berg et al (1999) point to the importance of rapid implementation of liberalization and structural reform for the subsequent output growth recovery, thus corroborating a 'radical' approach to reforms. Moreover, Hernández-Catá (1997) argues that the quicker the old enterprises and forms of production wiped out and replaced by new ones with higher productivity levels, the sooner the output of an economy will rebound.

The speed of implementation was closely connected with the issue of sequencing. However, there was no broad agreement on this aspect of reforms, since some of them were to become preconditions for others (e.g. price liberalization preceding trade

[3] In gravity analysis, which is widely used for explaining the intensity of economic interaction between countries, beside economic weight (expressed, as a rule, in per capita income) the constituent of spatial proximity is viewed as an essential one.

[4] The term *Washington Consensus* has become popular in usage and signifies 'neoliberlal or market-fundamentalist policies' despite its originally somewhat different meaning. For details see Williamson (2000).

liberalization, institutional reforms implemented before privatization of large enterprises). A large number of blunders made during transition were to be traced back to an inappropriate sequencing of the reform package. Havrylyshyn (2001) in his comprehensive survey of studies on growth performance of countries in transition concludes that there is a broad consensus on the required content of the reform package, but stresses that the issues related to the sequencing and speed of reforms are not settled yet. Additionally, special attention should be paid to the right sequencing of reforms during transition, since further growth prospects depend on the right sequencing of the reforms' constituents (Staehr, 2005).

Inflation and stabilization

Large discrepancies between monetary and real sectors of their economies, inherited from final years of the 'planned era', called for a price liberalization and, hence, rather high rates of inflation. No transition economy escaped negative effects of inflation, although its rates ranged substantially across countries.[5] Rapidly implemented measures allowed bringing down the inflation in most transition economies that embarked upon rapid liberalization of prices. Price liberalization was complemented by measures aimed at liberalization of exchange rates. In this context, some economies (e.g. Bulgaria, Estonia and Lithuania[6]) opted for currency boards by having pegged their currencies to a hard currency or a basket of such, whereas others chose flexible exchange rates, allowing their currencies to fluctuate within envisaged boundaries.

In addition, most of the transition economies experienced during the initial period of transition difficulties in getting their fiscal systems balanced that had been caused by the breakup of the old tax collecting system. Further developments in the fiscal sphere have been marked by the increase of the share of social expenditures, because in economic sphere state had to give way to a private sector.

Privatization

Being one of the core elements of the whole reform package,[7] small- and large-scale privatization was called for ensuring that formerly insignificant private sector would

[5] For instance, in 1992 inflation rates varied from 10 percent in the Slovak Republic to 1664 percent in FYR Macedonia (Source: EBRD database).
[6] Source: EBRD database.
[7] Often privatization is deemed to be the most important part of the reforms, determining further developments in countries undergoing transformation. On this account, Brezis and Schnytzer (2003) argue, that diverging paths of China and Eastern Europe are, not at least, explained by their differing approaches to privatization.

play a major role. In most of the ECA countries small- and, in part, large-scale privatization was carried out fairly rapidly. However, methods and the overall strategy differed significantly. This led to a mixture of outcomes across transition economies. While some countries succeeded to create and develop a rather well functioning private sector, others failed in this endeavor due to numerous reasons. In this context, Nellis (1999) argues that privatization is to be complemented by other significant measures securing the whole process of transition.

A number of available studies on this aspect of reforms ascribe successful performance of the newly emerged private sector to a well devised and implemented privatization course. For instance, Frydman et al (1999) state that appropriately privatized enterprises performed better than the rest of the field in terms of attained productivity levels. Furthermore, Pivovarsky (2001) points to performance improvements of enterprises acquired and controlled by foreign investors.

2.1.4 Macroeconomic performance

From the beginning of the transition process, it was clear that all transition economies would have to put up with large contractions of their output and employment. These contractions were to be caused by macroeconomic stabilization measures, aimed at halting inflation and taken right after initial liberalization steps had been put into effect. Moreover, this trend was to be enhanced by a reallocation of resources from ill productive sectors to profitable ones. Thus, old sectors were assumed to give way to new ones, implying that output would rebound to the pre-transition levels and, probably, and grow further in the subsequent years. The very initial stage of transformation was supposed to be 'dominated by two main mechanisms, reallocation and restructuring' (Blanchard, 1997: 55). Output growth rates were expected to surpass those of the advanced economies, eventually leading to convergence of income levels.[8]

In general, output in almost all transition economies contracted by much more than expected, implying high rates of negative growth. By the time the level of production reached its lowest level, the total loss of economies' production averaged around 40 percent (Fischer and Sahay, 2000: 4). It must be noted that across the ECA region in the initial stage of transition output contractions have become an outcome of a substantial

[8] In this context, Kolodko (2000) stressed the ability of some transition economies in a matter of few decades to catch up with advanced economies provided they further growth-friendly reforms. Polanec (2004) shows on the sample developments of 25 transition economies over the time frame from 1990 to 2002 that convergence of income levels has been instigated only in the last third of the of this period, i.e. when they resumed growing at sufficiently high rates.

decrease of productivity levels compounded by negative growth rates of factor accumulation (See Table 2.2).

It is worth mentioning that in the initial stage of transition (1991-1995), the scope of output contractions in the economies of the CIS was the largest. During the same period, productions levels of the economies of the Baltics and South-East Europe plummeted much more drastic when compared to those of the economies of Central Europe. On the whole, when compared with the region of CEE, larger output contractions across the economies of the CIS and more moderate growth rates in the mid-1990s was generally attributed to inconsequently implemented structural reforms and their initial handicap.[9]

Table 2.2 Transition economies: economic growth and its constituents, 1991–2006

Country group	Period	Real GDP growth rate	Investment to GDP ratio	Capital growth (percent)	Labor growth (percent)	Labor productivity growth (percent)
CIS*	1991–1995	-11.3	21.2	-8.9	-2.1	-9.8
	1996–2000	3.3	20.4	4.0	-0.4	3.5
	2001–2006	8.2	24.8	6.7	0.9	7.5
Baltics	1991–1995	-9.1	17.3	-5.6	-4.4	-4.8
	1996–2000	5.5	23.6	5.4	-1.2	6.9
	2001–2006	8.4	28.2	7.9	1.8	6.6
Central Europe	1991–1995	-0.6	21.4	3.1	-2.9	2.3
	1996–2000	3.8	25.4	4.7	-0.2	4.1
	2001–2006	4.2	24.9	4.1	0.6	3.6
South-East Europe	1991–1995	-6.6	15.2	-6.9	-3.0	-3.6
	1996–2000	5.5	19.8	6.1	0.0	5.4
	2001–2006	4.7	22.7	6.1	0.2	4.6

Notes:
CIS: Armenia, Azerbaijan, Belarus, Georgia, Moldova, Kazakhstan, Kyrgyz Republic, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
Baltics: Estonia, Latvia and Lithuania.
Central Europe: Czech Republic, Hungary, Poland, Slovak Republic,and Slovenia.
South-East Europe: Albania, Bulgaria, Croatia, Macedonia and Romania.

Source: Iradian (2007a: 28)

The whole region's general economic rebound from the mid-1990s was predominantly based on increased growth of productivity levels and accumulation of capital. These

[9] One should note, however, that in this context Belarus and Uzbekistan, the FSU transition economies, pose a challenge, since their output and growth records stand in stark contrast with those of other countries of the CIS and even CEE. This inconsistency is attributed to favorable developments in both domestic (i.e. sufficient input supplies) and external (i.e. secured export markets) conjunctures.

gains were to a large extent premised on the macroeconomic stabilization, structural reforms and a more efficient utilization of existing capital stock and labor. In this stage of transition (1996-2000), the Baltics, Central Europe and South-East Europe outperformed the CIS in terms of growth rates. However, in the most recent stage of transition (2001-2006) growth rates of the CIS economies were substantially higher and almost reached the rates of the Baltic economies.

Data issues

When considering general developments across transition economies, an important aspect has to be taken into account. It may be suggested that in most of transition economies during the initial years of transformation production levels and growth rates are believed to be understated. In this context, De Broeck and Kostial (1998) demonstrate on the example of the output developments of Kazakhstan during the initial stage of transition, due to the rapid emergence of new privately-owned firms and rather large sizes of unofficial economy. Official statistics could not embrace these elements.

More to the point, Kaufmann and Kaliberda (1996) estimate that during the initial years of transition the size of unofficial economy throughout the whole post-socialist world grew on average by 50 per cent, while its share ranged from 15 to almost 33 percent of overall GDP. Similarly, in their econometric study of transition economies Eilat and Zinnes (2002) provide more support to these assertions and find that a one-dollar official decline of GDP was accompanied by an expansion of the shadow economy of 31 cents.

Growth issues

It was anticipated that transition economies would perform differently in many respects. This circumstance gave an impetus for scholars to find out what factors contributed to the existed differences in performance, particularly in output growth. How large were the contributions of stabilization and structural reforms to output growth? Campos (1999) asserted that due to a large number of factors exerting influence on output growth it was not that simple to determine, which one was of utmost relevance. Practically all works on this issue provided answer, considering initial conditions, structural reforms and economic policy variables as a set of determining variables.

There is no concord in provided answers. With the significance of the determining variables differing, the studies generally state that growth got accelerated, if macroeconomic stabilization had been implemented early and the scope of structural reforms

had been wide enough. For instance, Berg et al (1999) in their attempt to define the relative contributions to growth of initial conditions, structural reforms, and macroeconomic policies, ascribed the drastic fall of output during at the outset of transition to adverse initial conditions and imbalances in fiscal and price schemes.

De Broeck and Koen (2000) in their comprehensive study of the developments of the Baltics and CIS countries during initial stages of transition provide an explanation for the drastic output contractions experienced by most of the transition economies of the FSU. Major focus is made on total factor productivity, growth rates of which even prior to transition were negligible. With the reforms being carried out, the output contraction was to a significant extent caused by substantial investment cuts in physical capital and labor. This caused further decrease of productivity levels reducing the capital stock along with its efficiency. This sequence of events went along the logic of the workings of 'creative destruction' releasing capital and labor without, however, causing newly emerged industries, if anything, to absorb them in a sufficient manner to compensate previous losses in total production.

2.1.5 Social sector

Resembling the workings of 'creative destruction', processes of reallocation of resources and restructuring could not but bring about drastic changes in income distribution patterns. As a result, increased income inequality became a source of insecurity among residents. Against this background, Grün and Klasen (2001) stated that in most transition economies well-being levels declined severely as a result of risen inequality and fallen real incomes; their indicators suggested 'most transition countries were, by 2001, below the level of economic well-being of the late 1980s'. Furthermore, Jensen et al (2002) in their study draw attention to intergenerational redistribution of wealth caused by newly emerged economic structures benefiting only selected groups of employees. Another important aspect touching upon welfare issues is that average well-being fell less than suggested by output developments due to increases of the share of private consumption in output (e.g. Pomfret, 2003b).

It is obvious enough that countries in transition, having undergone such significant changes in the structural make-up of their economies, in the nearest future ought to aspire to a more egalitarian type of income distribution, since otherwise the attained positive outcomes owed to restructuring might be undermined by low degree of social cohesion. Likewise, Verme (2006) draws attention to the importance of appropriate in-

come distribution policies for poverty reduction in a transition economy after growth recovers and starts accelerating. Mitra and Yemtsov (2006) provide some projections on income inequality in countries undergoing transition and assert that future developments of income inequality will be defined by both transition-related factors and those of another type. The former imply, for instance, further structural adjustment and resource reallocation induced by transition from 'plan to market', whereas the latter are related to, among other things, technological change and globalization.

2.1.6 External sector

As mentioned in the previous chapter, globalization and its adjoint phenomena are supposed to influence further developments of economies along with their income distribution patterns in the countries in transition. This assertion is valid, since the workings of globalization determine to a great extent the way countries interact with each other through exchange of goods and services along with factors of production.

In the case of transition economies the processes of internationalization coincided with their external sector's (implying international trade and foreign investment) reorientation, reflecting their general course of economic transformation. On the whole, this goes in line with the assertion proposed by Manzocchi and Ottaviano (2001) that integration is to cause different sorts of divergences and structural adjustments within transition economies. In this context, the EU enlargement process points to the occurred adjustments in trade and foreign investment patterns of the CEE economies throughout the whole transition period (Papazoglou et al, 2006).

Foreign Trade

While considering an array of issues related to trade developments across the region of Europe and Central Asia, it is essential to roughly distinguish between the CEE economies and the CIS countries due to the following consideration. The economies of Central and Eastern Europe, in general, was more successful vis-à-vis those of the CIS in economic performance, not least because of their fairly quick 'east-west' trade reorientation (See Table 2.3).

The shares of the CEE economies' (represented as South-East Europe and EU-8) exports destined to Western Europe (EU-15) have been on steady rise in the period from 1993 to 2003. The same trend is observed when imports of the CEE economies are drawn into consideration. In contrast to the region of CEE, the share of exports of the

CIS economies destined to the economies of Western Europe (EU-15) has diminished (from 46.2 percent in 1993 to 39.6 percent in 2003) (See Table 2.3).

Table 2.3 Transition economies: geographic distribution of trade flows, 1993–2003 (in percent)

	Year	ECA Region	*of which*			EU-15	ROW
			CIS	SEE	EU-8		
Exports							
CIS	1993	21.0	*37.6*	*12.9*	*36.7*	46.2	32.8
	1996	47.7	*70.2*	*4.5*	*19.0*	32.5	19.8
	2000	47.6	*78.0*	*2.8*	*14.3*	33.6	18.8
	2003	39.3	*73.7*	*2.3*	*18.2*	39.6	21.1
SEE	1993	30.9	*44.0*	*16.7*	*31.7*	53.9	15.2
	1996	27.7	*29.9*	*21.4*	*37.0*	59.3	13.0
	2000	28.4	*28.1*	*21.1*	*40.9*	61.2	10.4
	2003	27.9	*22.3*	*18.4*	*45.9*	62.2	9.9
EU-8	1993	27.5	*45.2*	*7.0*	*45.4*	61.7	10.8
	1996	25.1	*46.0*	*4.9*	*47.3*	65.1	9.8
	2000	25.0	*52.0*	*4.1*	*42.5*	65.3	9.7
	2003	23.7	*42.3*	*4.5*	*50.7*	65.4	10.9
Imports							
CIS	1993	27.7	*23.4*	*20.8*	*40.2*	42.9	29.4
	1996	47.9	*63.6*	*7.9*	*23.3*	28.7	23.4
	2000	39.0	*53.1*	*8.2*	*28.8*	33.1	27.9
	2003	37.8	*53.3*	*8.3*	*28.0*	34.8	27.4
SEE	1993	22.8	*22.7*	*29.5*	*36.0*	47.9	29.3
	1996	24.3	*20.3*	*34.9*	*26.5*	52.0	23.7
	2000	24.6	*9.5*	*40.7*	*28.0*	61.1	14.3
	2003	22.2	*7.6*	*40.2*	*30.5*	63.7	14.1
EU-8	1993	25.3	*26.2*	*12.0*	*60.9*	62.6	12.1
	1996	26.1	*25.9*	*12.7*	*59.6*	64.1	9.8
	2000	19.9	*16.7*	*16.5*	*63.6*	68.6	11.5
	2003	22.1	*17.2*	*17.4*	*61.3*	67.5	10.4

Notes:
CIS: Armenia, Azerbaijan, Belarus, Georgia, Moldova, Kazakhstan, Kyrgyz Republic, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
SEE: Albania, Bulgaria, Croatia, Macedonia and Romania.
EU-8: Estonia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.

Source: World Bank (2005: 72-75)

Furthermore, during the same period their imports from Western European economies have lost in their weight (from 42.9 percent in 1993 to 34.8 percent in 2003). Interestingly, within the ECA region's subgroups (i.e. EU-8 – EU-8, SEE – SEE and CIS – CIS) trade has intensified throughout this period.

On the whole, this reorientation enabled the countries of Central and Eastern Europe to gain access to markets of the significantly richer Western Europe. Earned export revenues enabled the CEE economies to resume capital accumulation and gradually increase their at that time obsolete capital stock. All that was complemented by significant volumes of capital inflows.

It must be noted, however, that at the very outset it was not that clear, in which way this reintegration of CEE was to take place, since there had been attempts to establish a free trade area for the countries of the region. For instance, the Central European Free Trade Agreement (CEFTA) was called into existence in 1992 by then Czechoslovakia (now the Czech Republic and the Slovak Republic), Hungary and Poland with Slovenia joining in 1996.

In line with the above stated, Caetano and Calego (2005) assert that most of the CEE economies have enormously benefited from trade with the EU with their trade specialization reflecting newly emerged economic structures. It should be stressed that the perspectives of EU membership alone provided a strong impetus to adapt their economic structures together with the institutional frame.[10]

It is necessary to distinguish between the two groups within Central and Eastern Europe. On the one hand, there are more successful economies of the so called Visegrad group (the Czech Republic, Hungary, Poland and the Slovak Republic), Slovenia and the Baltics, on the other a number of SEE economies lagging behind in terms of income levels, its growth rates and the pace of reforms. The first group of countries managed to attract needed foreign investments from and boost their exports to the countries that make up the core of the EU.

As far as the developments of trade in the CIS region are concerned, one important caveat is called for, since trade within the CMEA area and, particularly, within the then Soviet Union, was completely of different nature. Production units, being dispersed throughout the whole country, were just to execute their output plans and exchange produced items among each other using highly subsidized transport networks.

Therefore, due to the dissolution of production links during the initial phase of transition, exports of almost all republics of the FSU plummeted substantially.[11] Havrylyshyn and Al-Atrash (1998) attribute this mainly to the disintegration of trade

[10] By January 2007, ten of the transition economies of CEE are already members of the EU.
[11] For instance, the value of total exports of the CIS economies has declined from 400.6 bln. US dollars in 1990 to 99.7 bln. US dollars in 1993 (Source: World Bank, 2005: 64).

links and collapse of the payments system as well as sharp decreases of incomes and demand in the FSU countries. In general, transition reforms implied, among many aspects, the steady liberalization of trade. It would integrate the economies of the formerly 'self-isolated' CMEA area into the world trading system.

However, as Michalopoulos (1999) stated, the accomplishments in this endeavor differed throughout the region of Europe and Central Asia. While most of the CEE economies had already integrated their economies into the multilateral trading system, the CIS economies had yet to harmonize their trade regimes and, most importantly, reduce non-tariff barriers embodied in red-tape, corruption and the like. More to the point, Elborgh-Woytek (2003) pointed out that despite some positive trends in trade developments, most of the CIS economies had to intensify their efforts in opening their economies further by upgrading their infrastructure, fostering regional cooperation and pursuing further market-friendly reforms.

A rough comparison of the two groups of countries – CEE and the CIS – in terms of their trade performance throughout their economic transition may lead to the following implications. Firstly, a reorientation of trade flows and specialization adjustment based on comparative advantage goes hand in hand with restructuring and resource (re-)allocation. Secondly, participation in regional trade agreements (RTAs) (or other forms of such arrangements) may provide additional momentum for readjustment of specialization patterns. Thirdly, proximity to large markets (such as those of the European core in the case of the CEE countries) offers ample opportunities for a proper expansion of exports. Last but not least, growth-encouraging institutional frame complementing external sector (for instance, in form of legal support, regulating instruments or arrangements, absence of excessive red-tape, etc.) is of definite significance.

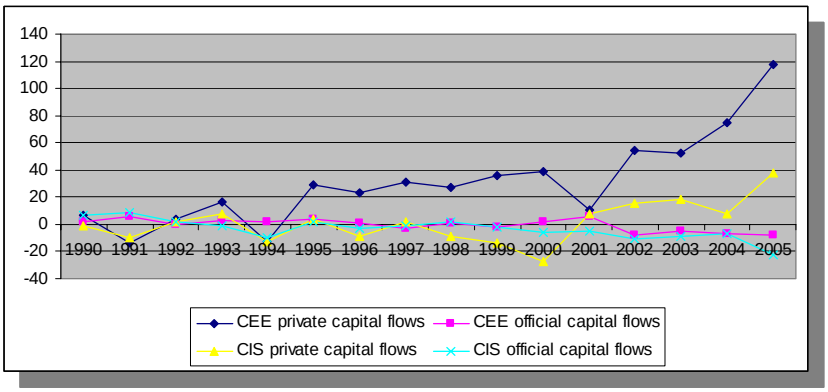
Foreign investment

Since financial possibilities of nearly all transition economies were severely constrained right from the pre-transition period, foreign assistance was badly required to get the needed reforms carried out. Along with significant financial support, substantial technical assistance was called for in all transition countries that lacked the required experience in running their economy in line with market principles. Both financial and technical assistance were provided by international financial institutions and governments of

advanced economies.[12] In addition, frequent cases of extraordinary financing in form of written-off or restructured debts, official aid and the like were to ease financial constraints of most transition economies. Much of the initially provided 'institutional' capital flows appeared to have induced, rather than followed, the reform efforts of the economies in transition.

In the initial stage of transition the amounts of official capital flows (expressed in net terms) exceeded those of private flows in both country groups (See Figure 2.1). It was intended that after the initial transition stage was complete, these 'institutional' capital flows were to give way to private investments and other types of capital flows.

Figure 2.1 Transition economies of CEE and the CIS: private and official capital flows, 1990–2005 (net, in bln. US dollars)



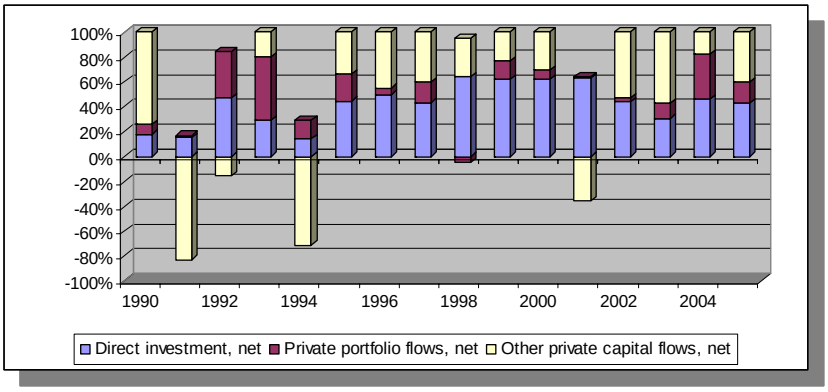
Source: IMF World Economic Outlook database

Additionally, from the end of the 1990s onwards across both regions outflows of official capital exceeded the inflows thereof, what is related to reimbursement of borrowed financial resources. In the region of Central and Eastern Europe from the mid-1990s onwards, private capital flows started to grow in momentum. Ever since their scope has been increasing. In contrast, in the CIS region private capital flows were more moderate in their scope. It is worth mentioning that up until the end of the 1990s outflows of private capital from the region were larger than their inflows. This trend has been reversed in the course of recent years.

[12] In the period from 1991 to 1996 the share of official development assistance (ODA) received by transition economies of Europe and Central Asia was about 40 percent of total net flows (Source: Claessens et al, 1998: 2).

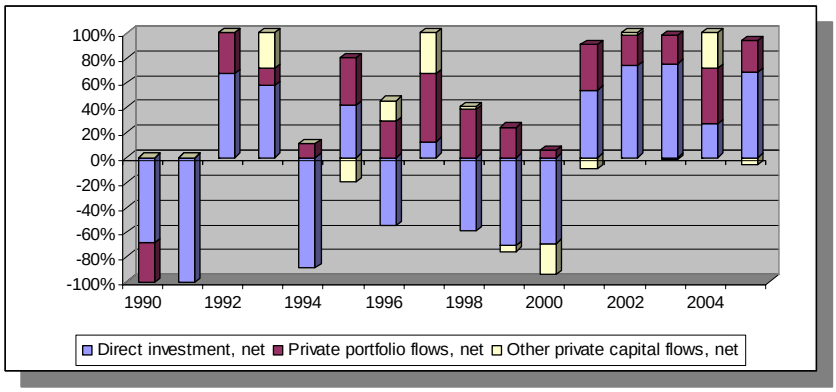
Turning to the make-up of private capital flows, it may inferred that, across both regions, the shares of portfolio investment have been insignificant throughout the whole period, whereas those of foreign direct investment have been considerable (See Figures 2.2 and 2.3). There are yet certain distinctions across the regions. The type of other private capital flows (e.g. private loans, credits, etc.) has been more significant in its scope in the CEE region.

Figure 2.2 Transition economies of CEE: composition of private capital flows, 1990–2005 (in percent of total)



Source: IMF World Economic Outlook database

Figure 2.3 Transition economies of the CIS: composition of private capital flows, 1990–2005 (in percent of total)



Source: IMF World Economic Outlook database

As far as foreign direct investment (FDI) in both regions is concerned, it is obvious that on the whole the economies of Central and Eastern Europe have managed to attract significantly larger volumes of FDI, when compared with the CIS economies.[13] In addition

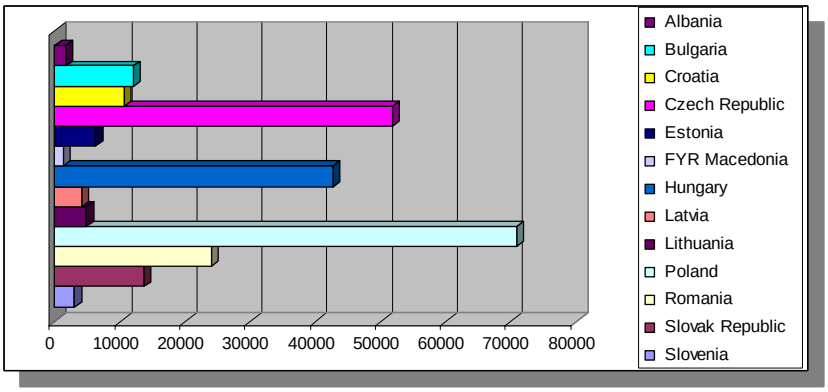
[13] Thus in net terms in the period from 1990 to 2005 the scope of attracted FDI in the CEE region has equaled to 269.79 bln. US dollars; this value for the CIS has been significantly lower (72.92 bln. US dollars) (Source: calculated based on data from IMF World Economic Outlook database).

there have been significant differences within both regions in terms of attracted FDI volumes (See Figures 2.4 and 2.5).

Observed differences in the distribution of FDI flows across transition economies may be attributed to a number of factors (e.g. business and investment climate, spatial proximity to investing countries, structure of production and trade flows, etc.). Therefore, reflecting differing progress of and prevailing conditions in the ECA region's transition countries, private capital started flowing into their economies with various intensity and timing (Claessens et al, 1998).

Figure 2.4 Transition economies of CEE: FDI stock as of 2005

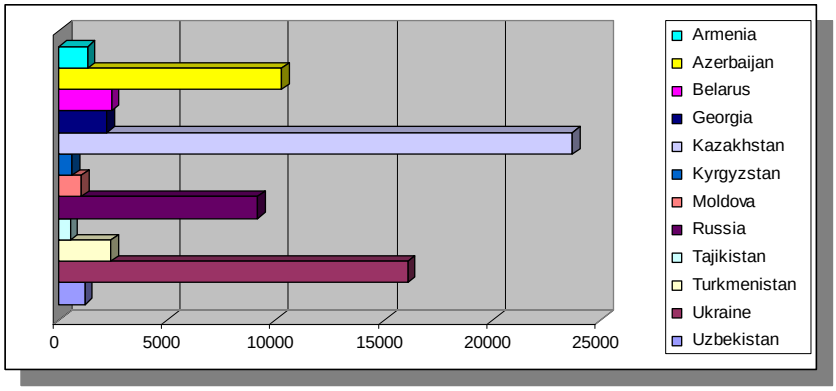
(in mln. US dollars)



Source: EBRD database

Figure 2.5 Transition economies of the CIS: FDI stock as of 2005

(in mln. US dollars)



Source: EBRD database

In view of this, Campos and Kinoshita (2003) along with Shiells (2003) argue that there is an unambiguous distinction in motivation for investing in the CEE economies and the CIS countries. The former attract foreign investment, as a rule, in manufacturing due to their lower wage levels and reasonably sound infrastructure, whereas the latter tends to attract foreign investment in resource-intensive production activities.

In addition, when explaining differing performances of the ECA region's countries, the process of the EU enlargement has to be taken into account. In this context, Clausing and Dorobantu (2006) provide evidence that the amount of FDI received by the CEE economies was indeed positively influenced by their EU accession perspectives. Prospective EU membership, requiring harmonization of institutional basis of candidate countries, induced multinational firms to expand their operation in this region and invest in an array of productive activities.

However, not all countries of Central and Eastern Europe were equally successful in attracting foreign investment. As Garibaldi et al (2001) point out, these differences in foreign investment patterns are, among other factors, attributed primarily to economic fundamentals. Furthermore, other things must be considered as well. For instance, upon examining the performance of the CEE transition countries, Brada et al (2006) conclude that political instability, incurring higher costs of foregone FDI, prevents economies from attaining higher growth paths. Successfully implemented reforms along with a reliable institutional framework are apt to encourage foreign investment activities.

2.1.7 Institutions

An economy based on market principles indeed requires a strong institutional framework to maintain its good functioning. Embodied in laws and regulations, accounting procedures, behavior and habits, an appropriately developed institutional frame helps to secure stability and contributes to the accomplishment of reforms. In the case of all transition economies, the necessity for institutional reforms (legislation amendments, creation of a two-level banking system, reform of a fiscal system, etc.) was widely recognized from the onset of the transformation process.

As shortly mentioned in the previous section, substantial technical assistance was provided by international financial institutions and other donor organizations on a relentless basis to support the institutional readjustment in the countries in the initial years of their economic transformation.[14] However, the results of these aspirations differed substantially across countries, among which in spite of having numerous deficiencies CEE economies being better placed than the CIS countries.

[14] Thus in the period from 1990 to 1994 transition economies of both regions have been endowed with financial resources equal to 26.37 bln. US dollars by international financial institutions (Source: calculated based on data from IMF World Economic Outlook database).

The fact that low quality institutions affect adversely and hinder growth is an obvious one. By discouraging foreign investment and adversely affecting in an array of ways domestic economic activities, they prevent the economy from taking paths with higher rates of economic growth. For instance, Crafts and Kaiser (2004) in their empirical study demonstrate the significance of institutions' quality for growth prospects of transition countries. Hence, rising gaps between high performing and less successful economies may be in part attributed to differences in the quality of institutions[15]. However, being a determining factor of economic performance, institutions are themselves subject to influences of other factors, not least of economic development records.

In line with this assertion, Berengaut and Elborgh-Woytek (2005) put forward that the quality of institutions in transition economies have been influenced by two key factors – conflicts and '*soviet legacies*'[16]. The larger the scope of their influence, the more discouraging their effect on the quality of institutions is supposed to be. Moreover, Iwasaki (2003) along with Beck and Laeven (2005) in their studies on institutions and growth in transition economies argue that sustainable development and growth in transition economies could be seriously hindered by the poor quality of institutions, whose upgrading might be substantially discouraged by strong reliance on natural resources and governments ill-disposed towards needed reforms.

Taking into account initial conditions, the mode for implementation of devised reforms as well as the results attained, it seems expedient to distinguish between the relatively successful group of economies of CEE and the FSU countries, whose performance leaves much to be desired. Most of the CEE economies embarked on the transition process earlier than those of the FSU. These two groups in their turn are in no way homogenous and comprise countries that are distinct from each other in many respects. Gros and Suhrcke (2000) demonstrate that a group of transition economies, sharing similar features and differing from other countries with comparable incomes, has undergone the process of divergence and comprises presently two sub-groups: high performing CEE economies and CIS countries along with transition economies of SEE lagging behind in many respects.

[15] A set of the World Bank's 'ease of doing business' indicators help to establish differences in the quality of institutions.

[16] This term comprises a set of items typical for command economies (e.g. lack of efficient markets, underdeveloped private sector, inappropriate tax and legal systems, lack of public administration's integrity, etc.).

These differences in transition performance point to a wide range of issues related, for instance, to the implementation strategy and sequencing of reforms, role of politics and institutions. Often, it is inferred that there is a two-way link between output growth and market-oriented reforms, implying that well implemented reforms enhance growth prospects, which in their turn encourage further reforms (Falcetti et al, 2005).

Understandably, views on outcomes of the transition across the whole ECA region would be at odds. In this context, Davidson (2001) assesses reform strategies and attained results in most of transition economies and concludes that the whole performance is to be seen as poor despite a number of positive developments (e.g. resumption of economic growth in most transition countries, accomplished reforms in most economic spheres). However, on the whole, according to Kornai (2006), this transformation has proved successful, since such all-encompassing changes are always apt to incur rather high costs (which they in fact did); but nonetheless, considerable gains (in form of obtained democratic institutions and economic freedoms[17]) from the undergone transformation cannot be neglected.

2.2 Transition processes in the economies of the Baltics

2.2.1 The Baltics before transition

Before the onset of transition processes across the whole ECA region, the Baltic region, comprising Estonia, Latvia and Lithuania, had an economic structure that primarily reflected their participation in the regional division of labor within Eastern Europe and the Soviet Union. The economies of the Baltics, being an integral part of the Soviet economic complex, exhibited typical traits of a centrally planned economy (e.g. highly regulated prices, dominating public sector in domestic and external economic activities, etc.) Being extensive in its nature, economic growth in these countries, like in many others of the COMECON bloc, could not maintain growth of living standards of the residents despite the undertaken measures to liberalize certain spheres of economy.

During the years of independence in the first half of the twentieth century, the primary sector was the dominant one in the economies of the Baltic region. Their integration into the Soviet economy brought significant changes into their economic struc-

[17] The index of the ease of doing business and the index o f economic freedom are usually employed to measure these items' developments.

ture: the region underwent rather speedy industrialization in the 1950s (Shen, 1994). Thus, the dominant specialization profile of the Baltic economies comprised machinery and metalwork, timber and wood products, precision instruments, chemical and construction materials. Such 'overspecialization' implied, among other things, high interdependence among the regions of the Soviet Union and was reflected in rather large volumes of exchange in goods and resources.

The poor economic condition at the outset of the 1990s compelled Estonia, Latvia and Lithuania to take the path of political reforms and economic transformation, which had to incur quite high social costs. This economic transformation aspired, first and foremost, at establishing a system based on market mechanisms that were to make economic activities more prudent. To get rid of inherited structural distortions and functional inefficiencies, the Baltic countries had to get over a series of challenges by carrying out reforms and readjusting their systems.

Economists are often inclined to consider the Baltic economies along with other CEE countries, despite the fact that previously they had been tightly integrated into the Soviet economy. This seems plausible, since in terms of their structure, trade specialization, income levels, the Baltic economies differed significantly from the rest of Soviet Union and possessed resemblances with other nations of Eastern Europe (See Table 2.1). But unlike other COMECON members, the Baltic republics were not de jure sovereign. This circumstance made their starting conditions vis-à-vis other CEE countries (Poland, Hungary, the Czech Republic, the Slovak Republic, etc.) more challenging due to numerous institutional constraints.

The three Baltic countries in question were before transition rather diverse despite exhibiting numerous similar traits. Below is just a simplified account of their differences.

1. Lithuania and Latvia were more heavily industrialized than Estonia.
2. Therefore, Estonia was to a lesser degree dependent upon the FSU markets than Latvia and Lithuania were.
3. Estonia and Latvia were less homogeneous than Lithuania in terms of their population make-up.[18]

[18] In 1989 the shares of title nations in Estonia and Latvia equaled to 61.5 and 52.0 percent, respectively, whereas in Lithuania this share was 79.6 percent of total population (Source: Economist Intelligence Unit).

4. Estonia was deemed to be better conditioned for market reforms than Lithuania and Latvia.[19]
5. Geographic proximity and linguistic affinity of Estonia with Finland places it in a more advantageous position in comparison with its two neighbors.

Shen (1994: 214)

2.2.2 Reform strategy and accomplishments

Output collapse

Drastic falls in output were inevitable due to huge disproportions and imbalances inherited by almost all transition economies from their communist past. In this respect the Baltic economies were not much different from the common pattern. Therefore, in view of developments of other economies during transition, the output contraction in all three Baltic economies seemed similar in terms of duration and scope of reforms. It must be noted, however, that there were obvious distinctions in the transition experiences of the CEE and the CIS.

Although transition paths of the Baltic economies were quite similar, there were yet some differences within this group of countries in terms of their output (See Figure 2.6). Estonia and Lithuania had already had first signs of recession in 1990, whereas Latvia's output continued growing until 1991. In 1992 all three economies had their highest negative growth rates (-14.2 percent in Estonia, -34.9 percent in Latvia and -21.3 percent in Lithuania). In terms of total accumulated output decline Estonia and Lithuania experienced output contraction up to 1994 with their output levels reaching lowest points. Latvia's growth rates turn positive already in 1994. However, on the whole accumulated output contractions in Latvia were significantly larger than in other Baltic economies.

This rather drastic contraction of output in the three Baltic economies was caused by an array of factors. In this regard de Broeck and Koen (2000), while focusing on input changes and productivity development, stress that output contractions in the Baltics along with other FSU countries were attributed to a variety of causes, such as fiscal cutbacks, crisis of the credit system, etc. In addition, supply and demand shocks

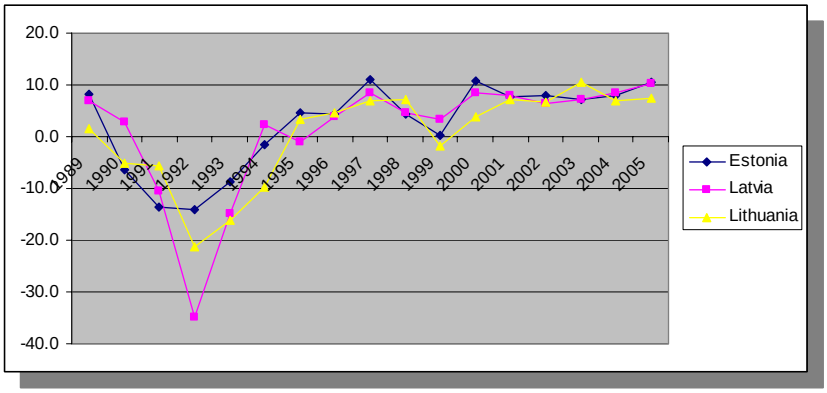
[19] Despite being within the Soviet Economy, in the 1980s Estonia was extensively engaged in joint-ventures with foreign companies (For details see International Monetary Fund et al, 1991). These activities have substantially enhanced Estonia's awareness of market mechanisms.

were among the factors inducing the output collapse. The main supply shocks were caused by a disruption of previously existing production links between producers and their suppliers: for the most part the Baltics had to rely upon supplies of raw materials and energy resources.

In view of this fact, higher output losses of Lithuania and Latvia were probably to attribute to their higher dependence upon supplies from other republics of the Soviet Union. Another supply shock was caused by rather rapid liberalization of trade with most of the western economies leading to disproportional increases of imports compared to exports of the Baltic economies. This circumstance exerted a strong pressure upon producers operating mainly in domestic markets, which were at that time far less viable on many accounts than their competitors in the West.

Figure 2.6 Baltic economies: output growth rates, 1991–2005

(in percent)



Source: EBRD database

Such adverse effects brought about by demand shocks deprived enterprises of the Baltic economies of their previously secured markets for their products demanded by other enterprises located in other parts of the Former Soviet Union. Hence, the volumes of trade turnover with the republics of the Former Soviet Union plummeted substantially, whereas those with the western economies began rising at a swift pace. Actually, all Baltic economies intended and were compelled to change the geography of their trade links in favor of western economies.

Output recovery

The second half of the 1990s was marked by the processes of economic rebound in the Baltic economies (See Figure 2.6). Rates of output growth were certainly negligible in comparison with the scope of the previously experienced recession in all three economies. However, before the end of the decade the growth trends were significantly en-

hanced for the most part by favorable developments in both domestic and external sectors. These trends continued to persist until the end of 1998, when the Russian financial crisis broke out. Growth rates in all Baltic economies decreased sharply – though to a differing extent – and reached their new lows in 1999. From that moment onwards, growth rates of the Baltic economies were among the highest across the region of Europe and Central Asia reaching in the course of recent years two-digit values.

It must be mentioned that the economic rebound of the Baltic countries has been premised on favorable developments in both domestic and external sectors of their economies. Investment and government expenditures were fairly well complemented by persistently rising exports and increasing volumes of foreign investment. Moreover, Chado et al (2004) suggest that exports growth in combination with the increase of investments have had a positive effect on the economic growth of the three Baltic countries.

Like in other transition economies, recent economic growth has been primarily based on growth of productivity levels and accumulation of capital. The contribution of labor has been insignificant (See Table 2.4).

Table 2.4 Baltic economies: economic growth and its constituents, 1996−2006

Country	Annual real GDP growth rate (in percent)	Investment as percent of GDP	Contribution to Growth (percentage points)			Share of TFP in output	Growth in productivity of labor (in percent)
			Capital	Labor	TFP		
Estonia	7.6	29.6	4.5	0.1	3.0	39	7.4
Latvia	7.4	26.2	4.2	0.4	2.8	38	6.6
Lithuania	6.4	22.5	3.1	0.1	3.1	49	6.1
Baltics	7.1	26.1	4.0	0.2	2.9	41	6.7

Source: Iradian (2007a: 17)

Initially, a major part of newly founded firms in the Baltic were not competitive enough to gain substantial market shares abroad and secure relatively high export revenues. However, at the same time they were compelled to import lots of capital goods, which in value terms often exceeded their import capacities. Consequently, relatively high current account deficits became one of the major concerns. They pointed to rather still immature status of these economies, which were still supposed to renew and upgrade its

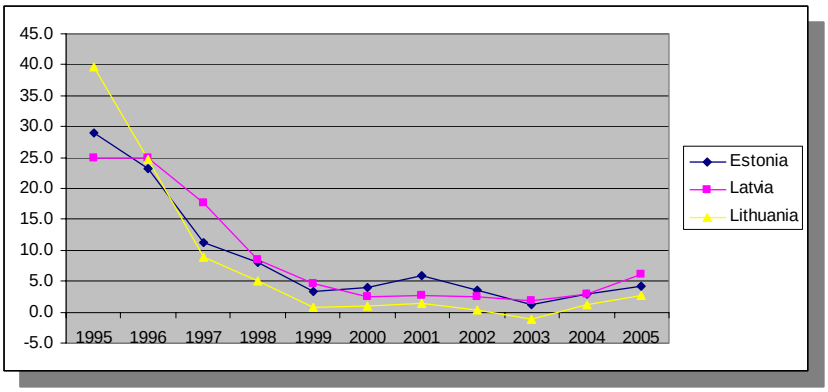
capital stock (Lutz, 2006). These were to a great extent facilitated by capital flows from abroad, which required first and foremost price and monetary stability in the economies in question.

2.2.3 Price liberalization and monetary reforms

From the mid-1990s growth perspectives of the Baltic economies were favorably influenced by positive effects stemming from fairly successfully implemented measures aimed at stabilizing price levels. All three economies of the Baltics managed to reduce inflation rates and achieved rather stable price levels by the end of the 1990s (See Figure 2.7). One of the important measures taken to lessen adverse effects of price liberalization was the introduction of their own currencies by all three economies. Estonia was the first to leave the rouble area (June 1992), Latvia and Lithuania followed suit shortly after that (March and June 1993). In addition, capacities of the newly established central banks in all three republics were substantially enhanced after the Bank of England had restituted their gold deposits placed there before the 1940s (Hiden and Salmon, 1994: 192).

Figure 2.7 Baltic economies: inflation rates, 1995–2005

(in percent)



Source: EBRD database

Practically regulated exchange rates of the Baltic economies – either through a currency board in Estonia and Lithuania, or a fixed peg in Latvia (See Table 2.5) – helped to secure stability of their currencies and domestic prices. This circumstance implied, among other things, fairly tight fiscal discipline for their governments. Thus far, despite relatively large current account deficits, the regulated exchange rate polices have proved a useful instrument in implementing stabilization and restructuring policies while simultaneously pursuing long-term development strategy.

The choice of the exchange rate regime depends upon an array of circumstances. Deriving from an intention of the Baltic economies to secure considerable inflows of foreign investment and maintain purchasing power of their currencies, their choice of inflexible exchange rate regimes seems plausible despite increasing current account deficits. This sort of strategy seems viable in given favorable conditions in the Baltics (e.g. low production costs due to relatively low labor costs).

Table 2.5 Baltic economies: liberalization of economic spheres (as of 2006)

Country	Current account convertibility	Controls on inward direct investment	Interest rate liberalization	Exchange rate regime	Wage regulation	Tradability of land
Estonia	full	no	full	currency board in ERM II	no	full
Latvia	full	no	full	fixed peg in ERM II	no	full except foreigners
Lithuania	full	no	full	currency board in ERM II	no	full

Source: EBRD database

The Baltic economies, along with other CEE countries, have so far benefited greatly from their relatively low labor costs. However, in the longer time span further price and wage adjustments are to bring about deterioration of this seemingly permanent competitiveness. Under these circumstances, in the absence of self-regulating mechanisms, such as flexible exchange rate regimes, imbalances will be felt somewhere else in the economy, leading to underutilization of available resources (in form of higher unemployment and greater output gaps). However, in the long run releasing a grip on the exchange rate would seem a more plausible option, since it would enable to serve as a preventive mechanism in view of probable imbalances stemming from external sector developments.

2.2.4 Privatization

Being one of the core elements of the whole reform package, large-scale privatization was not uniformly implemented in the Baltics. Understandably, proposed privatization schemes were to be adapted to the realities and needs of the local economy (Gillies et al, 2002). Therefore, while Estonia in its privatization endeavor relied more on a direct sale of the formerly state-run enterprises, Latvia and Lithuania opted for the dominance of

voucher-based privatization (Shen, 1994). Aimed at creating dynamic private sectors, both options had their pros and cons. Estonia's case reveals that direct selling of enterprises as a rule takes more time, but enables to find appropriate investors capable of doing things in an appropriate manner. The voucher-based privatization comes about in a shorter time span, implying, however more difficulties in getting external financing and expertise. Often, there were misconducts in place, which were caused by conflicts of interests between different constituencies. As expected, employees of old and inefficient industries did not want to lose their positions.

With the privatization of large enterprises proceeding at a moderate pace across the region, Estonia and Latvia embarked on a privatization of land. In April 1993 Estonian authorities allowed foreigners to purchase land related to an acquired main enterprise. One year after Latvia has proceeded with privatization of land at rapid pace, within a short time span Lithuania following suit.

Since most means of production and land had been in private property before the forced integration into the Soviet economy, privatization course acquired additional aspects. All property items, illegitimately dispossessed, were, if applicable, to be returned to the original owners. Only if no claim was raised, could privatization of an object be embarked upon. Conundrums of this sort called for an appropriate and well functioning institutional framework, in general, and legal system, in particular.

As many enterprises of the Baltics, like in other countries of the COMECON bloc, used to enjoy directly or indirectly the monopoly status, all of them were entitled to reorganization up till the possibility of vertical or horizontal disintegration into smaller independent units. As already partly mentioned above, among primary methods employed during privatization were tender, auction, leasing with acquiring prospects and the like. In general, all Baltic countries managed to establish a sound institutional framework embodied in privatization authorities and privatization procedures.

The principal objective of the whole privatization program was the establishment of an optimal array of ownership forms that would enable to efficiently utilize available resources in an economy. Furthermore, this implied, among other things, a dominant status of the newly established private sector that is more apt to attaining higher productivity levels. In view of this, Jones and Mygind (2000) point to efficiency gains the Baltic economies accrued from privatization process, i.e. the substantial increase of the private sector's share. Taking stock of the above mentioned, one must note

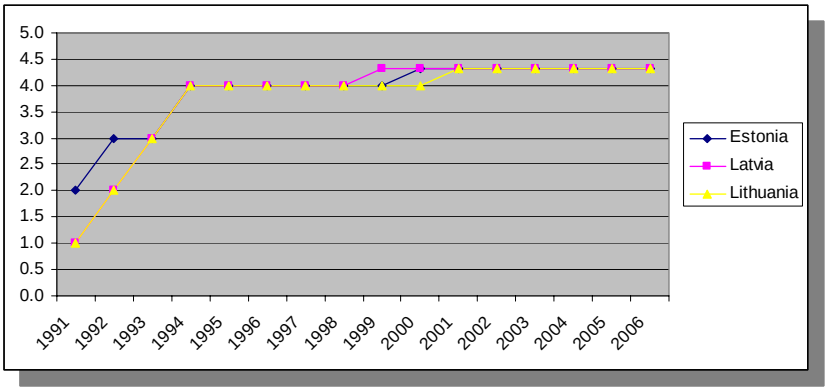
that in general all Baltic economies implemented privatization at a rather rapid pace, with Lithuania being the quickest, Latvia the slowest and Estonia faring in between.

2.2.5 External sector

Foreign trade

In the early 1990s, the Baltic economies liberalized substantially their external sector. These changes occurred almost uniformly across the Baltic region (See Figure 2.8). Presently, their foreign trade regimes are reckoned liberal. This may be inferred from their presently high scores of the EBRD trade liberalization index.

Figure 2.8 Baltic economies: EBRD index of trade liberalization, 1991–2005



Note: minimum score "1.00" (complete lack of progress); maximum score "4.33" (advanced market economy)

Source: EBRD database

Throughout the 1990s this liberalization of trade across the Baltic economies has gone hand in hand with significant changes in their trade patterns. Such changes implied alterations in terms of geographical distribution and structural composition of their trade flows caused by a rapid dissolution of previously existing production links primarily with other economies of the Former Soviet Union.

From the outset of the transition process it was clear that the Baltic economies were not able to abruptly abandon their markets in the East, since most enterprises depended to a great extent on supplies of raw materials and energy resources and were, thus, closely linked with the enterprises from other parts of the FSU (Hiden and Salmon, 1994). Moreover, it was the CIS countries that took up greater part of the produced output of certain industries right up until the mid-1990s. However, eastern markets were rather unpredictable in their further development (e.g. lack of credibility and decreasing purchasing power were commonplace), what eventually forced the Baltics to seek its fortune in the West and intensify their efforts to reform their economies.

Touching upon their trade orientation, Sorsa (1994) argued that trade integration of the Baltics with Western economies would lead to trade creation that would considerably outweigh trade diversion resulting from maltreatment of markets of the FSU. However, Laaser and Schrader (2004) point out that the Baltic countries managed to integrate their economies into the European division of labor and maintain some trade links with the CIS countries instead of giving up them altogether. These links would bring further benefits to the Baltic economies, which can develop itself into a gateway from Europe into the CIS markets. It should be noted that in certain sectors (e.g. transport, food and pharmaceuticals, chemicals, etc.) the Baltic economies by 2000 were still predominantly present in the ex-CMEA, including the FSU countries despite the dominant shares of the EU in foreign trade of the Baltic economies (Liuhto and Jumpponen, 2002).

Their aspirations to restructure their economies along with their foreign trade patterns led to the establishment of a number of regional trade agreements aimed at securing markets for their products both in the East and the West. Export revenues were to serve as an important complementary addition to investments, whose levels plummeted substantially during the initial transition years. Triggered output growth in the Baltic economies in the mid-1990s is surely to certain extent to be attributed to their trade performance, which was, as Hansen and Kvedaras (2004) argue, enhanced by favorable external conditions.

The strategy of export expansion pursued by the Baltic economies was mainly aimed at winning new market shares, what enabled them to earn additional means to further capital deepening in their newly established industries. This directly contributed to their more rapid structural and functional transformation. Moreover, Havrylyshyn and Al-Atrash (1998) stressing the link between the economic transformation and proximity to the western markets, state that the Baltics, like most of the CEE countries and in contrast to the CIS countries, is deemed to attain its 'natural' trade patterns,[20] i.e. resulted from their presently given comparative advantage and market-based distribution mechanisms.

Additionally, in accordance with their given comparative advantage, Sorsa (1994) asserted, in trade with Western Europe the Baltic economies were first to specialize in labor- and resource-intensive exports, and then develop a comparative advan-

[20] The term is used as opposed to 'distorted patterns' that used to dominate trade before transition.

tage in skill-intensive industries. Currently, the export profile of the Baltic economies is rather heterogeneous, the scope of which ranges from technologically sophisticated export items of Estonia to, to some extent, resource-intensive exports of Latvia and Lithuania (Laaser and Schrader, 2005).

The region's foreign trade performance has been so far quite impressive. The Baltic economies, having realized substantial trade potentialities, managed to reorient their trade to make the most of their comparative advantage and benefit from their participation in the international division of labor. These shifts in foreign trade patterns were also accompanied and, in part, enhanced by capital flows that were also indispensable for the success of the overall transformation and output recovery.

Foreign investment

Since financial capabilities of the Baltic economies at the beginning of transformation were severely constrained, it was clear that remarkable volumes of capital inflows would be required to, first, successfully undergo adjustment and restructuring processes and, then, trigger growth recovery. These capital flows were of different nature. At the outset the Baltic economies, like many other transition countries, relied primarily on the financial resources provided by international financial institutions (e.g. World Bank, IMF, EBRD, etc.) in form of loans with favorable repayment conditions. Making the most of these financial resources, the Baltic economies managed to carry out their reform packages in most economic spheres. Moreover, in the course of transformation, institutional loans and grants gave way to private investments, which were enhanced by attained success of the implemented reform package.

As far as the experience of attracting of foreign direct investment is concerned, it is worth noting that the Baltic economies were better placed in comparison with other republics of the FSU. Even being within the Soviet economy, they were involved in endeavors with foreign direct investment, made possible in the second half of the 1980s. For instance, Estonia, Latvia and Lithuania, being relatively small in economic terms, were front-runners among republics counting by the beginning of 1990 104, 39 and 18 joint-ventures, respectively (International Monetary Fund et al, 1991: 104). This experience no doubt spurred up the absorption capacities of the countries in question.

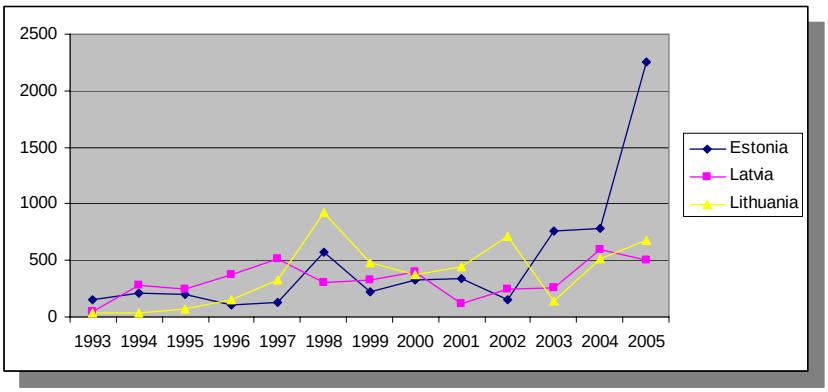
In general, the Baltic economies have performed differently in terms of attracted foreign investment throughout the whole transition period (See Figure 2.9). Estonia has been more successful in attracting foreign investment from abroad. Thus, as of 2005 the

value of FDI stock per capita was equal to 4621.8 US dollars. This has by far outweighed corresponding figures for Latvia (1827.3 US dollars) and Lithuania (1433.2 US dollars).[21]

Originating from rather various sources, capital inflows, in general, have had favorable effects upon the course and dynamics of the Baltic transition. A significant number of enterprises and firms benefited from attracted foreign capital by readjusting their profiles and management structures as well as modernizing their production facilities. Although foreign investment cannot be deemed a universal remedy against economic diseases stemming from communism, enhanced by a set of other measures it can produce much-needed positive outcomes. In the case of transition economies, mostly of CEE, they proved indispensable in contributing to establishing new and/or modernizing existing industries, what substantially facilitated their output recovery.

Figure 2.9 Baltic economies: net FDI flows, 1993–2005

(in mln. US dollars)



Source: EBRD database

Foreign investment is also deemed to be closely intertwined with trade links. Such trend became more and more evident, as private capital flows got intensified and increased substantially in the export-oriented sectors. For instance, Jensen (2004) in her empirical study points to the presence of a two-way causation between trade and FDI flows between the EU and CEE economies. This implies that much of the foreign investment attracted by the economies of the region is linked to their export activities. In addition, Sorsa (1997) stresses that trade arrangements of the Baltic economies facilitated further trade development and technology transfer not least through the workings of the effects brought about by FDI.

[21] Source: calculated based on data from EBRD database.

2.3 Transition processes in the economies of Central Asia

2.3.1 Central Asia before transition

Being a relatively vast region in terms of territory and sparsely populated, Central Asia[22] comprises five countries, which throughout the recent history was an integral part of the Soviet economic complex. With some exceptions, the economies Central Asia within the Soviet division of labor were primarily considered as suppliers of primary goods, i.e. agricultural products and raw materials. Despite their division into republics the region was seen as one economic region. This made its republics very interdependent, as far as production, distribution and utilization of energy and water resources are concerned.

However, it would be wrong to consider the region as being at that time just a supplier of primary goods, since a significant number of factories were located here as well, constituting often essential links of manufacturing chains. Most of such production units, located in the region, were supposed to directly or indirectly supply other enterprises of the Soviet defense industry, which was apt to attract and employ high quality factors of production – technology, physical and human capital. For instance, Tashkent, the capital of Uzbekistan and the then fourth largest city in the Soviet Union, exhibited high degree of concentration of industrial production, a result of the relocation of factories and plants from western parts of the country prior to the mid-1940s (Pomfret, 1998). Moreover, other republics of the region had industrial capacities, primarily embodied in plants involved in enrichment of gained resources, thus often representing primarily up-stream activities along the value chains.

In addition, before the onset of transition the countries of Central Asia differed in terms of their ethnic composition. In this respect, Kazakhstan, the Kyrgyz Republic and Tajikistan exhibited larger shares of other nationalities in their population, whereas Turkmenistan and Uzbekistan were more homogenous.[23]

[22] Central Asia is defined differently in various sources. In the present work Central Asia is used in its narrow meaning, implying the five republics of the ex-Soviet Union (Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan). There is, however, a broader vision, for instance, represented by ADB, in line with which, besides these five, Azerbaijan, Mongolia and Xinjiang Uygur Region of the People's Republic of China are included.

[23] Thus, as of 1989 the share of title nations in Kazakhstan, the Kyrgyz Republic and Tajikistan equaled to 39.7, 52.4 and 58 percent, respectively. These values were higher in Turkmenistan (72 percent) and Uzbekistan (71.1 percent) (Source: Economist Intelligence Unit).

2.3.2 Reform strategy and accomplishments

With the break-up of the Soviet Union in the early 1990s, these countries were impelled to undergo fundamental changes in all major spheres being brought about, among other things, by their gained independence. This gained sovereignty implied self-reliance in economic policies, what formerly was the prerogative of Moscow, the then center of the massive and cumbersome economic system. Processes taking place rapidly have caught most of these economies off their guard, since they were not prepared to face political and economic challenges.

Right from the onset of the transition process, all five economies were placed rather differently. Kazakhstan and Turkmenistan, being supposed to benefit considerably from terms-of-trade improvement due to large reserves of petroleum and natural gas resources, faced substantial constraints in their exporting capabilities due to limited capacities of existing pipeline networks. The Kyrgyz Republic and Tajikistan, smaller economies of the region sparsely endowed with natural resources, faced difficulties stemming from their geographical remoteness from main transport hubs. Uzbekistan was placed somewhere in between, while having moderate natural gas reserves and suffering from its rather disadvantageous landlocked geographical location. Having relatively different starting conditions, they embarked upon transition taking differing paths, which led them to their today's even more contrasting outcomes.

Already in the early 1990s, the newly emerged Central Asia countries had to start establishing their national economies with all required institutions through implementation of a package of economic reforms, which was to be devised either on their own or with financial and technical support of international financial institutions (World Bank, IMF, EBRD, etc.) Unlike, for instance, the Baltic countries (which were in general uniform in their reform paths), the Central Asian countries represent a sample of economies that differed considerably in their reform modes.

In terms of the speed of implemented reforms in the first half of the 1990s, the Kyrgyz Republic was the fastest. While the pace of Kazakhstan in reforming its economy was slightly slower, Uzbekistan and Turkmenistan lagged considerably behind. Tajikistan's aspiration to undertake needed reforms were interrupted by a civil war that incurred high losses in both physical and human capital.

In the context of the Central Asian economies' transformation, the appropriateness of either of the two approaches to reforms – radical or gradual – has been ques-

tioned and no unanimity among scholars and policymakers has been reached. On the one side, it was hoped that taking a rather radical approach would facilitate the processes of 'creative destruction' and pave the way for new and more efficient economic structures. However, the Central Asian economies were often considered not being apt to take the radical approach to reforms due to their regionally inherent features, which, among other things, comprised:

> […] a complete absence of previous experience with market institutions, coordination and practice, attitudes of population as well as the challenge of building new national economies and adapting their economic systems, which were not economic systems themselves, to the new requirements of the transition period.
>
> Kalyuzhnova (2000: 166)

In the course of their economic transformation in the 1990s the economies of Central Asia differed considerably in terms of their attained progress, not least due to rather dissimilar initial conditions and approaches to reforming their economies. In addition there were country-specific features, which influenced transition paths.

Kazakhstan, whose industrial sector was strongly integrated with those of other republics, mainly of the Russian Federation, was hit by negative consequences originating from price liberalization measures taken in Russia in 1992. Upon gaining its independence, the Kazakh leadership embarked on economic reforms with a moderate speed (being second only to the Kyrgyz Republic in the region). Restructuring (e.g. price liberalization, small-scale privatization, etc.) along with macroeconomic stabilization were implemented with mediocre results. Despite some accomplishments in implementing reforms, Kazakhstan failed to lay foundations for a viable institutional framework in the initial stages of its transition and, therefore, suffered from the lack of efficiency of the newly created structures.[24]

The Kyrgyz Republic was rightly seen as a high-speed reformer of the region, since it implemented essential constituents of the reform package within a short time span that implied significant reduction of state interference in the economic sphere. Accordingly, by the end of 1993 government procurement schemes were eliminated and most of the prices liberalized. Privatization of enterprises was of smaller scope than in the countries of CEE and the Baltics, but considerably more extensive than in those of

[24] For details see Figure 4.3, p. 131.

Central Asia. However, privatization suffered substantially from inefficiencies due to insider trading and did not lead to anticipated gains in productivity.

Tajikistan found its economic situation significantly exacerbated after a fratricidal conflict within the country broke out and endured up until 1997. This circumstance prevented its authorities from following through the reforms, which had already been partially launched. Thus, privatization of dwelling facilities was complete until 1993. Price liberalization and elimination of state procurement schemes followed with a four-year delay. Therefore, due to the interruptions it does not make much sense to compare its progress with those of other Central Asian economies. This notwithstanding, it is committed to rapid further reforming.

Turkmenistan was from the outset rather reluctant to undertake transformation of its economy. Instead its leadership was inclined to misuse the revenue originating from its affluently available natural gas reserves. Neither part of the intended reform package has been thoroughly implemented. With the state still retaining much control over the economy, neither price liberalization nor elimination of state subsidies along with its procurement activities was realized. Therefore, being blessed (or rather cursed) with abundant natural resources and having significantly benefited from the terms-of-trade improvements, Turkmenistan has made very little progress, as far as its systemic transformation is concerned. In this context, Pomfret (2001) points out that despite its favorable external conjuncture, prospects of Turkmenistan's sustainable growth are by no means secured due to the lack of reforms.

Uzbekistan, being the most populous country of Central Asia, has started reforming its economy not as drastically as, for instance, Kazakhstan or the Kyrgyz Republic. The completed reforms were in fact rather partial, since state continues to dominate certain sectors of economy through price controls, its subsidies and procurement schemes. However, unlike Turkmenistan, Uzbekistan has undertaken measures to reform selected spheres of its economy in spite of having taken a rather piecemeal approach to the implementation of reforms. In this respect Kalyuzhnova (2000) stresses that Uzbekistan opted for 'a piecemeal strategy towards transition', i.e. a gradual or step-by-step approach. Pomfret (2000c) disagrees and denies existence of any Uzbek model or approach, since the reforms thus far have been implemented in an inconsistent manner. Its relatively good performance in the initial stage was due to favorable external conditions and fairly well implemented policies. This approach has proved justified due to rather

poor record of other FSU economies, which preferred taking a radical approach. Price liberalization and small-scale enterprise privatization were to a large extent completed only by 1996.

Thus, the region of Central Asia comprising five transition economies offers a variety of approaches towards transition. Neither of the countries concerned seems to have attained outcomes it aspired after, since either reforms were carried out incompletely, or approaches taken proved inappropriate, or the institutional frame appeared unreliable. Therefore, as Perlman and Gleason (2005) state, the cumulative effect of the implemented measures would only be enhanced by further reforms aimed at establishing and developing institutional framework. In any case, further steps along the transformation path seem indispensable, if substantial progress is to be made altogether.

Output decline

While considering an array of issues related output developments and its growth rates, one has to address the issues of reliability of output data, since there may often be substantial discrepancies. Against this background, Taube and Zettelmeyer (1998) and Pomfret (2003) draw attention to the issues related to the reliability of output records of the Central Asian transition economies. There supposed to exist a clear pattern: within the Central Asian region the more market-oriented economies are inclined to have larger private sectors and service sectors within them, which could not have been 'statistically absorbed' at once.

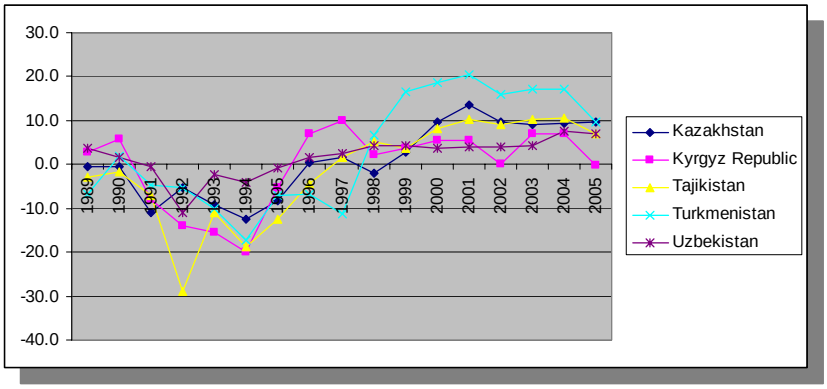
Therefore, the Kyrgyz Republic and Kazakhstan, the economies that were undergoing transformation right from the initial years at a rapid pace are believed to have their output levels underreported.[25] Another reason, which is equally significant, is the sharp increase of the shadow economy. Therefore, in line with arguments of Eilat and Zinnes (2002), it is reasonable to assert that the Kyrgyz Republic, Kazakhstan and Tajikistan have larger shadow economies (related to officially measured GDP) than Turkmenistan and Uzbekistan do. As Uzbekistan and Turkmenistan initially embarked on reforms at a fairly slack pace and, thus, retained much control over their economies, their output performance are deemed overstated. However, the available data on output performance during transition of the Central Asian countries still proves useful, since it reflects essential trends and patterns of output behavior.

[25] The same would be valid for employment statistics.

As Russia launched its liberalization program in 1992, all Central Asian economies had to follow suit to obviate substantial trade imbalances resulting from price differentials. However, these measures were to just limit losses. This notwithstanding all countries concerned suffered substantial setbacks in most sectors caused by the disruption of production links. One should at the same time note that due to different specialization profiles, the scope of output collapse differed across the region (See Figure 2.10).

Figure 2.10 Central Asian economies: output growth rates, 1990–2005

(in percent)



Source: EBRD database

Kazakhstan and the Kyrgyz Republic experienced recessions up until 1996, when their output levels reached their lowest levels and started recovering. The output behavior of Turkmenistan was in line with the region's main pattern: its output was falling until 1998, when old sectors contracted significantly, and started its revival because of substantial exports growth. Tajikistan, being involved in military conflict, experienced sharp output fall until 1997, when military actions were ceased. It must be noted that its output plummeted substantially already in 1992, when its output contracted by 29 percent. Uzbekistan's output was falling until 1996, however less dramatically than in other countries of the region.

The differences in output performance (or rather limiting its contraction) in the first half of the 1990s depended upon an array of factors. For instance, De Broeck and Kostial (1998) point to an excessive accumulation of physical capital as a contributor to the output decline. Furthermore, disorganization and sectoral misallocation are also believed to have contributed. Credit contractions and reductions in aggregate demand are supposed to have had adverse effects on the output level. Since, these conditions, among other things, were variously present in the Central Asian economies, their output performance differed. In the same way, Kalyuzhnova (2000), while comparing the two

largest economies of the region, stresses that, unlike Uzbekistan, Kazakhstan had to suffer severe output contractions due to severance of its links along supply chains that went beyond its borders and ill competent (i.e. poorly prepared for market conditions) bureaucracy.

As regards Uzbekistan's rather 'successful' output performance in the initial stage of its transition, Taube and Zettelmeyer (1998) infer that Uzbekistan's output-overstatement cannot cover the whole difference in output performance. In addition, there must have been other factors in place that favorably affected the output behavior of Uzbekistan. Zettelmeyer (1999) included to these favoring conditions, firstly, absence of excessive accumulation of physical capital (what has been termed overindustrialization), secondly, favorable cotton price developments, and, finally, relative self-sufficiency in energy resources.

The smaller economies of Central Asia were adversely affected by either of the following circumstances: overindustrialization of their yet small and dependent industrial sectors, less favorable external economic conditions and small domestic market size along with high dependence upon imports of energy resources. Their less impressive output records (when compared with those of Uzbekistan), were, among other things, due to higher reliance upon the developments of the Russian economy (Robson, 2006). In addition, large scope of output contractions observed in Tajikistan until the end of the 1990s should be ascribed to its military conflict.

Output recovery

Across the region the Kyrgyz Republic stood out for rather rapid resumption of economic growth (which reached the value of 9.9 percent in 1997). This fact was primarily ascribed to the swift pace of implemented reforms in the initial stage of transition. However, in 1998 this positive trend was undermined by adverse effects stemming from the Russian financial crisis. In addition, Kazakhstan's economic revival was hampered in the same year.

By the end of the 1990s, all Central Asian economies, resembling other CIS countries, resumed their growth, which was mainly based on the expansion of their exports in terms production volumes and prices. China's rapid economic expansion and inelastic world demand for the commodities of the Central Asian economies contributed to the improvement of their external conjuncture. Therefore, the countries of the region (Kazakhstan and Turkmenistan), richly endowed with highly demanded exportable

natural resources (e.g. oil and gas), outperformed those with moderate reserves of such resources (the Kyrgyz Republic, Tajikistan and Uzbekistan), which had to rely more on exports of agricultural and mining products.

Like other transition economies of the CIS region, economic growth of the countries of Central Asia has been primarily based on increments of productivity and accumulation of capital. The contribution of labor has been of less significance (See Table 2.6). In addition Iradian, (2007b) suggests that almost half of the total growth in the period from 2001 to 2006 originated from the recovery of previously lost output and a favorable external environment. These two factors are unlikely to continue for a long time. Therefore, the undiversified export structure and favorable terms-of-trade developments may expose the region's countries to considerable external risks. Long-term rapid growth, therefore, will be increasingly dependent on the ability of the region to diversify and raise investment in the non-resource sectors.

Table 2.6 Transition economies of Central Asia: economic growth and its constituents*

Country	Period	Real GDP growth (percent)	Investment to GDP ratio (percent)	Capital Growth (percent)	Labor growth (percent)	Labor productivity growth (percent)
Kazakhstan	1991–1995	-9.2	27.8	-6.5	-2.2	-7.2
	1996–2000	2.6	16.9	2.3	-1.1	3.6
	2001–2006	10.4	24.7	8.0	2.7	7.5
Kyrgyz Republic	1991–1995	-12.1	15.6	-10.0	-1.2	-10.9
	1996–2000	5.6	16.3	3.2	1.5	4.1
	2001–2006	3.6	19.8	5.2	1.6	2.0
Tajikistan	1991–1995	-16.2	27.9	-12.5	-1.2	-15.1
	1996–2000	2.9	8.5	-1.1	-0.5	3.5
	2001–2006	9.0	16.6	5.4	1.7	7.1
Uzbekistan	1991–1995	-4.0	21.7	-2.4	1.3	-5.2
	1996–2000	3.3	23.8	5.8	1.2	2.1
	2001–2006	5.7	23.5	5.1	1.9	3.7

* Turkmenistan is not represented due to the lack of data.

Source: Iradian (2007a: 28)

Confirming the above mentioned, Verme (2006) argues that the region's sustainable growth is not secure despite its strong revival based on export expansion, since it failed to absorb labor resources that had been previously released in the course of restructur-

ing. In this context, Pomfret (1998) emphasized as well that regardless of recent growth trends, primarily due to high prices of their exportables, the Central Asian economies had failed to lay foundations for broad-based sustainable development; substantial windfalls of foreign exchange just led to excessive specialization in primary sectors and increased income inequalities, what would just further undermine social coherence.

Further policy reforms and regional cooperation initiatives aiming at promoting economic growth on a sustainable basis could prove the way out. Realization of such schemes would determine whether the region will conduct 'business as usual', be able to close the gap or fall behind more advanced economic regions (Dowling and Wignaraja, 2006).

2.3.3 Price liberalization and monetary reform

One of the first steps in the transition process was price liberalization. The prices of many items in the Central Asian countries, like in other countries of the FSU, deviated significantly from those on international markets. The first wave of price liberalization took place right after Russia embarked upon its own transition in 1992. Further measures aimed at liberalizing prices were undertaken in the subsequent years across the region. However, the extent of these measures eliminating price controls varied substantially: Tajikistan, Turkmenistan and Uzbekistan retained control over most prices, while the Kyrgyz Republic and Kazakhstan only a small fraction of them.

Rather high inflation rates ensued releasing greatly distorted prices. Especially, during the initial years of transition, the countries' economic situation was substantially exacerbated by high inflation rates, which brought about considerable devaluation of their currencies and caused strong disturbance of investment schemes adversely affecting the whole macroeconomic system. Thus, in the course of the first three initial years of transition (1992 – 1994) Kazakhstan's average inflation rates were equal to 1645.1 percent, whereas in the time span the values of this indicator amounted to 602.7 percent, 1234 percent, 1781 percent and 915.9 percent in the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan, respectively.[26] By the mid-1990s, when inflation was brought under control, exchange rates of the national currencies were more or less stabilized, what promised more security for national investment schemes badly required for

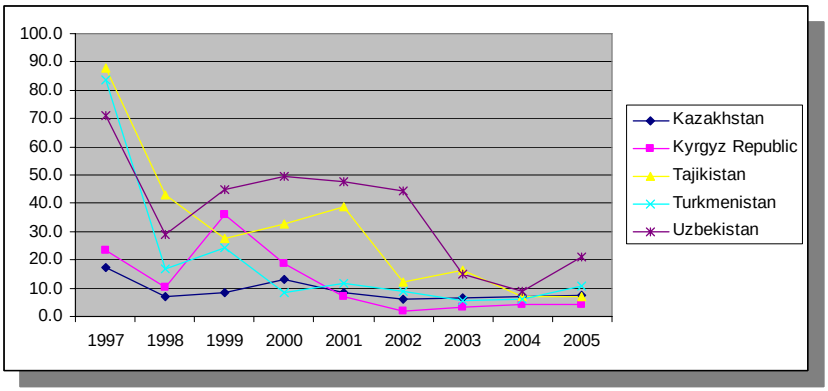
[26] Source: calculated based on data from EBRD database.

growth revival throughout the region. However, this stable period was to endure only until August 1998, when the Russian financial crisis broke out[27] (See Figure 2.11).

As a consequence, inflation rates in all economies of the region rose – although to a differing extent – after August 1998. In recent years inflation rates have been brought to moderate levels in all republics of Central Asia apart from Uzbekistan.

Figure 2.11 Central Asian economies: inflation rates, 1997– 2005

(in percent)



Source: EBRD database

One of the steps required for taming high inflation rates in the first half of the 1990s was the introduction of national currencies. Until 1993 all Central Asian economies remained in the rouble zone. This circumstance prevented them from conducting their independent monetary policies. Such a deficiency, compounded by the disruption of the payment system and high inflation rates, called for an introduction of national currencies.

Among the economies of Central Asia, the Kyrgyz Republic was the first to introduce its new currency in 1993, while other countries followed suit within a short time span.[28] Apart from Turkmenistan, which opted for a fixed exchange rate regime, all Central Asian economies adopted managed floating exchange rate regimes (See Table 2.7). However, despite its declared commitment to maintain rather liberal exchange rate regime Uzbekistan is frequently inclined to intervene in the markets of foreign exchange by imposing limiting thresholds on released volumes of foreign exchange.

[27] In this connection, Pastor and Damjanovic (2001), having analyzed the workings and outcomes of the 1998 financial crisis, point at a strong dependence of some of the Central Asian economies on the Russian economy's developments. Furthermore, as Robson (2006) argues, economic growth of the Central Asian economies along with other CIS countries is still to a significant extent influenced by conditions of the Russian economy through trade and financial links.

[28] Tajikistan lagged behind due to the civil war and introduced only by the end of the decade.

Table 2.7 Central Asian economies: liberalization of economic spheres (as of 2006)

Country	Current account convertibility	Controls on inward direct investment	Interest rate liberalization	Exchange rate regime	Wage regulation	Tradability of land
Kazakhstan	full	yes	full	managed float	no	full except foreigners
Kyrgyz Republic	full	no	full	managed float	no	limited de facto
Tajikistan	full	no	full	managed floating	yes	limited de jure
Turkmenistan	limited	no	limited de jure	fixed	yes	limited de jure
Uzbekistan	full (sometimes limited de facto)	yes	limited de jure	managed float	yes	limited de jure

Source: EBRD database

2.3.4 Privatization

Another important constituent of the transition reform package, privatization, was to establish a private sector – a bone of a market economy. Thus, privatization encompassed objects that had been previously in public property including housing, diverse facilities of trade and catering industry as well as enterprises. Like in other transition economies of CEE and the FSU, a mixture of different methods was employed to implement privatization program. Depending on the type of property objects to be privatized, either direct or indirect sales (i.e. using voucher or coupon schemes, which were distributed among each country's residents) came into question. Deliberately for the purposes of privatization, each of the Central Asia country established state agencies, whose tasks included administration and organization of transfer of state property at the disposal of other economic subjects (e.g. domestic and foreign private investors).

As already stated in the section on reform strategies, there were considerable differences in approaches taken towards privatization. Kazakhstan and the Kyrgyz Republic, having opted for a more rapid implementation of reforms, aspired to carry out to a possibly large extent the small-scale component of privatization quite quickly and then turn to the more important part, the large-scale privatization. They were quite successful in the former, having created dynamic private sectors within their economies. However,

the latter incurred a wide array of difficulties mainly stemming from deficiencies of their institutional frameworks.

Quite understandably, Tajikistan could not boast with such quick and fairly positive results in small-scale privatization due to its political instabilities. However it could catch up with the regions' top reformers by the end of the 1990s. In the large-scale privatization, there was little progress mainly due to the lack of feasibility of its previously richly subsidized large enterprises.

Turkmenistan has thus far made only small progress in small-scale privatization, while changing nothing in its large-scale type. Uzbekistan has also embarked upon both small- and large-scale privatization. By the mid-1990s small-scale part of it was complete. As far the large-scale phase is concerned, the major part of all formerly state-run enterprises was de jure privatized through establishing joint-stock companies, in which the state was the main shareholder. The common feature of the implemented privatization was the absence of a well functioning regulating and enforcing framework, which should have provided clear-cut division between political and economic constituencies.

2.3.5 External sector

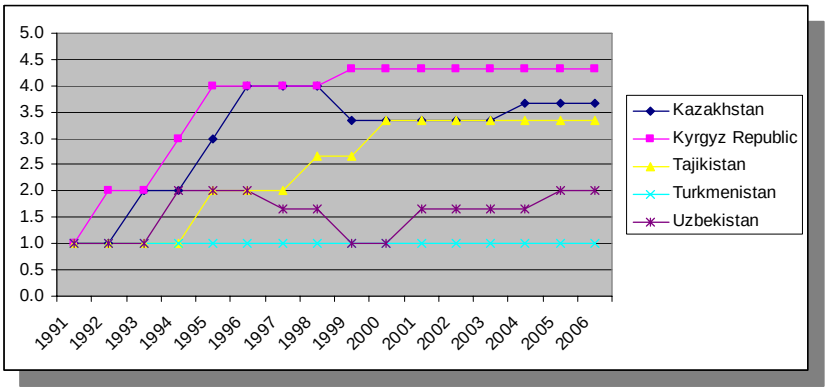
Foreign trade

The countries of the region differed also in the liberalization degree of their foreign trade policies (See Figure 2.12). In this context, the Kyrgyz Republic was fastest in liberalizing its external sector. Kazakhstan's pace was more moderate. Tajikistan managed to liberalize its foreign trade regime during the last years. While Uzbekistan liberalized its foreign trade regime only partially, Turkmenistan made no progress in this respect.

Shortly after the onset of the transition processes, the Kyrgyz Republic, Kazakhstan and Uzbekistan applied for the WTO membership and committed themselves to the IMF conditions requiring unlimited current account convertibility. In this endeavor the Kyrgyz Republic was the most successful and became the first CIS economy to accede to the WTO in 1998. Kazakhstan is considered to maintain a fairly liberal trade regime. Uzbekistan, on the contrary, is considered to have a substantially less liberal trade regime than the first two. While Tajikistan, after reaching some stabilization within its borders, tried to close the gap in liberalizing its trade policies and applied for the WTO membership in 2001, Turkmenistan pursuing its neutrality policies does not aspire to memberships in international organizations. All five, being members of the CIS, have rather differing visions and, therefore, pursue different policies towards the CIS. Ka-

zakhstan, the Kyrgyz Republic and, from recent times, Tajikistan are interested in a deeper economic (re-)integration, whereas Uzbekistan seeking its self-sufficiency is rather passively present in the regional cooperation initiatives.

Figure 2.12 Central Asian economies: EBRD index of trade liberalization, 1991–2006



Note: minimum score “1.00” (complete lack of progress); maximum score “4.33” (advanced market economy)

Source: EBRD database

Measured by the ratio of trade turnover to output, all Central Asian economies exhibited features of open economies, whose trade, however, was primarily determined by their specialization within the Soviet labor division (Pomfret, 1998). Prior to their independence, all production, with a number of exceptions, located in the economies of Central Asia was rather of up-stream nature and, therefore, resource-intensive. Additionally, the transport infrastructure was also developed in line with the then existing specialization patterns of the Central Asian region that often traversed multiple inter-republican borders.

Compared to their trade and specialization patterns of the pre-transition period, the economies of Central Asia underwent substantial changes, what generally reflects their newly evolved structure of the economies. Accordingly, their development strategies were outward-oriented, since most of them attempted to adjust their trade flows in accordance with their existing comparative advantage. Due to their differing endowment with natural resources, they were to benefit rather differently from external trade. Consequently, their trade performance varied across the region.

Right from the beginning of transition, it was rather clear that, for instance, Turkmenistan and Kazakhstan were to benefit from their terms-of-trade improvements, since formerly they had to supply natural gas and petroleum to underrated price condi-

tions. However, their export capacities were significantly constrained by at that time existing transport infrastructure (mainly pipeline network) that was fully oriented towards western parts of the FSU. Only in the long run this sort of bottlenecks might be eliminated through, for instance, constructing new pipelines providing access to other destinations. The Kyrgyz Republic and Tajikistan, being rather poorly endowed with natural resources, had to readjust their import behavior, since they previously used to substantially benefit from capital transfers from the center that enabled them to import far more than their export capacities allowed for. Uzbekistan, being sufficiently endowed with some natural resources, pursued policies of self-sufficiency in terms of fuel and food. In line with this pursued strategy it organized its trade and related to it policies. Its imports are financed by revenues originating primarily from exports of cotton and gold.

One-sidedness of currently prevalent trade patterns of the Central Asian economies is not supposed to bring them positive outcomes in the long-term perspective, since these are based mainly on exports of primary goods. This type of trade strategy is apt to bring about difficulties stemming from the 'Dutch disease' phenomenon leading to the loss of other industry's competitiveness. For instance, Spechler (2000) corroborates that rapid growth of exports indeed contributed to the recovery of output, having caused, however, the emergence of dualistic economies,[29] in which exporting industries do not induce growth of other industries through the workings of 'cross-linkages' or multiplier effects. Therefore, many domestic sectors still dwell upon the drawback inherited from the centrally planned system, namely lack of efficiency and ill-competitiveness. Moreover, Najman et al (2005) show, on the example of Kazakhstan, that rapid expansion of oil exports caused understandably high rates of economic growth, leading however, to an even more uneven income distribution within the country and undermining social coherence of the society.

Foreign investment

Right from the beginning of transition all Central Asian economies found themselves confronted with substantial deficits of financial resources needed to maintain the then current consumption as well as sustain investment schemes. The latter was to be neglected almost altogether due to restructuring and liberalization measures. On top of all,

[29] The concept envisaged à la Lewis.

economic restructuring itself pointed to the expediency of attracting resources from abroad.

In view of lack of their domestic financial resources for carrying out economic reforms, the Central Asian economies were entitled to borrow from international financial institutions (such as World Bank, IMF, EBRD, etc.) on rather favorable terms. There was, however, certain differences in allocation of provided facilities. Since the Kyrgyz Republic and Kazakhstan exhibited their willingness to move ahead along the reform path, they were treated rather generously. Turkmenistan and Uzbekistan got less financial and technical support due to their reluctance to carry out reforms at a more rapid pace. Since Tajikistan's priority was at that time reaching peace, it could not embark upon its reforms and was, therefore, initially neglected. Besides, there were numerous loan schemes provided by the governments of the Paris Club. However, these capital inflows provided as institutional loans are to be repaid with certain interest. Therefore, within a short time span the economies of Central Asia accumulated significant debts, which present substantial burden for, for instance, the Kyrgyz Republic and Tajikistan,[30] which do not possess large export growth potentials of Kazakhstan or Turkmenistan.

The institutional type of capital flows was supposed to give way to foreign private loans and investment embodied in either FDI or portfolio investment. Portfolio investment was not a viable option from the outset, since financial markets of the Central Asian economies were rudimentary and, therefore, did not exhibit any absorptive capacity.

Attracted foreign direct investment in the region has been distributed unevenly across the region's economies (See Figure 2.13). Against this background, Kazakhstan by far outperformed other countries of the region. Thus, its FDI stock per capita as of 2005 amounted to 1561.5 US dollars. These values were considerably lower in the Kyrgyz Republic (119.9 US dollars), Tajikistan (79.2 US dollars), Turkmenistan (368.2 US dollars) and Uzbekistan (45.5 US dollars).[31]

Characterizing foreign investment patterns, it is worth noting that they, as a rule, represent the flip side of trade patterns. In the context of transition economies' changed

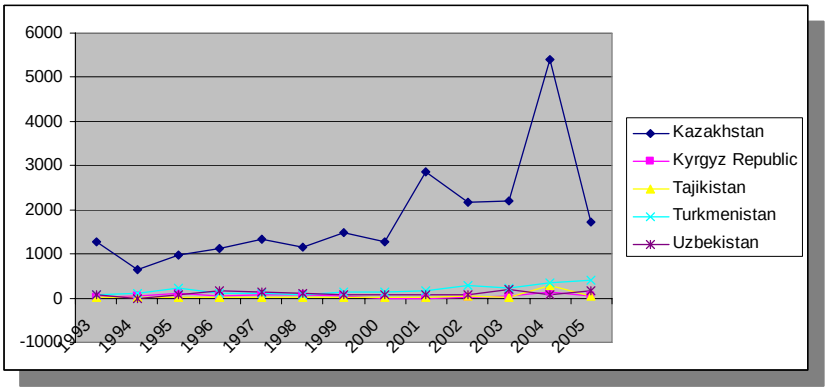
[30] Thus, as of 2004, the ratio of total debt to GDP of the Kyrgyz Republic equaled to 94.9 percent , whereas that of Tajikistan was 43.2 percent (Source: World Bank).
[31] Source: calculated based on data from EBRD database.

patterns of international trade, foreign investment also reflects the changes of their economic structures.

That implies that throughout the region, the countries in question attracted considerable amounts of foreign investment into the sectors that currently dominate their economic structure and export make-up. For instance, Tøndel (2001) stresses that the transition economies of Central Asia tend to attract FDI primarily due to their abundantly available in natural resources.

Figure 2.13 Central Asian economies: net FDI flows, 1993–2005

(in mln. US dollars)



Source: EBRD database

Campos and Kinoshita (2003) along with Shiells (2003) point to a definite distinction in motivation for FDI between the CIS countries, in general, and Central Asian economies, in particular, on the one side, and economies of CEE, on the other. Whereas foreign investment in the former is explained primarily by 'resource-seeking' motives, foreign investment in the latter is due to 'efficiency-seeking' reasons (i.e. lower labor costs, cheaper infrastructure maintenance, etc.).

This sort of distinction is deemed a critical one, since there are quite different effects stemming from these two 'sorts' of foreign investment. 'Efficiency seeking' FDI is mostly absorbed by manufacturing industries and causes spillover effects. These effects are supposed to bring substantial benefits to adjoint industries and sectors. On the contrary, 'resource seeking' FDI does not tend to bring about such positive effects. Furthermore, Bayulgen (2004) argues sizeable capital inflows may bring reforms to a standstill by undermining the institutional framework of the country. This argument seems valid for all transition economies of Central Asia, whose institutions ought to be substantially improved.

Summary

Taking stock of the chapter, it is worth noting that the whole ECA region comprised countries that differed from each other by the onset of transition and performed rather differently. In general, the pursued sequence of reforms was first to liberalize their economies and then stabilize them, thus paving the way for 'natural' structural adjustment of an economy along with its trade patterns in line with their given comparative advantage. In terms of accomplishments (scope and tempo of output recovery, trade and foreign investment performance, etc.) during the transition stages, CEE economies on the whole outperformed those of the CIS. In the course of this transformation, most transition economies found their structural set-up modified. In line with this, the CEE economies specialized in labor-intensive manufacturing, while the CIS had to focus on resource-intensive production. These pattern changes found their expression in foreign trade conducted and foreign investment attracted by these economies.

In this context, the Baltics and Central Asia provide an example of two economic regions of the Former Soviet Union, which differed substantially in terms of their transition modes and attained progress. The Baltic economies have undergone substantial changes in the course of their transformation since the early 1990s. During the initial stage of their transition they had to incur large economic and social costs (i.e. output contraction and exploded unemployment rates), which were hard to escape during the reform-phase due to the huge structural imbalances inherited from their past.

This notwithstanding, through comprehensively implemented reforms they managed to do away with old economic structures and establish new ones, functioning on market principles. Economic recovery in the Baltic economies has thus far been based primarily on the reallocation of existing inputs, i.e. increases in efficiency as a result of the economic restructuring. However, further growth of their economies will depend on how successfully they develop and upgrade their existing factors of production and employ advanced technologies. The newly emerged structure of their economies is also reflected in the changed trade and investment patterns, not least brought about by their aspirations to accede to the EU.

With the break-up of the Soviet economy in the early 1990s, the five newly established economies of Central Asia were caught off their guard by harsh changes and had to embark upon their transition despite rather unfavorable starting conditions. Having much in common, these economies were yet different in many aspects, which in

turn, to a certain extent, influenced their further developments. In terms of their approach to the reforms, they were quite different: while some opted for a radical approach, others adhered to the gradual strategy. Accordingly, their accomplishments and reform records throughout the transition process differ substantially. The economies of Central Asia had to experience substantial output contractions incurring high social costs. By the end of the 1990s, their output levels started rebounding, not least due to high prices and sustainable demand for their exportable primary commodities. The newly emerged patterns of foreign trade and capital inflows reflect their current economic structures that have undergone substantial alterations since the onset of transition. FDI were attracted primarily to the resource-intensive sectors that dominate their economies.

On the whole, different growth performance of both regions' transition economies was to a certain extent determined by the set of inputs (the stocks of physical and human capital along with technologies employed) and influenced by their 'geographical conditions' (e.g. proximity to rich economies with substantial potentials for exports and attracting foreign investment) and institutions (e.g. reform perceptibility with germane to it reform strategies, legal and institutional framework).

Chapter 3 External Factors of Economic Growth in the Baltics

Trade and foreign investment patterns, reflecting a country's participation in the international labor division, are closely interrelated with its economic structure. The character of both trade in goods and services and capital movements may in certain cases significantly influence the dynamics of an economy. This chapter is concerned with the factors – trade, capital flows and of other types – that exert influence upon the growth dynamics of the Baltic economies. Among other important aspects, the evolution of trade and foreign investment patterns of Estonia (section 3.1), Latvia (section 3.2) and Lithuania (section 3.3) throughout their transition will be considered below.

3.1 Estonia

Like any other small economy, Estonia had to pay increased attention to its foreign trade and activities aimed at attracting foreign capital. While being one of the region's few countries impelled to rely mostly on its external strategy, it had more opportunities to take advantage of large markets of its trading partners and, understandably, faced more challenges due to possible cyclical slumps in those countries (Weber and Taube, 1999). It may, therefore, be suggested that its almost immediate output growth recovery is to be attributed to a significant extent to its successful external strategy comprising trade and foreign investment policies.

3.1.1 Trade

The evolution of Estonia's trade has gone along with its overall transition process and brought considerable changes to its economic structure. As a result, its proportional make-up of industries has undergone remarkable transformation, inducing notable shifts of resources from less productive sectors into more productive ones.

Turning to the evolution of its trade structural make-up throughout transition from 'plan to market', it is worth noting that the formerly conducted trade of Estonia within the Soviet labor division was based on completely different principles, implying often just an exchange of inputs, intermediate or final products that would have been fully implausible within the market environment (e.g. due to different set of transport costs or specialization based on the available stock of production factors).

Exports

Understandably, with the disruption of the formerly existent trade and production links, price liberalization and state divestment and its intentions to diversify their trade flows, the export profile of Estonia was about to change significantly. In this context, an indicator of revealed comparative advantage – reflecting factual shares of each sector in total exports – has undergone noteworthy changes in most cases substantially. Yet, even in the case of negligible alterations, changes in the quality of many produced items are assumed remarkable.

The distribution of exports in terms of their sectoral composition (See Table 3.1) points to some notable changes. Throughout the period the share of a commodity group *machinery and equipment* has increased, whereas those of *clothing*, *foodstuffs* and *chemicals* have decreased. Other commodity groups have exhibited somewhat stable developments experiencing rather negligible changes in terms of their shares in total exports.

Table 3.1 Estonia: exports by commodity group, 1996-2004 (in percent of total)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Machinery & equipment	14.2	18.1	22.2	23.2	37.6	33.0	24.7	25.0	27.5
Timber & related products	14.4	16.5	17.1	20.6	15.3	15.2	17.3	17.1	15.1
Clothing	19.2	16.3	16.0	16.3	13.7	13.9	14.6	13.3	9.0
Metals & metal products	6.5	6.8	8.0	7.7	7.1	6.9	7.8	8.5	4.6
Foodstuffs	15.0	16.2	13.2	8.8	5.9	8.0	8.2	7.5	7.3
Chemicals	10.2	8.5	7.4	6.6	5.5	6.3	7.0	7.8	4.7
Transport vehicles	4.1	3.6	3.3	2.9	2.6	3.2	4.1	4.3	6.1
Mineral products	5.8	4.4	2.6	2.5	2.5	2.1	2.7	2.8	4.6
Other	3.8	3.8	3.7	3.8	9.9	11.3	13.6	13.6	21.0

Source: Bank of Estonia

This kind of transformation implying growth of more sophisticated goods in the structural make-up of Estonia's exports is well reflected through its specialization indicators. For instance, Estonia's Lafay index[1] in 2000 and 2001 has gained in its value for more refined items when compared some years earlier (See Table 3.2).

[1] This index measures the contribution of a sector to an economy's country overall trade balance (trade surplus or trade deficit). See for details Marconi and Rolli (2006).

Table 3.2 Estonia: Lafay index and world exports shares

TOP 5 (3-digit SITC classification) 1993-1994	LFI	WES
288-Non-ferrous base metal waste and scrap	2.77	0.62
247-Other wood in the rough or roughly squared	2.68	0.45
842-Outer garments, men's, of textile fabrics	2.33	0.11
248-Wood, simply worked, and railway sleepers	1.51	0.10
562-Fertilizers, manufactured	1.51	0.16
TOP 5 (3-digit SITC classification) 2000 –2001		
764-Telecommunications equipment and parts	6.78	0.36
248-Wood, simply worked, and railway sleepers	1.95	0.69
821-Furniture and parts thereof	1.69	0.26
247-Other wood in the rough or roughly squared	1.35	1.58
635-Wood manufactures	1.15	0.59

Source: Zaghini (2005: 636)

Imports

While adjusting to its new economic realities in terms of its domestic demand and production capabilities, Estonia has witnessed its imports undergo noteworthy changes as well (See Table 3.3). In this context, a steadfast increase of imports of capital goods in value terms is worth mentioning. The combined share values of 'machinery and equipment' along with 'transport' vehicles have been rising to the detriment of those of other categories.

Table 3.3 Estonia: imports by commodity group (in percent of total)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Machinery & equipment	22.7	25.3	29.5	30.7	38.7	33.4	29.5	27.8	28.2
Chemicals	13.0	12.2	11.6	12.8	11.2	11.8	12.3	12.3	6.8
Clothing	12.4	11.0	11.0	11.2	9.6	10.3	10.4	9.2	6.7
Foodstuffs	14.4	12.7	11.3	10.8	8.6	9.4	9.6	9.2	9.0
Metals & metal products	8.1	8.5	9.3	8.2	8.2	8.1	8.9	9.2	6.8
Mineral products	9.2	7.9	5.8	6.0	6.1	6.1	6.1	5.6	6.8
Transport vehicles	7.3	10.6	9.6	7.6	7.0	8.9	10.7	14.9	12.0
Timber & related products	4.8	4.7	4.9	5.2	4.9	5.2	5.1	5.2	5.6
Other	5.1	4.6	4.4	4.9	5.8	6.7	7.2	6.6	18.1

Source: Bank of Estonia

Current account balance

Estonia has been running substantial current account deficits since the onset of the transition processes. Thus by 2005 the size of its current account gap reached 688 mln. US

dollars (or 5.3 percent of GDP)[2]. This may be in part due to the currency board arrangement that maintains fixed exchange rate of the Estonian kroon, which is often alleged to be overvalued. However, in line with the arguments of Mody and Rosenberg (2006), as a transition economy, Estonia during the initial stage of its transformation found large portions of its physical capital stock significantly undermined. This implied that great amounts of physical capital (e.g. equipment, machinery, etc.) had to be imported. Besides, certain volumes of energy resources are still to be imported from Russia. These trends prove non-sustainable in the longer term and are to be reversed some time. In view of this, Bems and Jönsson (2005) confirm this suggestion in their simulation model and predict that Estonia is likely to move ahead along this trend from 2008 onwards.

Trade geography

Along with the structural composition, its geographical distribution has undergone notable changes from the very initial years of transition. These developments were first and foremost characterized by the subsequent decrease of the share of Russia and other republics of the Soviet Union in the external trade of Estonia. In accordance with the predictions of the gravity approach, the FSU countries were to gradually give way to the countries of Western Europe, as far as their shares of Estonia's foreign trade are concerned. This trend has been valid throughout the whole transition process for both constituents of trade flows – exports and imports.

Table 3.4 Estonia: main trading partners in 1994 and 2005 (in percent of total)

	1994		2005		1994		2005
Exports to:				**Imports from:**			
Finland	31.7	Finland	26.6	Russia	23.1	Germany	14.4
Russia	16.2	Sweden	13.2	Finland	17.8	Finland	14.0
Sweden	10.8	Latvia	8.7	Sweden	10.8	Russia	9.6
Germany	9.5	Russia	6.4	Latvia	8.2	Sweden	7.9
Latvia	2.0	Germany	6.2	Germany	6.8	China	5.5
Other	33.3	Other	38.9	Other	33.3	Other	48.6
Total	100.0		100.0	Total	100.0		100.0

Sources: Bank of Estonia, International Trade Centre database

[2] Source: World Bank; for details see Annex 1, p. 288.

In terms of its export markets, Estonia exhibited a general trend observable in the whole region. Yet dominant before transition, Russia and other countries of the Former Soviet Union have given way to the countries of Western Europe in terms of their shares in the course of subsequent years.[3] For instance, in 1991, Estonia's exports was up to 95 percent 'absorbed' by republics of the Former Soviet Union, with almost two thirds thereof destined for Russia alone. In 1992 the CIS (the successor of the Soviet Union) accounted already for half of merchandise trade, with the large part of that falling on trade with Russia. Accordingly, in just a two-year time span Russia's share decreased quickly to one-fifth of Estonia's overall exports, while the CIS economies took up just 38 percent (Jeffries, 1996: 265).

Almost right from the beginning of its transformation, Estonia managed to redirect its exports (See Table 3.4). In the mid-1990s Estonia's main export destination was Finland, whose shares has been increasing ever since. Presently, only a small fraction of Estonia's exports are taken up by the CIS countries. For instance, in 2005 only 6.4 percent of its overall exports volume was destined for Russia and 8.5 percent for the CIS economies in total. In view of that, the shares of Finland and Sweden rose substantially and amounted to 26.6 percent and 13.2 percent, respectively.

The import side of Estonia's foreign trade revealed the same trends. At the outset the shares of Russia and the Soviet Union were prevalent making in 1991 46 percent and 85 percent of Estonia's imports, respectively. The shares of Estonia's imports from Russia and the CIS decreased substantially very soon, amounting to just 19 percent and 30 percent of the overall import volume of Estonia in 1993. During the initial years of the transition process, the shares of Western European economies did not outdo those of Russia and the CIS. However, with the time passing by, the shares of the EU countries were steadily to rise, thus overtaking those of Russia and the CIS by the mid-1990s (Jeffries, 1996: 265). Currently, the breakdown of Estonia's import flows evidence the onset trend (See Table 3.4). For instance, in 2005 Germany (14.4 percent) and Finland (14.0 percent) were the economies, from which most of Estonia's imports originated. Such developments evince that Estonia is supposed to have attained its 'natural' pattern of foreign trade, i.e. those that are prevalent when the market mechanisms of distribution are in place.

[3] It should be noted here that this kind of developments was commonplace in all FSU economies, since, as Havrylyshyn and Al-Atrash (1998) state, formerly dominant intraregional trade volumes were to plummet due to the collapse of the whole planning system.

Trade regime

Throughout the whole time span since the onset of the transition process in the early 1990s, Estonia has been pursuing very liberal policies in its external trade. It scrapped almost all trade restrictions that were present before its independence. Export surcharges, quantitative limitations and licensing were cancelled in the course of trade liberalization reforms in the early 1990s. Only few small exceptions in sensitive agricultural products has been made, which remain in line with its trade arrangements with its European trade partners (Jeffries, 1996). Estonia's tariff barriers are among the lowest in the world, implying that foreign and home produced products are treated similarly.

In terms of its openness to trade, Estonia is deemed the most open among the transition economies[4] (Havrylyshyn and Al-Atrash, 1998). This fact is mainly due to its small size and proximity to the richer economies. This kind of conducted exchange in goods and services between Estonia and its richer trade partners enhanced the catch-up process that was strongly enhanced by its measures aimed at liberalizing its external sector, among other spheres of its economy. In view of that, Estonia's openness brings opportunities along with challenges (Ehrlich et al, 2001). The latter implies its rather excessive dependence upon the economic dynamics of its trading partners.

Regional trade agreements and memberships

Closely related to its overall economic transition, trade developments of Estonia were also to a certain extent determined by an array of arrangements, such as regional trade agreements and memberships in international and regional organizations. These were of both complementary and contending nature to each other. In this context, Estonia had to consider and assess net effects resulting from tighter trade links. Only a few traits of the then possible directions will be considered below.

EU

From the very beginning of its transition, Estonia managed to establish closer trade links with the economies of Western Europe – notably, Finland and Sweden (See Table 3.4) – and redirect its trade flows. This reorientation has been encouraged through a free-trade agreement with the EU in 1995, which secured easier access to Western European markets. In this connection, there have been numerous arguments that Estonia, like many of the new EU members, (after losing its presence in Eastern markets) could face setbacks caused by its reduced

[4] Thus, as of 2006, Estonia's openness ratio (measured as the ratio of the sum of exports and imports related to GDP) equaled to 1.37 (Source: calculated based on data from Statistics Estonia).

role of a 'spoke' within the trade scheme of the recently enlarged EU, whose richer core represents the 'hub'. However, rather positive experiences of Estonia demonstrate that trade developments are even apt to deepen further bringing substantial welfare gains for smaller economies.

WTO

Upon gaining its independence, Estonia applied for a WTO membership and attained it in 1999. This allowed it to unify its arrangements with a large number of countries on a multilateral basis in a speedy mode. This step has been in line with its intentions to pursue liberal trade policies.

Regional scope

In the initial period of transformation Estonia along with other two Baltic economies intended to establish a free trade area in the region. However, with the prospect of joining the common European market through the EU membership, for Estonia this endeavor has become less and less attractive. Alone the fact that neither of the Baltic economies does not account for a substantial proportion in Estonia's overall trade (See Table 3.4), demonstrates that an option of a tighter intra-Baltic integration proved non-viable.

3.1.2 Capital flows

Capital flows, in conjunction with trade are of great relevance, especially for small and open economies. The case of Estonia vividly proves that capital flows are apt to contribute significantly to an economy's growth. Owing to substantial capital inflows Estonia managed first to increase its capital stock and, thus, recover its output levels and then attain high output growth rates. Attracting capital from abroad has been adjoined with other important parts of the whole reform package. Estonia has managed right from the outset to establish a very favorable institutional basis for foreign investment (more on this in section 3.1.3).

Resembling other countries in transition of the region, Estonia has been sufficiently provided with institutional loans, which initially made up a significant share of all capital inflows from the rest of the world (See Table 3.5). These facilities, provided by international institutions, were primarily aimed at facilitating Estonia's economic restructuring. However, despite their significance, institutional loans and credits were to be complemented by private capital flows either in form of credits or investment with the former leading to the build-up of sovereign debt.

Table 3.5 Estonia: net capital flows, 1992-1996 (in mln. US dollars)

	1992	1993	1994	1995	1996
Official Flows	93	122	46	95	77
Private Flows	104	163	195	200	408
o/w: FDI	82	162	214	202	150
Portfolio	0	0	-14	-22	145
Short Term Debt	0	0	8	22	77
Commercial Debt	22	0	-13	-1	-4
Total Flows	197	285	242	295	485
US$ GNP	4326	3900	3795	4064	4353
Total Flows/GNP (percent)	4.6	7.3	6.4	7.3	11.1

Source: Claessens et al (1998: 27)

Since most transition economies at that time did not maintain institutional frameworks capable of attracting and allocating portfolio investments, the lion's share of these capital flows was, evidently, to fall on FDI. It is clearly seen that in the initial stage of Estonia's transformation, in terms of its shares, FDI was the prevalent one among the types of private flows (See Table 3.5).

Furthermore, Estonia's experience provides a good example of how tightly trade flows are intertwined with foreign investment, both of which are apt to bring about positive externalities. In this context, Sinani and Meyer (2004) considering the case of Estonia, stress in their study of the impact of FDI on local in industries and corroborate that FDI implying outsider ownership causes positive spillover effects, from which other enterprises may profit significantly.

Potentially attainable FDI is to be maintained by an appropriate institutional framework. In this direction, Estonia has made substantial progress. For instance, its enduring attempts to liberalize and unify its regulatory frame in line with the EU standards are assumed to have boosted FDI inflows. In view of this, Gilles et al (2002) draw attention to the importance of an appropriate investment climate to attract and make the most of the foreign direct investment. In the case of Estonia, much of foreign investment was attracted through well thought privatization schemes aimed at boosting productivity levels. Though, there might be some vulnerability concerns stemming from Estonia's rather liberal attitude towards capital movements (Ehrlich et al, 2001). These are to be rebutted, however, since the largest chunk of its FDI originate from countries[5]

[5] For instance, Sweden and Finland made up 40.5 percent and 29.8 percent each in Estonia's total FDI stock by 2001 (Source: Bank of Estonia).

with viable financial systems and its institutional framework warrant certain level of prudence.

Throughout the 1990s, Estonia has performed well in terms of attracted FDI. The shares of FDI have been increasing in Estonia's total capital stock (See Table 3.6). Increased volumes of flows and stocks have become forerunners of increased productivity levels and output growth.

Table 3.6 Estonia: foreign direct investment (FDI) overview (selected years)

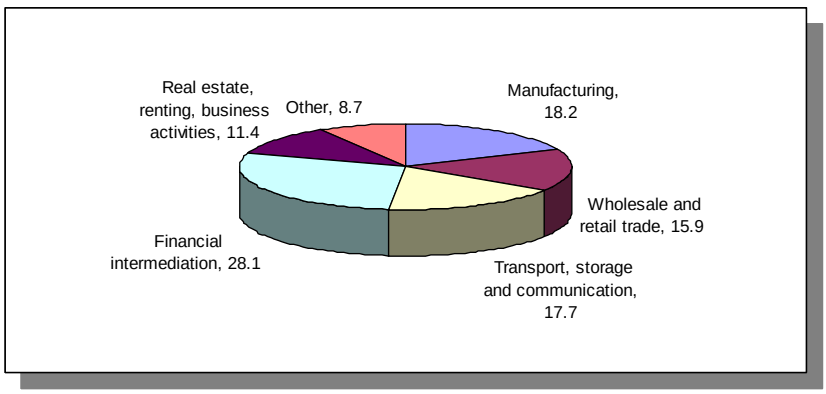
	1990-2000	2002	2003	2004	2005	1990-2000	2003	2004	2005
	(Millions of US dollars)					(as percent of gross fixed capital formation)			
FDI flows	(Annual average)					(Annual average)			
Inward	261	284	919	1 049	2 853	24.5	34.6	32.9	79.1
Outward	38	132	156	268	603	3.0	5.9	8.4	16.7
FDI stocks	**1980**	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
Inward	..	..	2 645	10 067	12 274	..	48.4	91.7	93.6
Outward	..	..	259	1 419	1 968	..	4.7	12.9	15.0

Source: UNCTAD, World Investment Report 2006

As regards sectoral distribution of FDI attracted, it is closely related to Estonia's economy's developments. Among its sectors, services clearly dominate in terms of the shares of attracted FDI. Comprising such branches as financial intermediation, transport along with real estate and business activities, it makes up to three-fourths in 2003 of the whole volume (See figure 3.1).

Figure 3.1 Estonia: sectoral distribution of FDI stock, 2003

(in percent)



Source: Statistics Estonia

Equaling to 18.2 percent, the share of manufacturing is rather modest. Since then this distribution has changed in favor of the sector of services. Thus in 2005 its share has grown to 77 percent of the total volume of Estonia's FDI stock.

As expected, Finland (51 percent) and Sweden (21 percent) are Estonia's largest investors, which in total account for over two-thirds of its foreign investments by 2006. Their prevalence in foreign investment might be well expected by their intensified trade links. In addition, besides export-oriented industries, substantial amounts of FDI have been directed into the sector of services (e.g. financial intermediation, transportation and communication, wholesale and retail, etc.)

3.1.3 Other factors

Migration

Estonia's general economic transformation could not but cause significant shifts in its labor market. With its closer economic integration into the European division of labor, Estonia's economy began to encounter increasing difficulties in mobilization of well-qualified human resources due to the outward migration of such. The very process has been further enhanced by Estonia's accession to the EU. Around 1 percent of Estonia's labor force is reported to have left for other destinations (mainly Scandinavian countries).[6] The dearth of well-qualified labor may adversely influence Estonia's competitiveness in its domestic and export-oriented sectors.

Technological edge

The technological edge of Estonia's economy determines its competitiveness on international markets and reflects the quality level of its inputs. The higher the quality of inputs, the more sophisticated goods can be put out. Since technologically more sophisticated products have higher income elasticity of demand, they tend to secure certain market shares along with revenues and profits. Due to its relatively low wages and apt human resources, Estonia has become a preferred outsourcing location for an array of high-technology producers from a number of European countries (Nissinen, 2002).

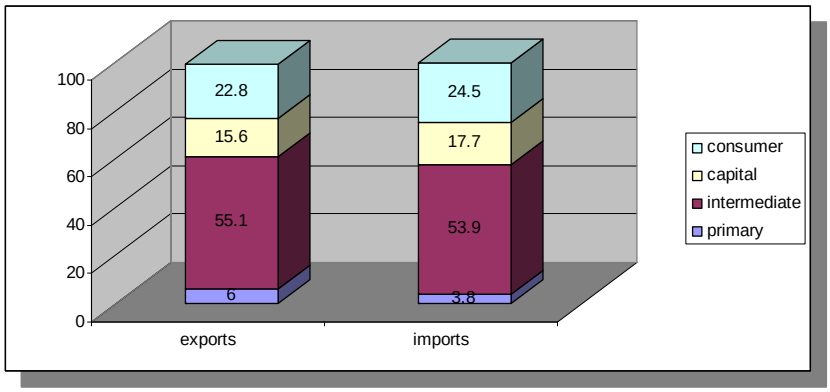
In view of this, when considered in terms of proportions of tradables broken down in line with stages of technological processing, Estonia's export and import profiles are similar to each other (See Figure 3.2). The same distribution pattern is observed

[6] Source: Economist Intelligence Unit.

in the case of items classified as high-tech products, since the share of these products in its total exports (9.7 percent) is not less than that of its imports (9.6 percent).[7]

Figure 3.2 Estonia: breakdown of exports and imports in line with stages of technological processing, 2005

(in percent of total)



Source: International Trade Centre database

Thus Estonia has managed to upgrade its export profile, what is reflected in the bigger share of highly treated manufactured exports, which in turn secure a higher value added. Furthermore, it suggested that that Estonia despite its relatively low share of products classified as high-tech goods, stands out among the CEE countries for its further undergoing technological deepening (Movshuk, 2002). Besides significant changes in the export structure resulting in a more diversified product mixture, Estonia has also substantially improved the quality (i.e. non-price characteristics) of its exportables.

Exchange rate

Besides their non-price characteristics, exports are subject to the influence of price factors, which are determined by the cost structure and exchange rate developments. In the case of Estonia, the dynamics of the latter was closely related to its foreign exchange policies if form of a currency board arrangement (CBA). Under this system, upon its introduction (in 1994), the Estonian kroon was pegged to the D-Mark and, afterwards, repegged to the euro (in 1999). Throughout the whole transition period its average exchange rate has equaled to 13.9 for one US dollar.[8]

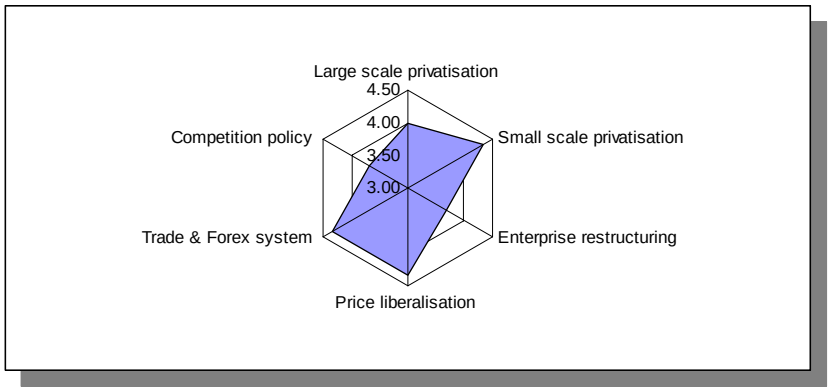
[7] Source: International Trade Centre database.
[8] Source: EBRD database.

Against this background, it has been often argued that, while remaining rigidly tied to the European currency, the allegedly overvalued kroon, combined with rising wages, may undermine Estonia's external competitiveness. However, notwithstanding its increased real effective exchange rate, the Estonian economy is assumed to retain its competitive edge due to ever increasing share of exportables with income elasticity of demand (Lutz, 2006).

Institutional framework

Based on well devised trade and investment strategies, Estonia's impressive growth performance has been well complemented by appropriate adjustments in its institutional framework. Most of these have been brought about in the initial stages of its transition and touched upon numerous facets of Estonia's economy (See Figure 3.3). With its transition performance index averaging 3.81, the economy has made substantial progress in this respect.

Figure 3.3 Estonia: progress of transition, 2006



Note: minimum score "1.00" (complete lack of progress);
maximum score "4.33" (advanced market economy)
Source: EBRD Transition Report 2006

Its regulatory basis is thought to have significantly contributed to a fairly smooth transformation of its economic structure. Its much less regulated product and labor markets (compared, for instance, with those of most Western European economies) enable swift transfer of inputs and products across sectors. Furthermore, it fares well in international comparing rankings of competitiveness due to its good governance and enterprise efficiency. Thus among all twenty-eight transition economies it has ranked fine, while being second only to Lithuania, in the ease of doing business.[9] Finally, it is worth men-

[9] Source: World Bank (2007).

tioning that much of Estonia's institutional transformation has taken place in the wake of its EU-membership aspirations.

3.2 Latvia

Latvia, another transition economy of the Baltics, has its own specifics along with a number of similarities with other two economies of the region. Throughout its transition, Latvia's economic structure has undergone remarkable changes, which are also well reflected in the character of its currently present economic links. Moreover, Latvia's recent impressive record in attaining substantial rates of economic growth is to a certain extent attributable to its trade and foreign investment performance enhanced by prevalently positive accomplishments of reforms.

3.2.1 Trade

Upon restructuring of its economy in the 1990s, Latvia witnessed its trade undergo significant alterations in many respects. Its new economic environment and changed character of trade flows in terms of their make-up and geographical distribution demonstrate that Latvia's participation in the international labor division has also been defined anew. Such structural transformation of the content of trade flows of Latvia is closely related to general economic developments in terms of its structure and composition. Its altered patterns of trade flows are well reflected by the modified make-up of both exports and imports.

Exports

In general, Latvia's export profile may suggested to be of dual nature implying the existence of two broad categories of exportable items. On the one hand, there are high-value-added goods primarily destined to the CIS markets, and there are low-value-added items exported predominantly to the EU economies, on the other.

Throughout the years of its transformation, the structural make up of Latvia's exports has undergone significant changes (See Table 3.7). In the considered period (1996–2004), among commodity groups, the share of *wood and wood products* has grown more rapidly when compared with other commodity groups. Noteworthy is also the increase of exports of *machinery and equipment*, *chemicals* and *transport equipment* in terms of their shares in overall exports. Other commodity groups have shrunk in proportions.

Table 3.7 Latvia: exports by commodity group (in mln. Latvian lats, fob)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Wood & wood products	194.1	288.5	358.4	376	423	427	473	582	645
Textiles	134.4	151.2	172.2	155.4	159	177	180	209	228
Food, beverages & tobacco	93.7	98.4	71.5	60.9	72	80	81	97	121
Chemicals	53.2	63.6	62.4	54.4	60	71	83	97	111
Machinery & equipment	76.8	87.8	72.6	49.7	62	80	91	117	166
Transport equipment	32.8	20.1	17.4	38.1	40	72	101	94	131
Mineral products	20.7	14.2	24.1	14	16	24	27	34	53
Total incl others	795.2	971.7	1069	1008.3	1131	1256	1408	1651	2115

Source: Central Statistical Bureau of Latvia

The change of Latvia's export profile in the course of its transformation becomes evident, when one considers the Lafay index for a sample of Latvia's top five exportables in two different points of time (See Table 3.8). Both in terms of values of the index and world exports shares, petroleum products have given way to wood products.

Table 3.8 Latvia: Lafay index and world exports shares

TOP 5 (3-digit SITC classification) 1993-1994	**LFI**	**WES**
334-Petroleum products, refined	6.19	0.25
248-Wood, simply worked, and railway sleepers	3.51	0.30
333-Petroleum oils	2.82	0.05
247-Other wood in the rough or roughly squared	2.30	0.56
634-Veneers, plywood, improved or reconstituted	1.32	0.22
TOP 5 (3-digit SITC classification) 2000–2001		
248-Wood, simply worked, and railway sleepers	8.86	1.65
247-Other wood in the rough or roughly squared	2.30	1.45
673-Iron and steel bars, rods, angles, shapes	2.10	0.47
635-Wood manufactures	1.82	0.49
634-Veneers, plywood, improved or reconstituted	1.78	0.63

Source: Zaghini (2005: 637)

Imports

As regards its import profile, it becomes obvious that Latvia has undergone corresponding transformation in terms of the structural composition of its imports as well. This kind of trend goes in line with Latvia's expanded demand for capital and consumer goods. Thus, among its importables, the commodity groups *food products*, *metal products* and *transport equipment* stand for their higher growth in terms of their shares

throughout the considered period from 1996 to 2004, whereas other commodity categories have grown less rapidly (See Table 3.9).

Table 3.9 Latvia: imports by commodity group (in mln. Latvian lats, cif)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Mineral products	283.3	222.3	385.7	378.5	401	465	531	630	738
Machinery & equipment	214.1	305.9	208.2	206.7	205	230	261	301	345
Chemicals	140.6	172.2	133.2	195.8	249	245	243	297	476
Food, beverages & tobacco	77.6	109.6	197.8	142.9	150	207	244	314	400
Textiles	102.5	123.7	196.2	132	148	163	172	194	215
Metal products	81.8	125.9	146	120.3	163	182	211	277	385
Transport equipment	75.5	132.1	158.5	115.7	115	136	165	181	227
Total incl others	1,278.2	1,582.4	1,881.0	1,723.9	1,934	2,202	2,497	2,989	3,744

Source: Central Statistical Bureau of Latvia

Current account balance

While considering recent developments of Latvia's trade, it becomes evident that Latvia resembles a lot its neighbors in running rather large current account deficits. Thus by the end of 2005, the size of the current account gap has increased up to 7.4 percent of GDP.[10] This circumstance might be mainly explained by Latvia's recent impressive growth records strengthened by favorably low (often negative) real interest rates, EU transfers and swift rises of real wages.

This impressively large current account deficit of Latvia should not be considered as an extraordinary phenomenon. In the literature it is widely accepted that an economy catching up with other economies through integration is always apt to run fairly extensive current account deficits. For instance, Blanchard and Giavazzi (2002) point to the fact that an economy, which becomes tightly linked with other economies and has better growth prospects than its trading partners, tends to have larger current account deficits. Latvia, as one of the transition economies, is just a case in point. Its EU-membership aspirations and the accession process per se along with its prospective adoption of the euro in the nearest future could not but cause its trade (along with capital) links with its European trading partners to get intensified.

As a rule, most economies' substantial current account deficits stem from the excessive dissaving of its public and private sector, what often leads to the phenomenon

[10] Source: World Bank, for details see Annex 2, p. 229.

of triplet deficits. However, Latvia's persistent current account deficits are to be attributed to its private sector's dissaving, which is encouraged by its recent growth performance and rather optimistic growth prospects in the nearest future.

These current account deficits rapidly increased the amount of Latvia's foreign liabilities, which are to be repaid in the long run. This suggests that the Latvian economy should augment its exports and/or cut its imports, by increasing the income elasticity of demand for the former and, if applicable, reducing of that for the latter. This endeavor would be sufficiently eased if capital inflows were primarily absorbed by export sectors, what could significantly improve the ability of Latvia's economy to upgrade the make-up of its exports and, thus, by gaining additional market shares and increase earnings from its exports. Otherwise the domestic sector of Latvia has to suffer significant setbacks that imply lower than potentially possible level of consumption and welfare of its households.

Trade geography

Closely related to their structural make-up, Latvia's trade flows have undergone substantial changes in terms of their geographical distribution. As regards its export destinations, there has been a distinctive reorientation from Eastern markets to those of Western Europe. Thus in the course of few years the share of economies of the Former Soviet Union has decreased from 95.5 percent in 1990 to 47.5 percent in 1996.[11]

Table 3.10 Latvia: main trading partners in 1994 and 2005 (in percent of total)

	1994		2005		1994		2005
Exports to:				**Imports from:**			
Russia	28.1	Lithuania	10.5	Russia	23.6	Germany	14.4
Germany	10.5	Estonia	10.4	Germany	13.5	Finland	14.0
UK	9.7	Germany	9.9	Finland	8.5	Russia	9.6
Sweden	6.9	UK	9.8	Sweden	6.4	Sweden	7.9
Ukraine	5.9	Russia	8.3	Lithuania	6.0	China	5.5
Other	38.9	Other	51.1	Other	42.0	Other	48.6
Total	100.0		100.0	Total	100.0		100.0

Sources: Central Statistical Bureau of Latvia, International Trade Centre database

The order of Latvia's top five export destinations has changed (See Table 3.10). Yet dominant in 1994, Russia has lost its dominant position as Latvia's most important ex-

[11] Source: Havrylyshyn and Al-Atrash (1998: 8).

port destination in the course of subsequent years. In terms of their shares, Latvia's exports have been distributed more evenly amongst its export destinations in 2005. Likewise, its import sources have been diversified. The shares of Western European economies have increased at the cost of that of Russia.

Trade regime

A widespread disruption of its previously existent trade links mainly with the FSU economies pointed to the necessity to secure markets for its given and potentially producible exports as well as maintain supplies of required capital and consumption goods. Latvia's changed trade patterns in terms of composition of trade and geographical distribution of its trade flows have been also complemented by alterations in the institutional frame of its external trade. Thus in the course of its reforms in the 1990s, Latvia has substantially liberalized its trade regime. Its trade has been largely freed from all sorts of previously effective restrictions (Jeffries, 1996). Its newly acquired memberships in trade and cooperation agreements have facilitated the very process of regulatory framework harmonization.

Regional trade agreements and memberships

Latvia's general economic transformation has been substantially influenced by its reorientation of trade flows from East to West. This endeavor has been realized, not least through an array of trade arrangements, which in fact either complemented or rivaled each other. Therefore it is worth mentioning some significant aspects of such arrangements.

EU

In the initial years of its transition, Latvia together with other CEE economies aspired to closer ties with substantially richer economies of the EU. As a result, a free-trade agreement signed with the EU, which came into force in 1995, resulted in elimination of numerous restrictions on Latvian exports, with an exception of some 'sensitive' products (agricultural products, textiles, steel, etc.). What is more, to complete the restructuring process of some of its industries, Latvia has been granted an option to apply certain tariffs during the four-year transitional time span. This arrangement together with other a number of others forewent Latvia's accession to the EU in 2004, which in turn implied further harmonization of the trade-related regulatory framework. Latvia's attained EU

membership implied, among other things, significant reduction of control over its trade policies with non-EU members (e.g. Russia and other CIS countries).

WTO

Along with Estonia and Lithuania, Latvia has taken further steps in integrating its economy into the world trading system and aspired to accede to the WTO. In 1998, it became the first of the Baltic economies to accede to the WTO. This step has enabled it to unify its foreign trade regulatory framework.

Regional scope

Located between the other two Baltic economies, Latvia was interested in the intraregional from the outset to make the most of potentially attainable cooperation opportunities. For this purpose, it joint with Estonia and Lithuania established a free trade area in the early 1990s. However, this endeavor did not get further development due to intensified trade links with Western Europe and EU-membership aspirations. Negligible shares of Estonia and Lithuania in Latvia's trade turnover have become expressions of these developments in the early 1990s (See Table 3.10).

3.2.2 Capital flows

Similar to other transition economies of the region, Latvia had to rely on significant capital inflows from abroad. The amounts of capital inflows were to cover increasing gaps in its trade balance. In the initial years, the share of institutional capital (or official) flows was significant compared to those of other types (e.g. private loans or investment, etc.) (See Table 3.11).

Table 3.11 Latvia: net capital flows, 1992–1996 (in mln. US dollars)

	1992	1993	1994	1995	1996
Official Flows	106	185	127	44	56
Private Flows	43	55	230	359	342
o/w: FDI	29	45	215	245	325
Portfolio	0	0	0	43	0
Short Term Debt	0	5	1	25	13
Commercial Debt	-9	5	15	3	3
Total Flows	149	240	357	402	397
US$ GNP	6365	5333	5475	4925	5025
Total Flows/GNP (percent)	2.3	4.5	6.5	8.2	7.9

Source: Claessens et al (1998: 28)

Provided by institutional donors and governments, these resources were intended to assist Latvia in restructuring its economy. With the time passing by, the share of official flows became far smaller when compared with that of private flows. The latter in its turn primarily consisted of FDI. Portfolio investments have been negligible throughout the whole transition period.

In terms of its absolute values of attracted FDI, Latvia's performance has been less successful when compared with that of Estonia. Latvia's relative success was closely linked to its large-scale privatization. By 2005 the amount of FDI stock totaled 4783 mln. US dollars, or 28.7 percent of its gross fixed capital formation (See Table 3.12). Through increased volumes of attracted FDI Latvia managed to cover its current account gap, increase and renew its capital stock and, thus, induce productivity growth.

Table 3.12 Latvia: foreign direct investment (FDI) overview (selected years)

	1990-2000	2002	2003	2004	2005	1990-2000	2003	2004	2005
	(Millions of US dollars)					(as percent of gross fixed capital formation)			
FDI flows	(Annual average)					(Annual average)			
inward	276	254	292	699	632	25.9	10.7	18.5	13.9
outward	-4	3	36	103	135	-1.8	1.3	2.7	3
FDI stocks	**1980**	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
inward	..	..	2 084	4 575	4 783	..	27	33.6	28.7
outward	..	..	24	220	294	..	0.3	1.6	1.8

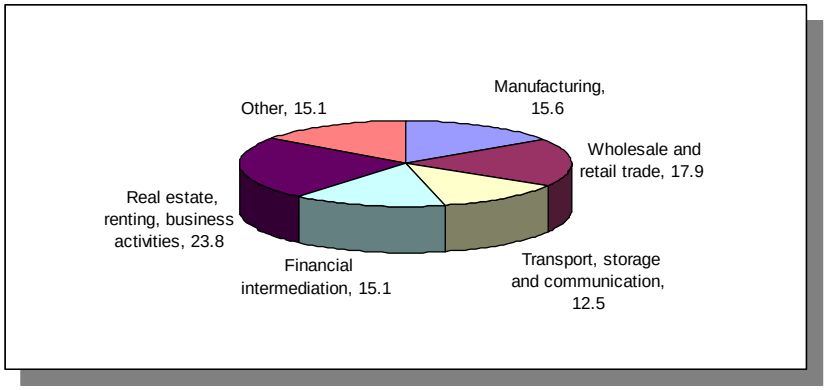
Source: UNCTAD, World Investment Report 2006

Patterns of sectoral distribution of attracted FDI have varied throughout the 1990s. Changes in the sectoral breakdown of attracted FDI in Latvia have gone hand in hand with the overall economic restructuring and appropriate movement from primary sector to the one of services throughout the whole transition period. Latvia's current distribution of attracted FDI fits well the general pattern observed across the Baltic economies.

Thus, the largest volumes of FDI have been accumulated in the sector of services, whose share exceeded two-thirds of the whole volume of attracted FDI as of 2003 (See Figure 3.4). It is represented by branches, such as real estate and business activities (23.8 percent), financial intermediation (15.1 percent), transport (12.5 percent) and wholesale and retail trade (17.9 percent) made up primarily by the following branches. (represented by real estate and business activities, financial intermediation transport and

communication sector, financial sector and manufacturing along with retail trade. Though not negligible, the share of manufacturing in this distribution not large (15.6 percent). By 2005, the sector of services has expanded its proportion up to 79 percent to the detriment those of manufacturing (14 percent) and other sectors (7 percent).

Figure 3.4 Latvia: sectoral distribution of FDI stock, 2003 (in percent)



Source: Central Statistical Bureau of Latvia

Along with the sectoral composition of FDI, the country breakdown has evolved accordingly over the whole transition period with ever increasingly presence of the EU. The greatest share of total attracted FDI as of 2005 is ascribed to the Scandinavian countries. Their shares are distributed in the following way. Sweden's share amounted to 13 percent, while that of Denmark and Norway was 9 percent each. The countries are followed by Germany (14 percent) and the US (8 percent).[12]

Despite an array of obstacles hindering the most efficient allocation of FDI and its utilization, Latvia has made substantial progress in this direction through steady improvements in its institutional frame, which are to secure potentially possible FDI in the future (more on this in section 3.2.3).

3.2.3 Other factors

Migration

With its accession to and closer economic integration with the EU Latvia saw a considerable portion of its labor force leave the country for destinations providing better payment opportunities.[13] These trends may have differing effects upon Latvia's economy.

[12] Source: Bank of Latvia.
[13] Thus, around 70,000 persons (or 6 percent of Latvia's labor force) are reported to have left the country (Source: Bank of Latvia).

Emigration may bring about positive effects for its domestic economy helping to reduce the unemployment rate, decreasing the fiscal burden of the state and inducing real wages to rise (Brunner et al, 2006). In addition, emigration may adversely affect Latvia's economy. Well-qualified workers, leaving the country, deprive it of potential positive externalities.

Technological edge

Resembling the other two Baltic economies, Latvia owes its currently impressive export performance to its competitiveness primarily based on its relatively low wage costs, reasonably well qualified human resources along with an appropriate institutional framework. However, high rates of economic growth lead, among other things, to a rapid increase of wages,[14] which in their turn undermine Latvia's external competitiveness.

With the things evolving that way, to further retain the competitive edge Latvia will have to either upgrade its exports' content or manipulate its exchange rate. Thus far Latvia's successful export performance was mainly due to its managed geographical diversification of its trade flows, while its exportables' content remains practically unchanged.

This implies that its exports remain primarily concentrated in resource- and labor-intensive products, which, as a rule, imply that low- and medium-skilled labor resources are primarily employed. When compared with imports in terms of the technological content, Latvia's exports exhibit larger shares of primary and intermediate goods (See Figure 3.5). Accordingly, the shares of capital and consumer goods in its total exports are smaller than in its imports. Similar patterns are observed in the case of high-tech products: the share of imports (4.4 percent) exceeds that of exports (2.2 percent) of this category of goods.[15]

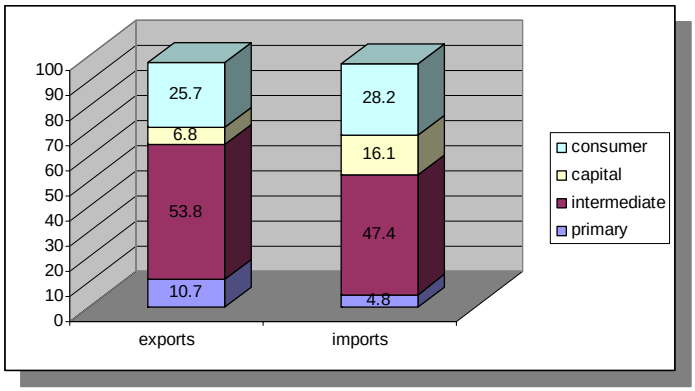
Dominant in the Latvian economy, these trends are at odds with those in other CEE economies, which made advances along the technology ladder and upgraded the content of their exports. Under these circumstances, further exports growth is to be attained primarily through increasing elasticity of demand for the economy's exportables, i.e. through increasing their technology-intensiveness. As Brunner et al (2006) state,

[14] Thus, in the period from 1994 to 2005, with their annual growth rates equaling to 15.3 percent wages grew have grown considerably more rapidly of Latvia's economy.
[15] Source: International Trade Centre database.

Latvia's exports are mainly concentrated in industries, for whose products world demand is growing rather slowly (or exhibit lower income elasticity of demand).

Figure 3.5 Latvia: breakdown of exports and imports in line with stages of technological processing, 2005

(in percent of total)



Source: International Trade Centre database

Exchange rate regime

Shortly after its introduction in 1994, the Latvian lat was pegged to SDR, an IMF virtual currency. It was then repegged to the euro. In 2005 the lat was adopted into the ERM2. Despite being able to pursue its discretionary monetary policy, the Latvian central bank has been acting like a currency board intending to secure the constancy of the Latvian currency's exchange rate. Therefore, throughout the whole transition period the exchange rate of the lat was very stable averaging at the mark of 0.6 per US dollar.[16]

Growing current account gaps and rising wages along with stable exchange rates must point to the issues related to the Latvian economy's competitiveness. However, these trends must be considered commonplace, since Latvia, which is in the process of restructuring and catching-up with more advanced European economies, has to rely on substantial capital inflows from abroad (Blanchard and Giavazzi, 2002; Lutz, 2006).

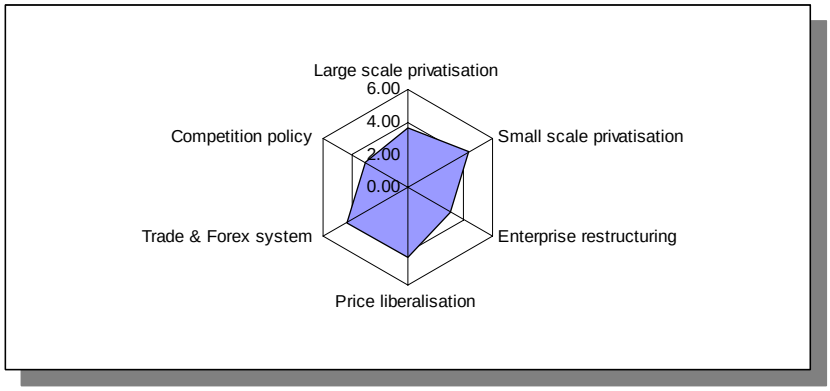
Institutional framework

From the early 1990s, Latvia had to rearrange its institutional frame in order to encourage exports and required imports along attract capital flows from abroad. Such changes implied adoption of numerous legal acts and substantial amendments in its legislation.

[16] Source: EBRD database.

Presently its legislation guarantees all common privileges of foreign investors. While enjoying equal treatment, foreigners are allowed to found startups in almost any economic sphere and transfer profits and repatriate invested capital. Furthermore, they are entitled to become owners of already functioning firms and enterprises of any industry of Latvian economy, what proved rather successful in the course of its large-scale privatization. Such institutional adjustments touched upon many spheres of its economy (See Figure 3.6).

Figure 3.6 Latvia: progress of transition, 2006



Note: minimum score "1.00" (complete lack of progress)
maximum score "4.33" (advanced market economy)
Source: EBRD Transition Report 2006

With its overall transition index average 3.43, Latvia has made considerable progress in this regard within a short time span. It has performed well, when compared with other transition economies. For instance, in the ease of doing business, Latvia had the third highest rank among twenty-eight transition economies.[17] Such swift enhancements in its regulatory frame have become possible, not least due to its aspirations to attain the EU-membership. In view of this, Latvia has done considerable progress during its preparations for the EU accession by modifying its national legal and regulatory framework to bring in conformity with main EU guidelines.

3.3 Lithuania

Lithuania's economy, the largest in the Baltic region, has undergone fairly serious structural transformation that is well expressed in the altered character of its foreign trade and investment patterns. Structural adjustments within its economy have foregone and

[17] Source: World Bank (2007).

accompanied the evolvement of Lithuania's trade and foreign investment patterns, which are closely related to its output recovery and growth.

3.3.1 Trade

Lithuania's newly defined trade patterns, modified since the onset of transition, may be characterized by the composition and geography of its trade flows. Like in the case of the other two Baltic economies, Lithuania saw its trade patterns go through significant changes due to the disruption of its formerly prevalent trade links with its Eastern partners and emergence of new ones with Western European economies.

Despite such essential shifts in the structural make-up of its tradables, Lithuania's trade profile has not changed drastically as in the case of the other two Baltic economies. A more diversified structure of its economy may be a good explanation for this. However, there have been some noteworthy shifts both in its export and import profiles, which go in line with its economy's recent developments.

Exports

In terms of the structural composition of its exportables, Lithuania has experienced rather slight changes (See Table 3.13). In terms of their share, mineral products have been dominating Lithuania's exports throughout.

Table 3.13 Lithuania: main composition of exports, 1998–2005 (in mln. US dollars, fob)

	1998	1999	2000	2001	2002	2003	2004	2005
Mineral products	712.5	452.4	808.6	1,072.0	1,048.4	1,426.8	2,344.9	3,222.8
Machinery & equipment	302.0	162.7	259.7	490.1	555.8	805.8	1,183.9	1,465.7
Textiles	690.5	685.8	709.6	748.5	836.9	990.2	1,088.5	1,097.0
Transport equipment	401.7	342.7	409.5	423.5	888.7	1,111.2	842.7	976.0
Total exports incl others	3,710.5	3,003.8	3,809.5	4,279.3	5,231.7	6,972.6	9,300.4	11,812.7

Source: Statistical Department of Lithuania

Petroleum products have been dominant among its exportables in terms of the Lafay index values and world exports shares[18] (See Table 3.14).

In terms of their share values, the increase of *machinery and equipment* and *transport equipment* has been impressive during the considered period (1998-2005). In absolute

[18] On the whole, as of 2005 the oil sector accounted for about 27 percent of its total export revenue (Source: Statistical Department of Lithuania).

values, growth of exports of other categories of Lithuania's exportables has been more moderate.

Table 3.14 Lithuania: Lafay index and world exports shares

TOP 5 (3-digit SITC classification) 1993-1994	LFI	WES
334-Petroleum products, refined	7.57	0.43
562-Fertilizers, manufactured	2.57	0.62
022-Milk and cream	1.94	0.55
842-Outer garments, men's, of textile fabrics	0.91	0.09
592-Starches, insulin & wheat gluten	0.89	0.46
TOP 5 (3-digit SITC classification) 2000–2001		
334-Petroleum products, refined	6.83	0.48
842-Outer garments, men's, of textile fabrics	2.20	0.32
562-Fertilizers, manufactured	1.76	1.15
821-Furniture and parts thereof	1.40	0.23
776-Thermionic, cold & photo-cathode valves, tubes	1.35	0.05

Source: Zaghini (2005: 639)

Imports

In absolute values, Lithuania's imports have grown rapidly.[19] This is valid for most categories of its importables (See Table 3.15). The observed shifts in the structural composition of Lithuania's imports have been in line with its increased demand for capital goods. Thus, the increase of the share of *machinery and equipment* along with *transport equipment*. What is more, the increase of *mineral products* has also been impressive. It is mainly attributed to its re-exporting activities of mineral products.

Table 3.15 Lithuania: main composition of imports, 1998-2005

(in mln. US Dollars, cif)

	1998	1999	2000	2001	2002	2003	2004	2005
Machinery & equipment	902.9	803.4	1,270.5	1,346.5	1,376.8	1,794.2	2,444.7	3,964.3
Mineral products	1,066.2	889.9	862.9	1,062.7	1,351.8	1,848.7	2,354.7	2,767.7
Transport equipment	711.1	363.4	477.7	730.8	1,265.5	1,546.5	1,636.5	1,827.3
Chemicals	533.0	485.6	496.6	584.7	669.8	851.7	1,046.2	1,208.0
Total imports incl others	5,793.5	4,834.5	5,456.5	6,060.3	7,520.0	9,653.4	12,385.6	15,556.5

Source: Statistical Department of Lithuania

[19] Thus, in the period from 1996 to 2005 Lithuania's average growth rate of imports equaled to 12.3 percent (Source: calculated based on data from EBRD database).

Current account balance

Lithuania's recent economic growth was mainly based on a rapid growth of its exports and fostered by substantial capital inflows from abroad. Resembling other economies of the region, Lithuania has been running substantial current account deficits for a number of years. Thus, by 2005 its current account deficit has grown up to 4.4 percent of GDP.[20] Such developments must raise questions of sustainability of such developments in the long term. On this account, Bonato and Leigh (2005) in their analysis of the recent developments of Lithuania's current account deficit conclude that it is consistent with its fundamentals. Its current account deficit is deemed sustainable because the country's intertemporal budget constraint is not violated (i.e. the present discounted value of its expenditure does not exceed the present discounted value of its future output).

These developments go in line with the workings of closer financial integration in Europe, in which poorer countries are apt to invest more and save less (Blanchard and Giavazzi, 2002). Therefore, Lithuania's presently given current account deficits might reflect its aspirations to attain consumption smoothing and, thus, maintain sustainable intertemporal optimization. Its residents respond to a risen permanent income by consuming more than their current income levels allow for, what increases gaps in the current account.

Trade geography

Structural changes in the content of Lithuania's trade flows imply certain shifts in their geographical distribution. In this case one deals with a pattern observed across the Baltic economies. Lithuania has reoriented its trade flows from East to West. For instance, in a matter of few years, the share of Lithuania's exports destined for economies of the Former Soviet Union has diminished from 91.4 percent in 1990 to 56.8 percent in 1996.[21]

However, this shift has not been as far-reaching as in the case of Estonia and Latvia. It is yet evident that the shares of Western European economies in Lithuania's overall trade turnover have increased during the considered period (See Table 3.16). Russia still retains its dominant position among main Lithuania's export destinations and import sources, although its shares shrank considerably.

[20] Source: World Bank, for details see Annex 3, p. 231.
[21] Havrylyshyn and Al-Atrash (1998: 8).

Table 3.16 Lithuania: main trading partners in 1994 and 2005 (in percent of total)

	1994		2005		1994		2005
Exports to:				**Imports from:**			
Russia	28.1	Russia	11.4	Russia	39.3	Russia	27.5
Germany	10.5	Latvia	10.0	Germany	13.8	Germany	14.8
UK	9.7	Germany	9.2	Ukraine	5	Poland	8.2
Sweden	6.9	France	6.8	Poland	4	Latvia	3.9
Ukraine	5.9	Estonia	5.7	Belarus	3.8	Netherlands	3.6
Other	38.9	Other	56.9	Other	34.1	Other	42.0
Total	100.0		100.0	Total	100.0		100.0

Sources: Statistical Department of Lithuania, International Trade Centre database

Trade regime

Lithuania's foreign trade regime has been substantially liberalized in the course of implemented reforms, what is well reflected by the high value of its trade and foreign exchange liberalization index (See Figure 3.9 on page 119). Previously effective export licensing have been abolished altogether (Jeffries, 1996). Non-tariff barriers have been eliminated almost at the outset of the transition period. Alone few exceptions have been made in regard to agricultural products. In general, import tariffs range from 5 to 15 percent, although higher tariffs (up to 25 percent) may be applied in the case of manufactured articles.

Regional trade agreements and memberships

The economic restructuring of the Lithuanian economy has been intensely accompanied by substantial changes both in the structural composition and geographical distribution of its trade flows. Such developments were to a significant extent influenced by trade arrangements. Some important aspects of these arrangements deserve closer consideration and are mentioned below.

EU

Like Estonia and Latvia, in the initial stages of its transition Lithuania engaged into a free trade agreement with the EU, which came into force in 1995. In line with this trade agreement, Lithuania gained access to Western European markets, while retaining an option to defend its own industries through tariffs within the four-year transitional period. These measures preceded its intentions to integrate closer with the EU and become its member in 2004.

WTO

Lithuania's application for a WTO-membership in the early 1990s and its subsequent attainment enabled it to swiftly unify its foreign trade regulatory framework with most members of the organization. This process has been strengthened by Lithuania's aspirations to integrate closer with the EU economies.

Regional scope

In the early 1990s, an option for closer intraregional economic integration of the Baltics seemed viable due to the existence of a wide array of common issues. In 1994, for this purpose, Lithuania together with Estonia and Latvia intended to create a free trade area across the region. In spite of this, the project proved less viable than thought due to intensified trade links with the EU economies since the mid-1990s. Therefore, neither Estonia nor Latvia was not among the countries exhibiting high shares in Lithuania's trade turnover in the mid-1990s (See Table 3.15).

3.3.2 Capital flows

Large amounts of capital flows enabled to increase Lithuania's imports in excess of its exports. Initially, institutional loans and grants made large portions of all capital inflows. These originated primarily from international financial institutions and governments. Afterwards, these were gradually replaced by ever increasing private capital flows in various forms (See Table 3.17).

Table 3.17 Lithuania: net capital flows, 1992–1996 (in mln. US dollars)

	1992	1993	1994	1995	1996
Official Flows	102	248	161	173	189
Private Flows	12	80	42	152	736
o/w: FDI	10	30	31	72	152
Portfolio	0	0	0	4	181
Short Term Debt	5	2	22	20	107
Commercial Debt	-3	47	-12	56	136
Total Flows	114	328	202	325	925
US$ GNP	11303	7674	7522	7227	7688
Total Flows/GNP (percent)	1	4.3	2.7	4.5	12

Source: Claessens et al (1998: 28)

Like Estonia and Latvia, Lithuania could not maintain at that time sufficiently well organized infrastructure for absorbing and placing portfolio investments. Hence, within the category of private flows, FDI exhibited larger shares.

Both in terms of absolute and per capita values of FDI, Lithuania's performance has been less successful when compared with the other two Baltic economies. This is primarily attributed to the initially slower course of implemented privatization of large state enterprises. From the second half of the 1990s onwards, however, with the acceleration of its privatization program their volumes have been rising. Thus by 2005, Lithuania's FDI stock amounted to 6461 mln US dollars, or a quarter of its gross fixed capital stock (See Table 3.18).

Table 3.18 Lithuania: foreign direct investment (FDI) overview (selected years)

	1990-2000	2002	2003	2004	2005	1990-2000	2003	2004	2005
	(Millions of US dollars)					(as percent of gross fixed capital formation)			
FDI flows	(Annual average)					(Annual average)			
inward	271	732	179	773	1 009	11.8	4.6	15.8	17.7
outward	9	18	37	263	329	-	0.9	5.4	5.8
FDI stocks	**1980**	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
inward	..	..	2 334	6 389	6 461	..	20.5	29	25.1
outward	..	..	29	423	708	..	0.3	1.9	2.8

Source: UNCTAD, World Investment Report 2006

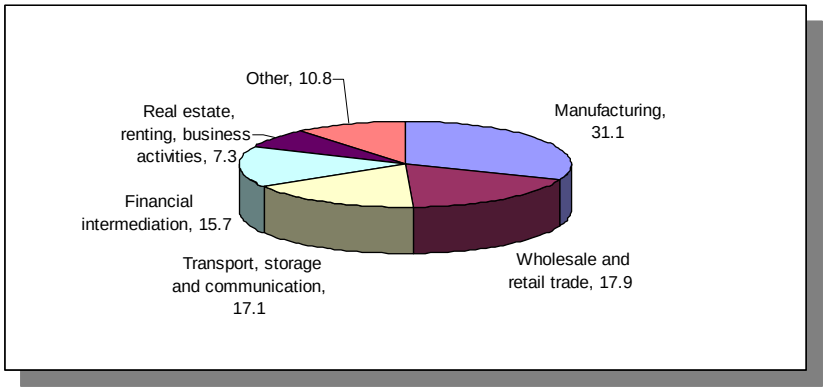
Before taking a closer look at the breakdown of Lithuania's attracted FDI, it is worth noting that it mirrors a general picture observed across the region. The sector of services is a dominant one (See Figure 3.7). With its share of around 60 percent in 2003, it embraces branches such as wholesale and retail trade (17.9 percent), transport (17.1 percent), financial intermediation (15.7 percent) along with real estate and business activities (7.3 percent).

There are yet some particularities, which primarily stem from structural characteristics of the Lithuanian economy. For instance, in contrast to Estonia and Latvia, as of 2003 Lithuania exhibited a larger share of FDI stock attributed to the sector of (31.1 percent). Accordingly, other industries had smaller shares: wholesale and retail trade (17.9 percent), transport (17.1 percent), financial intermediation (15.7 percent) and real estate along with business activities (7.3 percent).

As in the cases of Estonia and Latvia, Scandinavian economies are leading investors in Lithuania. Together they accounted for two-fifths of Lithuania's total FDI by 2005.[22] Among the top thee investing countries were Sweden (14 percent), Denmark (13.5 percent) and Germany (13.3 percent).

Figure 3.7 Lithuania: sectoral distribution of FDI stock, 2003

(in percent)



Source: Statistical Department of Lithuania

3.3.3 Other factors

Migration

Among external factors significantly exerting influence upon the growth dynamics of Lithuania's economy migration has become one of the significant ones. It must be noted that, since the onset of transition, Lithuania's overall population started plummeting due to decreased birth rates and, more importantly, increased scope of outward migration.[23] Attracted by higher wage levels, workers leave the home country for richer ones bringing about certain effects for both the former and the latter. Most of the Lithuanian migrant workers leave for countries, such as Great Britain, Ireland and Sweden. An exodus of workers from certain sectors of the Lithuanian economy is likely to induce labor market pressures and lead to the increase of domestic wages. Such trends may adversely affect its competitiveness (Ohnsorge et al, 2006).

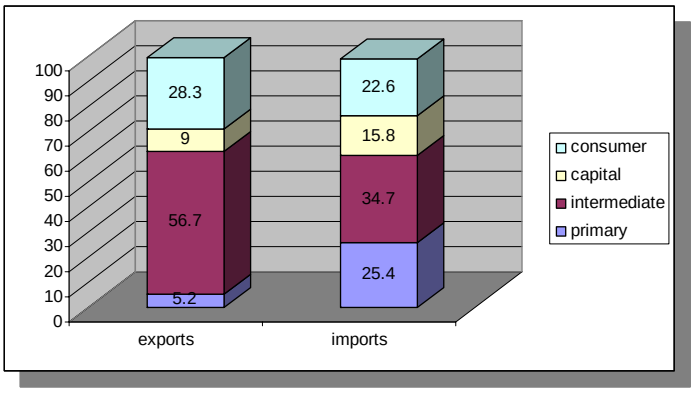
[22] Source: Statistical Department of Lithuania.
[23] Thus, around 7 percent of Lithuania's labor force is assumed to have emigrated since the onset of transition (Source: Economist Intelligence Unit).

Technological edge

The technological edge of Lithuania, reflecting the quality of its available inputs, determines non-price characteristics of its exportable items. Thus far Lithuania's competitive edge has been primarily based upon lower costs for its inputs, especially labor. Combined with large amounts of FDI (See Figure 3.7), they have brought about its manufacturing industry's quick revival. In the long run, however, with its wages rising, Lithuania is likely to lose its present competitiveness. Its current export profile does not match that of imports, when considered in terms of technological content (See Figure 3.8). The shares of intermediate and consumer goods in its total exports exceed those in imports, whereas the shares of primary and capital goods in total imports are larger than those in total exports.[24] The same may be mentioned of the category of products classified as high-tech products. In 2005, for instance, the share of this category was around 5.5 percent in the total volume of imports, whereas that of exports was only 2.3 percent.[25]

Figure 3.8 Lithuania: breakdown of exports and imports in line with stages of technological processing, 2005

(in percent of total)



Source: International Trade Centre database

To further retain its competitive edge, Lithuania is compelled to upgrade its exports. The technological content of its tradables will be one of the important determining factors of Lithuania's further economic growth in the long term.

[24] It is worth noting here that large shares of primary goods in imports and of intermediate items in exports are primarily attributed to oil refining and re-exports thereof.
[25] Source: International Trade Centre database.

Exchange rate regime

After its introduction in 1994, the Lithuanian litas was first pegged under CBA to the US dollar and then, in 2002, repegged to the euro. In view of Lithuania's diversified trade geography (See Table 3.16), its currency board system involves making allowance for a currency anchor, since most of its import costs are denominated in US dollars, whereas a substantial part of its exports revenues is expressed in euros. In 2004 Lithuania entered the ERM2. Throughout Lithuania's transition period, the average value of the litas varied around 3.7 per one US dollar.

Lithuania's augmenting current account gap, rising wages and stable currency should raise issues related its long-term external competitiveness. These facts are to be considered as signs of a ripening economy, which is currently in the process of restructuring and catches up with more advanced countries, while allowing itself to invest more than it saves through capital inflows from abroad (Lutz, 2006). Provided such restructuring is successful, high wages and an overvalued exchange rate may be leveled off by increased productivity.

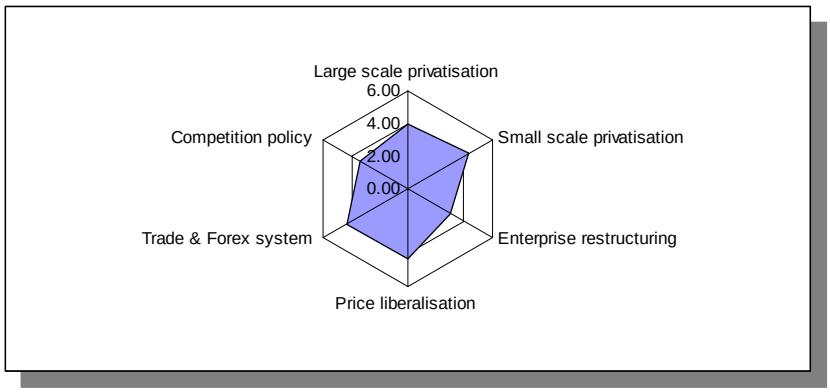
Institutional framework

Lithuania's progress in reorientation of its trade flows and attracting foreign investment has to be partially ascribed to considerable changes in its institutional frame. In the wake of such changes, it has adopted a large number of legal acts and amendments in its regulatory frame, which were intended to improve Lithuania's business and investment climate. This transformation touched on nearly all facets of its economy (See Figure 3.9). With its overall transition index average equaling to 3.43, Lithuania has made considerable progress in this respect.

Among all transition economies, currently it has the highest ranking in the ease of doing business.[26] This fact points to substantial advances that Lithuania has made in the recent years. What is more, these institutional changes have been brought about in the wake of its intentions to join the EU.

[26] Source: World Bank (2007).

Figure 3.9 Lithuania: progress of transition, 2006



Note: minimum score "1.00" (complete lack of progress)
maximum score "4.33" (advanced market economy)
Source: EBRD Transition Report 2006

Summary

The Baltic economies, having pursued fairly free trade policies, experienced substantial changes of their foreign trade and investment patterns in terms of geography and sectoral composition. Despite a few differences, on the whole, this transformation of trade and investment patterns across the three Baltic economies has been rather uniform.

While yet retaining few of their pre-transition trade links, they managed to expand economic links with Western Europe. This has substantially contributed to the recovery of their output levels and triggered the catch-up process (Fabrizio et al, 2006). Encouraged through trade arrangements, reorientation towards markets of Western Europe enabled to quickly implement further restructuring of their economies (Lücke, 2006). In line with the then given comparative advantage, initially the Baltic economies had to specialize and export labor- and, in part, resource-intensive goods to markets of Western Europe.

Expanded exports to Western markets have been complemented by substantial capital inflows of various types, among which FDI has become ever more important. Sectoral and geographical distribution patterns of attracted FDI very much resembles those of their foreign trade. The common feature of all Baltic economies is that inflow is substantially greater than outflow, since the economies are not mature and continue their development – an integral scheme to convergence (Lutz, 2006).

Such relatively rapid reorientation has been accompanied by further appropriate alterations in, for instance, regulatory framework, foreign exchange policies, trade re-

gime, etc. These have been implemented in the wake of the EU accession preparations, which implied general harmonization of many institutional constituents. Notwithstanding their current accomplishments of the Baltic economies, they will have to further their economic transformation by upgrading structural composition of their exports, if stable growth rates are to be sustained further.

Chapter 4 External Factors of Economic Growth in Central Asia

The countries of Central Asia have experienced notable changes – though to a differing extent – in the structure of their economies in the course of their transition. These transformations are well reflected in the altered patterns of their trade and foreign investment. This chapter deals with an array of external factors exerting influence upon the pace of economic development of the three economies of Central Asia. Accordingly, the factors in question are considered on the examples of Kazakhstan (section 4.1), the Kyrgyz Republic (section 4.2) and Uzbekistan (section 4.3).

4.1 Kazakhstan

Kazakhstan, the largest of Central Asian economies, has endured significant changes both in terms of its output structure and trade in the course of its transformation. Its external conditions are supposed to have exerted substantial influence on the course of its economy's transformation. In its case both trade and capital have been important determinants of output recovery and growth.

4.1.1 Trade

A rapid expansion of external trade in Kazakhstan has become one of the main causes of its economy's rebound. Due to both rising prices for its exportables and physical augmentation of their volumes swiftly growing exports triggered, first, a swift recovery of output growth and, then, its acceleration. However, the restored volumes of external trade along with that of output were made up completely differently when compared with the formerly prevailing trade and output structure of Kazakhstan. These fairly rash changes in the production and trade composition were inevitable. Since formerly the whole price building system was entirely of different nature, the economic structure and trade in terms of their values differed profoundly from those under current market conditions. In this context, Kazakhstan was from the outset to gain sufficiently from expected improvements of its terms of trade owing to substantially higher prices for an array of its resources, since formerly within the Soviet economy most of its tradables had been to a large extent undervalued (Pomfret, 2003).

Exports

Throughout its transition, Kazakhstan managed to expand export volumes considerably. In the course of this expansion, there have been noteworthy changes in the structural composition of its exportables. Thus, reflecting recent developments of its economy, Kazakhstan's currently prevailing exports are by far dominated by items of its primary sector, especially *mineral products*. Among its exportables, the dominance of *mineral products and metals*, is obvious (See Table 4.1). Their shares equaled to 74 percent and 16 percent of total exports in 2005, respectively. In the considered period (1998-2005), the share of the former has increased more rapidly than that of the latter. The shares of other categories of Kazakhstan's exportables have shrunk despite their rapid expansion in absolute values.

Table 4.1 Kazakhstan: exports by commodity group (in mln. US dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Vegetable products	366.8	378.5	559.7	392.7	408.2	659.5	640.7	456.5
Prepared foodstuffs	38.2	22.8	33.2	43.5	39.1	79.3	119.6	133.6
Mineral products	2302	2731.1	4790.6	5028.8	5917.5	8316.3	13727.1	20553.3
Chemical products	337.8	335.3	378.2	405.9	418.6	440	634.1	899.1
Textiles	74.5	62.7	97.9	94.9	115.4	155.4	188.9	213.9
Metals	1732.2	1817.2	2273.7	2109.9	2234.1	2635.1	3897.2	4419.1
Machinery & equipment	79.1	104.3	146.2	132.8	112.2	154.8	193.1	245.1
Total exports incl others	5334.1	5871.6	8812.2	8639.1	9670.3	12926.7	20096.2	27849

Source: Asian Development Bank (ADB) - Key Indicators 2006

Imports

In line with its demand structure and domestic production capacities, Kazakhstan's imports have undergone notable changes in their structural composition. Thus, due to increased export revenues, Kazakhstan has increased its imports of items of higher stages of processing. This trend has been intensified in recent years. As of 2005, its import profile was dominated by categories comprising *machinery and equipment*, *metals* and *transportation equipment*, which made up largest shares in total volume of imports (See Table 4.2).

Current account balance

With its steadily expanding exports, the Kazakh economy has not experienced difficulties related to increased gaps in its current account balance. Its current account deficits

have been covered through increased inflows of capital from abroad in form of investment or loans (more on this in section 4.1.2). In recent years, the current account gap has been widening due to increased imports of services combined with income debits. Thus, as of 2006 its current account deficit equaled to 486 mln. US dollars, what corresponded to 0.9 percent of its GDP.[1] These trends are caused, not least by a strengthening of the Kazakh national currency.

Table 4.2 Kazakhstan: imports by commodity group (in mln. US dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Prepared foodstuffs	292.9	241.6	289.9	331	333	426	611.1	741.1
Mineral products	733.6	421.7	657.6	904.4	822.9	1007.2	1873.5	2322.8
Chemical products	416.2	341.8	545.8	667.1	715.7	909.6	1128.3	1337
Plastics and rubber	142.3	116.1	193.2	239.8	267.9	362.8	504.2	664.8
Textiles	68	55	65.6	75.6	102.1	146.6	162.6	223.9
Metals	497.9	339.5	562.9	889.5	737.9	993.2	1666.1	2546.3
Machinery & equipment	1027	961	1402.4	1852.2	1881.7	2152.5	3421.9	4902.3
Transportation equipment	439	619.8	563	625	803.2	1222.8	1777.2	2341.7
Total imports incl others	4313.9	3655.1	5040	6446	6584	8408.7	12781.2	17352.5

Source: Asian Development Bank (ADB) - Key Indicators 2006

Trade geography

Kazakhstan, having to integrate itself into the world trading system and facing new conditions in terms of prices and distribution mechanisms, had also to rearrange its foreign trade pattern, which implied diversification of the geography of its exports along with imports.

In terms of their geographical distribution, Kazakhstan's exports have been diversified notably. The share of its exports to the economies of the Former Soviet Union (FSU) has been steadily diminishing, whereas the rest of the world has been gaining in its weight. Thus in a matter of just few years, the share of FSU economies in the volume of its total exports has decreased from 88.7 percent in 1990 to 58.8 percent in 1996.[2]

Presently, it conducts trade with a larger number of countries compared with the pre-transition period. The occurred shifts are evident (See Table 4.3). During the considered period Russia has lost its leading position as a main destination for Kazakhstan's exports. In addition the list of its top five destinations has become more diversi-

[1] Source: World Bank, for details see Annex 4, pp. 233-234.
[2] Source: Havrylyshyn and Al-Atrash , (1998: 8).

fied, while their shares have been distributed more evenly. This shift is primarily attributed to a reorientation of exports of primary industries caused by the increased demand for Kazakhstan's mineral products.

As regards countries, from which imports of Kazakhstan originated, there have been only minor changes. Russia has retained its dominance as a main source for Kazakhstan's imports. It is then followed by Germany, whose share has decreased only slightly during the considered period. One of the few changes is attributed to China's ascension to the third largest source for imports of Kazakhstan.

Table 4.3 Kazakhstan: main trading partners in 1994 and 2005 (in percent of total)

	1994		2005		1994		2005
Exports to:				**Imports from:**			
Russia	44.6	Switzerland	19.8	Russia	39.4	Russia	38.0
China	4.6	Italy	15.0	Germany	8.9	Germany	7.5
Switzerland	4.3	Russia	10.5	Ukraine	3.6	China	7.2
Ukraine	4.0	France	9.6	US	3.3	US	6.9
US	2.3	China	8.7	Turkey	2.7	Ukraine	4.9
Other	40.2	Other	36.4	Other	42.1	Other	35.5
Total	100.0		100.0	Total	100.0		100.0

Sources: International Trade Centre database, Asian Development Bank (ADB) - Key Indicators 2006

Trade regime

Since the onset of the transition process, Kazakhstan has liberalized much of its domestic and external economic sectors and increased its openness to foreign trade. Thereby it has freed its trade by eliminating numerous restrictions and cutting certain tariffs. Initially, the progress has been rather modest. There are still few quantitative restrictions on imports in place, whereas all export subsidies have been already eliminated. However, despite its wide-range trade liberalization it often erects tariff as well as non-tariff barriers that decrease the volume of traded goods.

The tariff system of Kazakhstan points to a protection pattern typically exhibited by those economies that pursue import substitution strategies. Accordingly, its tariffs rise with an increase of the degree of technological processing of imported items. Hence, it practically applies a broad band of tariffs[3] (Jeffries, 1996). At the same time,

[3] For instance, as of January 2006, Kazakhstan had ten tariff bands, among which the highest possible equaled 100 percent and non-weighted average tariff amounted to 7.4 percent (ADB, 2006: 26).

fairly low tariffs on capital goods and intermediate products facilitate an expansion of Kazakhstan's downstream and capital-intensive industries.

Further export diversification in the long-run, undoubtedly, necessitates significant alterations of its tariff structure. In this context, a promising option could be to have low and unified tariffs adjoint to other structural changes required for creating favorable trade regime and investment climate. Furthermore, numerous non-tariff barriers of different forms, *ad hoc* restrictions and frequently changing trade regulations are to be eliminated.

Regional trade agreements and memberships

WTO

Much of the abovementioned could be reached through Kazakhstan's WTO membership, to which it has been aspiring since 1996. The WTO accession process has been a rather lengthy process so far mainly due to the fact that Kazakhstan's membership in this organization is directly intertwined with its commitments to regional trade arrangements with other CIS economies. To accelerate its WTO accession, Kazakhstan will have to further liberalize its trade regime. This membership could result in some improvements, which, though, are not supposed to be substantial in the short term, since Kazakhstan already enjoys its most-favored-nation (MFN) status in trade with its important trading partners.

This is not, however, to underestimate the importance of its accession to the WTO due to possible benefits to be accrued from simplification of regulatory bases with its neighboring economies. Moreover, it could also thus attain improved access to foreign markets promoting further diversification of its exports make-up while securing sufficient protection of its domestic 'infant industries'. The most significant gains from its WTO accession are yet to be accrued in the long term, which are to result in increased allocative efficiency and higher rates of economic growth. In line with the quantitative estimations of the impact of Kazakhstan's accession to the WTO made by of Jensen and Tarr (2007), its accession would result in 6.7 percent higher consumption over the medium term and up to 17.5 percent thereof in the long term. Besides, these are to be complemented by further dynamic gains, provided its institutional framework would facilitate such kind of processes spilling over further to other spheres.

Regional scope

Since its independence, Kazakhstan has been an active proponent of closer integration of the economies of the region. In line with this, it has been taking part in a number of bilateral agreements on trade and investment with other CIS countries and other multilateral arrangements pursuing establishment of RTAs. The most significant of them is probably the Eurasian Economic Community (EAEC) that succeeded the CIS Customs Union of 1995. The efficacy of such kind of integration initiatives has been inadequate and challenged by a number of other inconsistently pursued regional integration schemes. However, intentions to foster regional trade, if pursued too intensively, might stand in stark conflict with the present comparative advantage of Kazakhstan and result in trade diversion exceeding trade creation. It is fairly evident that trade with non-CIS countries is currently more promising for Kazakhstan due to its increasing export capacities of mineral resources.

4.1.2 Capital flows

Upon gaining its independence Kazakhstan had to rely on considerable capital inflows from abroad since its own financial resources were in desolate condition. Economic collapse of the early 1990s and forced tight monetary policy of the subsequent years put severe constraints on Kazakhstan's domestic investment possibilities (Kaminski, 1996). Therefore, a dearth of investment resources made evident the necessity to attract foreign investment, which was to play a significant part in further restructuring and technological improvement, badly needed for a swift recovery of its economy.

Even by the onset of its economic transformation Kazakhstan was among the leading countries in attracting capital from abroad, while being second only to Russia among the CIS economies in terms of their amounts disbursed. In the initial stages capital inflows comprised both official and private flows, which supplemented each other differing in their shares throughout the early 1990s (See Table 4.4). Official flows primarily originated from international financial institutions and were intended to facilitate the process of structural readjustment of the Kazakh economy along with liberalization and stabilization measures.

From the mid-1990s onwards, the share of private inflows has been on a steady rise. These kinds of inflows were also complemented by private medium- and long-term loans, which eased financial constraints by a large number of enterprises.

Table 4.4 Kazakhstan: net capital flows, 1992-1996 (in mln. US dollars)

	1992	1993	1994	1995	1996
Official Flows	12	267	663	546	511
Private Flows	126	312	458	1228	1416
o/w: FDI	100	150	185	940	1110
Portfolio	0	0	0	7	0
Short Term Debt	9	-9	127	93	2
Commercial Debt	17	171	146	188	105
Total Flows	138	579	1121	1774	1927
US$ GNP	26795	25301	19622	19348	20949
Total Flows/GNP (percent)	0.5	2.3	5.7	9.2	9.2

Source: Claessens et al (1998: 30)

Since portfolio investments remained negligible, the lion's share of private capital inflows were in form of FDI. These substantial volumes of FDI helped ease the resulted mismatch in the current-account balance throughout most of the transition process, since Kazakhstan's current-account deficits were primarily financed through FDI and medium- and long-term loans. Due to its non-debt-creating nature, FDI despite rather impressive amounts attracted has not brought about any deterioration of the country's external indebtedness, as it could have been in the case of institutional loans. Total amount of FDI flows accumulated on a net basis throughout the transition period was around 25.152 bln. US dollars, or 44.8 percent of its gross fixed capital, by 2005 (See Table 4.5).

Table 4.5 Kazakhstan: foreign direct investment (FDI) overview (selected years)

	1990-2000	2002	2003	2004	2005	1990-2000	2003	2004	2005
	(Millions of US dollars)					(as percent of gross fixed capital formation)			
FDI flows	(Annual average)					(Annual average)			
Inward	1 040	2 590	2 092	4 113	1 738	29.2	29.5	44.5	18
outward	4	426	-121	-1 279	17	-	-1.7	-13.8	0.2
FDI stocks	**1980**	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
Inward	..	..	10 078	22 327	25 152	..	55.1	54.8	44.8
outward	..	..	16	..	..	..	0.1	..	..

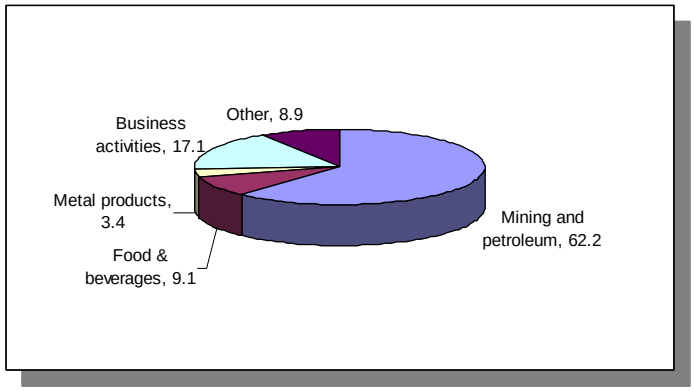
Source: UNCTAD, World Investment Report 2006

Turning to the sectoral breakdown of Kazakhstan's FDI, it is worth noting that its distributional patterns are closely intertwined with those of its trade flows and structural evolution of its economy. Taking a closer look at the sectoral distribution, it becomes

evident that FDI has been primarily absorbed by a limited number of the Kazakh economy's sectors. Thus, as of 2002, almost two-thirds of Kazakhstan's FDI stock was allocated to the sector of mining and petroleum (See Figure 4.1), reflecting, among other things, dominant positions of these branches in its trade flow's composition. Another third of its total FDI stock was distributed in the following way: business activities – 17.1 percent, food and beverages – 9.1 percent, metal products – 3.4 percent, and other branches – 8.9 percent.

Figure 4.1 Kazakhstan: sectoral distribution of FDI stock, 2002

(in percent)



Source: National Bank of Kazakhstan

Since the largest part of FDI was concentrated in oil and gas sectors, it was US oil companies (e.g. ChevronTexaco and ExxonMobil) that invested much of the attracted in the sector. Therefore, among Kazakhstan's main investors the United States – with its share varying between 40 and 50 percent of annual FDI inflows – has been in front of other countries.[4] The United Kingdom and Canada were the next largest investors, making each up to one-tenth of the whole amount of FDI inflows.

Generally, Kazakhstan's investment pattern, characterized by a prevalence of resource-intensive sectors in the overall foreign investment attracted, no doubt, confirm the assertion put forward by Tøndel (2001) and Shiells (2003) that the large amounts of FDI attracted into the Kazakh economy are primarily due to its abundant endowments with exportable natural resources. These trends in FDI flows should raise concerns about sustainability of such developments in the long run. Substantial capital inflows in

[4] Source: UNCTAD, FDI/TNC database.

the resource-intensive sectors and, thus, brought about real appreciation of the currency, are apt to inflict indirect losses to other sectors of an economy by crowding out resources from them.

It should be noted, however, that alternatively there might be positive effects stemming from large amounts of FDI allocated to Kazakhstan's primary industries. Expansion of these industries may trigger growth of other industries (e.g. financial intermediation, business services, manufacturing, transportation, etc.).

4.1.3 Other factors

Migration

Being sharp in its character, Kazakhstan's economic transformation of the 1990s brought about significant changes in its labor market. In this context, especially in the initial years after the onset of economic reforms, Kazakhstan experienced nearly an exodus of human resources.[5] Numerous well qualified specialists were among those who left the country. This considerably worsened the situation in many spheres of its economy, in particular its tertiary sector.

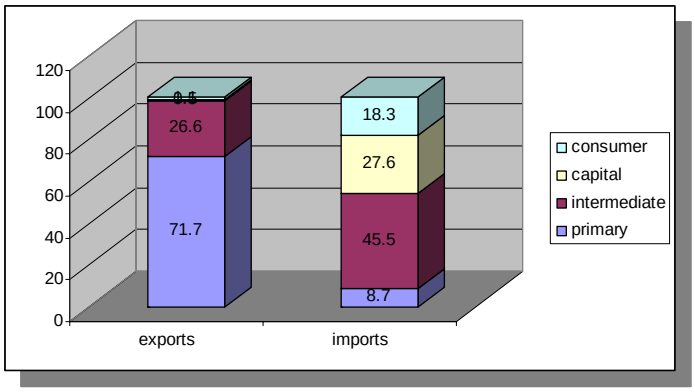
Technological edge

Kazakhstan's recent economic expansion has been based primarily on the growth of its resource-intensive exports, which are currently demanded in the international market. Deriving from the current make-up of its trade flows, it becomes evident that present comparative advantage lies in the industries exhibiting low and medium level of technological sophistication (See Figure 4.2).

Its export profile is by far dominated by primary and intermediate products, whereas capital and consumer goods are negligible in terms of their shares in total volume of exports. In the case of its exports the shares are distributed differently. The shares of intermediate, capital and consumer are larger, whereas that of primary products is smaller. This structural difference between exports and imports is also observed in the case of the category of tradables classified as high-tech products. The share of exports (1.5 percent) is by far exceeded by that of imports (6.4 percent).[6]

[5] For instance, from 1989 to 1995 net emigration reached the mark of 1.3 million persons, of which Russians and Germans made the greatest shares. This decreased Kazakhstan's labor force by about one-tenth. (Source: Agency of Statistics of Kazakhstan).
[6] Source: International Trade Centre database.

Figure 4.2 Kazakhstan: breakdown of exports and imports in line with stages of technological processing, 2005 (in percent)



Source: International Trade Centre database

The current composition of Kazakhstan's trade flows may raise issues related to its competitiveness in the long-term perspective. Presently dominated by primary and intermediate products, its exports are inclined to face setbacks since they are subject to price volatilities.

In addition, exports of resource-intensive industries are usually apt to rely primarily on the effect from the economies of scale and imply rather low labor intensivity and, hence, employment and slower pace of technological advance. Its expansion potential is limited by the existing reserves of non-renewable resources.

Exchange rate regime

Kazakhstan was impelled to introduce its own currency in the early 1990s to tame uncontrolled inflation and maintain rather stable price levels. Initially the exchange rate of the Kazakh tenge was maintained through the central bank's interventions but since 1999 Kazakhstan adheres to the floating exchange rate regime.

Due to increased importance of external sector, developments of its exchange rate are of high significance for the Kazakh economy. Moreover, taking into consideration the dominance of raw materials in the export make-up of Kazakhstan, the vulnerability of its export revenues is rather evident due to the possible terms-of-trade developments. Therefore, the final result of the much aspired diversification of export structure and its geographical distribution, as a direct consequence thereof, will be determined by an exchange rate conducive to a competitive non-oil export sector. In view of the fact that Kazakhstan despite significant volumes of its exports is a price taker in international markets and its exports supplies are denominated in US dollars, its import

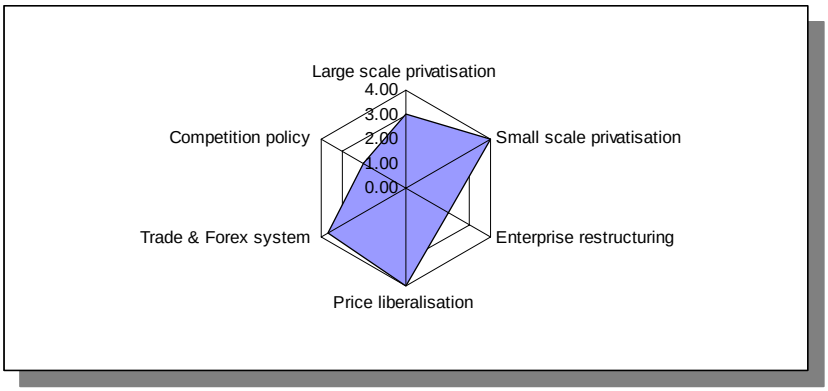
capacities will be to a great extent determined by the development of its exchange rate. For these purposes an appropriate flexible exchange rate is of high importance.

Kazakhstan's oil exports appear to expand throughout the coming years and, thus, exert a substantial pressure on the real exchange rate, the issues of external competitiveness of the Kazakh economy will dominate the agenda. This is exacerbated by its rather unfavorably diversified export composition and geographic distribution of its export markets (See Figure 4.2). In this connection, two lines of argumentation should be taken into consideration. On the one hand, expansion of oil sector – through exchange rate mechanism – may adversely affect other industries of its economy ('Dutch disease' phenomenon).[7] On the other hand, such potential adverse effects may be neutralized, if there appear enough forward and backward linkages among adjacent industries, including non-oil export sectors (staples thesis). The latter implies a diversification of both economic structure and exports.

Institutional framework

Kazakhstan's intentions to adapt to new economic realities after the collapse of the Soviet economy were doubtless to be complemented by an appropriate adjustment of its institutional framework regulating, among other activities, its external trade and foreign investment. Its progress in fostering institutions has been based on its intention to reform numerous spheres of its economy (See Figure 4.3). With its overall transition index equal to 2.88 it fares well among the CIS economies.

Figure 4.3 Kazakhstan: progress of transition, 2006



Note: minimum score "1.00" (complete lack of progress)
maximum score "4.33" (advanced market economy)
Source: EBRD Transition Report 2006

[7] Kutana and Wyzand (2005) in their study suggest that Kazakhstan exhibited symptoms of significant Dutch disease effects during the period from 1996-2003.

However, despite numerous accomplishments, there is still large room for improvement. Being one of the most advanced reformers in the CIS, it still fares in certain areas considerably worse than a number of advanced transition economies of CEE. Thus, among twenty-eight transition economies, Kazakhstan ranked eleventh in the ease of doing business.[8] This implies that many shortcomings are still commonplace. Therefore, Kazakhstan's aspirations to further foster external trade and foreign investment are to be complemented by extensive enhancement of its institutional frame.

4.2 Kyrgyz Republic

Like other transition economies of the former Soviet Union, the Kyrgyz Republic has endured considerable contractions in its output. Occurred in the wake of disintegration processes of the early 1990s, the Kyrgyz economy's transformation has brought about significant changes both in its structure and trade patterns. Capital inflows have been a significant determining factor in the development of its output.

4.2.1 Trade

Due to its landlocked geographical location and, hence, relatively high transport costs many of its formerly operating enterprises proved utterly unviable under new economic conditions. Therefore, the contraction of its industrial sector stood out for its rapidness and steepness. Despite the swiftly implemented economic reforms, its production along with foreign trade volumes failed to recover to the pre-transition levels, for it lost access to its formerly available markets and had no appropriate infrastructure to rearrange its trade flows adequately. Therefore, following drastic changes within its economy's structure, trade patterns of the Kyrgyz economy changed substantially. Such changes touched upon both exports along with imports of the Kyrgyz Republic. Prior to transition, manufactured output made a significant portion of the Kyrgyz exports, whereas currently its share has diminished and become less diversified.

Exports

Since much of the Kyrgyz economy's exports had been reliable upon imported inputs and intermediate products, after the collapse of the Soviet economy these were to plummet. Such stark contraction of the Kyrgyz exports in the early 1990s was a result of structural shifts and enduring adjustment process throughout transition, which ac-

[8] Source: World Bank (2007).

companied a rapid disintegration of the formerly set up vertical production and distribution linkages (Catsambas et al, 1999).

Turning to the structural composition of its exports during recent years, it may be inferred that the Kyrgyz exports are currently dominated by items of what is classified as medium-low technology industries. This implies that its exportables are primarily made up from primary and intermediate goods. (See Table 4.6). What is more, its exports are in fact of dualistic nature, since *precious metals* made up to two-fifths of total exports in 2005. In recent years the shares of *precious metals* and *mineral products* have been increasing to the detriment of those of other commodity groups.

Table 4.6 Kyrgyz Republic: exports by commodity group (in mln. US dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Prepared foodstuffs	71.7	53.4	37.3	32.7	30.1	25.8	42.9	37.2
Mineral products	41.0	57.2	86.8	58.4	62.4	74.7	94.1	96.8
Chemical products	18.3	14.6	14.5	18.0	25.2	9.7	21.7	13.5
Textiles	40.0	32.0	42.8	29.5	59.8	69.9	79.5	77.4
Precious metals	196.4	183.6	196.9	226.7	164.8	262.1	291.2	236.2
Metals	21.4	27.0	34.8	15.3	23.4	19.8	31.7	23.2
Machinery & equipment	46.7	27.5	33.4	28.5	26.9	28.2	35.5	32.1
Total exports incl others	513.6	453.8	504.5	476.1	485.5	581.7	718.8	672.0

Source: Asian Development Bank (ADB) - Key Indicators 2006

Imports

As regards imports of the Kyrgyz Republic, it is worth noting that in value terms they have been exceeding exports throughout the whole period since its independence. There have been no such drastic changes in the structural make-up of its imports as in the case of its exports. There have been some noteworthy trends in place. Reflecting high reliance of its economy's on fuels and equipment, the import profile of the Kyrgyz Republic has been dominated by three categories, namely *mineral products* along with *chemical products* and *machinery and equipment* (See Table 4.7).

Current account balance

In view of its relatively modest export capacities and high reliance upon exports of capital goods and mineral products, the Kyrgyz Republic has been persistently facing difficulties stemming from widening gaps in its current account. Throughout transition period its current account deficits have been varying around 4-8 percent of GDP. However, in 1998, as the Russian financial crisis broke out, the current account gap of the

Kyrgyz Republic reached its highest mark and equaled to 25 percent of GDP. As of 2005, its current account has reached the mark of 204 mln. US dollars (or 8.3 percent of GDP).[9]

Table 4.7 Kyrgyz Republic: imports by commodity group (in mln. US dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Prepared foodstuffs	66.7	34.5	31	35.8	47.4	59.5	83	101.3
Mineral products	221.3	128.7	133.8	129.5	163.4	195.6	273.3	334
Chemical products	89	60.9	59.3	67.3	78.4	91.7	112.9	130.8
Textiles	53	34.2	35.2	28.8	38.9	47.3	42.6	36.6
Metals	47.7	32	27.6	27.3	29.7	43.5	65	66.5
Machinery & equipment	146.7	148.9	98.2	56.5	89.6	89.1	107.3	156.1
Transportation equipment	41.8	29.9	41.8	31.8	32.1	51.2	70.3	41.4
Total imports incl others	841.5	599.7	554.1	467.2	586.8	717	941	1101.3

Source: Asian Development Bank (ADB) - Key Indicators 2006

Trade geography

The Kyrgyz Republic, being impelled to sustain appropriate production and consumption levels, had to adjust its trade flows in line with its comparative advantage. Significant alterations in the composition of its exports and imports implied, among other things, changes in the geography of its trade flows. The main feature of such transformation has become a decline in share values of the economies of the Former Soviet Union in the total trade turnover. For instance, in the course of just few years, the share of the FSU economies in total exports of the Kyrgyz Republic has diminished from 97.3 percent in 1990 to 59.1 percent in 1994.[10] This is partially revealed in the make-up of its main trading partners (See Table 4.8).

As regards the geographical distribution of the Kyrgyz trade flows, it may be inferred that its export destinations have been diversified to a greater extent than its import sources. This fact may be well explained by increased exports of precious metals from 1997 onwards. However, despite already occurred geographical reorientation of its trade flows, the Kyrgyz Republic is still very much relying on regional markets, for the capacity of its domestic market is limited and most of its exportables (apart from precious metals) exhibit low price-weight ratios, thus, precluding their transportation for longer distances.

[9] Source: World Bank, for details see Annex 5, pp. 235-236.
[10] Source: Havrylyshyn and Al-Atrash (1998: 8).

Table 4.8 Kyrgyz Republic: main trading partners in 1994 and 2005
(in percent of total)

	1994		2005		1994		2005
Exports to:				**Imports from:**			
Kazakhstan	28.1	UAE	25.8	Russia	21.9	Russia	34.2
Russia	17.2	Russia	20.0	Uzbekistan	20.1	Kazakhstan	16.3
China	16.5	Kazakhstan	17.3	Kazakhstan	18.4	China	9.3
Uzbekistan	12.9	Switzerland	9.7	US	11.1	US	6.1
Germany	1.9	China	4.0	Turkey	4.7	Uzbekistan	5.4
Other	23.3	Other	23.2	Other	23.7	Other	28.7
Total	100.0		100.0	Total	100.0		100.0

Sources:
International Trade Centre database, Asian Development Bank (ADB) – Key Indicators 2006

Trade regime

At the outset of transition, the state was still extensively involved in external trade through clearing schemes with governments of trading partners. However, by 1994 the trade system has been substantially liberalized. This step was in compliance with the general reform strategy. Since then the Kyrgyz Republic has been adhering to rather liberal external trade policies. Previously mandatory licensing for export and import activities was abolished and export taxes substantially reduced. One of the few ways the state may intervene is the option of export subsidies offered in form of tax incentives. Voluntary supply contracts replaced the state order system for exports (Jeffries, 1996).

While aspiring to the WTO accession, it further liberalized its trade regime by bringing it in compliance with the main guidelines of this organization. Therefore, nearly all quantitative restrictions on imports and exports have been lifted. Excise and value added taxes have been brought in line with international standards. In the late 1998 the Kyrgyz Republic has become the first CIS economy to accede the WTO. Thus, currently the Kyrgyz Republic is deemed to have one of the most liberal trade regimes among the CIS countries.[11]

However, despite these impressive achievements in liberalization of its trade regime, the Kyrgyz Republic did not manage to make the most its trade potentials, because of numerous formal and informal trade barriers imposed by its neighboring economies. This is manifested in the presently existent price differentials of traded goods across and within economies of Central Asia due to high natural (especially, un-

[11] Its tariff structure comprises 5 bands, the highest tariff equals to 15 percent, while the average non-weighted tariff amounts to 5.1 percent (ADB, 2006: 26).

derdeveloped transportation infrastructure) and man-made trade barriers (e.g. rent seeking activities) (Grafe et al, 2005). In this regard, some positive accomplishments have been reached with Kazakhstan. Little progress has been made in trade relations with Uzbekistan, which is pursuing policies of economic self-sufficiency.

Regional trade agreements and memberships

WTO

As shortly mentioned earlier, the Kyrgyz Republic has become the first CIS economy to attain a WTO membership. This very circumstance raised an array of issues related to the sequencing and compatibility of memberships in different organizations. Against this background, right after the WTO accession of the Kyrgyz Republic, its exporters faced a harsh reaction of the then yet protectionist Kazakhstan in form unprecedented *ad hoc* increase of import duties, which were brought to the previous levels shortly after that. In the medium term the Kyrgyz Republic's WTO membership seems to have brought about neither large positive nor negative effects because most of its trading partners are not WTO members and the dominant share of its trade is conducted with non-WTO members (See Table 4.8), whereas its exports of non-ferrous metals are exempted from the WTO regulations and subject to special arrangements (Mogilevsky and Hasanov, 2002). Moreover, the Kyrgyz economy had already been rather open long before it acceded to the WTO. Provided the Kyrgyz Republic substantially enhances its institutional frame, in the long-run perspective its already acquired WTO membership might prove rather useful, especially when its main trading partners accede to the organization.

Regional scope

Regional cooperation could prove a viable option for reducing trade barriers currently hindering expansion of trade within the region. Upon gaining its independence, the Kyrgyz economy could not but seek closer integration with other countries within and beyond the region, since the small size of its domestic market and ill developed transportation infrastructure precluded possible policies of economic self-reliance. For this purpose, it has established numerous relationships with other economies on both bi- and multilateral bases, with the latter getting more intensified in recent years. Therefore, it takes an active part in the CIS based regional groupings (e.g., EAEC, CAEC, etc.) along with a number of

other regional initiatives aimed at fostering trade within the region. These include, among others, the Central Asia Regional Economic Cooperation (CAREC) and the Shanghai Cooperation Organization and focus on trade facilitation, transport infrastructure and energy distributions issues. This notwithstanding, these regional cooperation initiatives demonstrated little efficacy, since much of their declared goals and targets are not consequently implemented by their signatory parties.

4.2.2 Capital flows

Resembling other economies of Central Asia, the Kyrgyz Republic, being deprived of the previously present direct capital transfer schemes and latent subsidies stemming from distorted price structure, had to embark on transition experiencing substantial dearth of investment resources. In addition, the necessity to carry out economic reforms, pointed to the expedience of attracting needed financial resources from abroad.

The capital that started flowing into the country was of different types, including soft institutional loans along with credit schemes on favorable terms. Multilateral financial institutions, governments of other countries along with private creditors have provided substantial amounts of financial resources, which were to facilitate restructuring of the Kyrgyz economy. In the initial years of transformation the share of institutional flows by far outweighed that of private flows (See Table 4.9). Only by the mid-1990s, the latter started to prevail.

Table 4.9 Kyrgyz Republic: net capital flows, 1992-1996 (in mln. US dollars)

	1992	1993	1994	1995	1996
Official Flows	4	203	205	218	199
Private Flows	0	10	38	100	233
o/w: FDI	0	10	38	96	46
Portfolio	0	0	0	2	-2
Short Term Debt	0	0	0	2	6
Commercial Debt	0	0	0	0	0
Total Flows	4	213	243	318	431
US$ GNP	2260	1971	1486	1534	1673
Total Flows/GNP (percent)	0.2	10.8	16.4	20.7	25.8

Source: Claessens et al (1998 : 30)

In general, out of possible options – FDI and portfolio investment – the former could come into question, since the Kyrgyz Republic did not possess appropriate regulatory framework capable of absorbing and allocating financial resources attracted in form of

portfolio investments. Therefore, the volumes of portfolio investments have remained negligible throughout its transition period.

As regards amounts of attracted FDI, it is worth noting that the the Kyrgyz Republic has performed rather moderately (See Table 4.10). As of 2005 its total FDI stock equaled to 522 mln. US dollars, or 21.4 percent of its capital stock. It must be noted that the largest share of its total capital stock has been formed in the course of few years (1995-1999), as Kumtor gold mining was being constructed.

Table 4.10 Kyrgyz Republic: foreign direct investment (FDI) overview
(selected years)

	1990-2000	2002	2003	2004	2005	1990-2000	2003	2004	2005
	(Millions of US dollars)					(as percent of gross fixed capital formation)			
FDI flows	(Annual average)					(Annual average)			
inward	53	5	46	175	47	22	17.1	63.8	12.2
outward	11	-	-	44	-	5.2	-	16	-
FDI stocks	**1980**	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
inward	..	..	447	677	522	..	32.6	31.3	21.4
outward	..	..	33	83	60	..	2.4	3.8	2.5

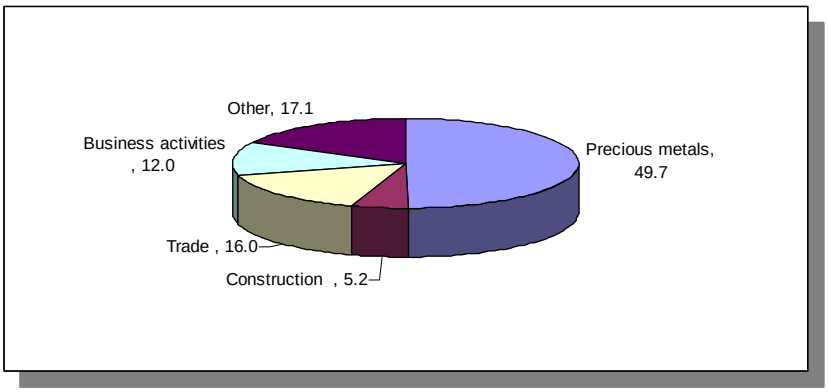
Source: UNCTAD, World Investment Report 2006

Reflecting its recently modified economic structure and external trade patterns, the sectoral breakdown of FDI is characterized by strong dominance of an industry involved in the production of precious metals (See Figure 4.4). Thus, as of 2002, it made up almost 50 percent of the whole FDI stock of the Kyrgyz Republic. The remainder was distributed among trade (16 percent), business activities (12 percent), construction (5.2 percent) and other branches (17.1 percent).

As of 2006, the total volume of FDI inflows accumulated throughout the whole transition period was distributed among countries investing in the Kyrgyz economy in the following way. The largest share attributed to Canada, whose share was 28.4 percent. It was then followed by Turkey and the United States with 12.4 and 11.6 percent, respectively. The shares of Kazakhstan (6.0 percent) and Russia (4.2 percent) have been rather small[12].

[12] Source: National Bank of the Kyrgyz Republic.

Figure 4.4 Kyrgyz Republic: sectoral distribution of FDI stock, 2002 (in percent)



Source: National Bank of the Kyrgyz Republic

In view of the above, it must be noted that insignificant volumes (when compared with, for instance, Kazakhstan) of attracted FDI are primarily due to its rather modest endowment with tradable natural resources, capable of attracting substantial amounts of FDI (Cummings, 2003). Such insignificant volumes of FDI cannot fully cover current account deficits the Kyrgyz economy has been constantly running. Hence, it has to rely on capital inflows of debt-creating nature, what has further direct implications for its long-term growth perspectives.

4.2.3 Other factors

Migration

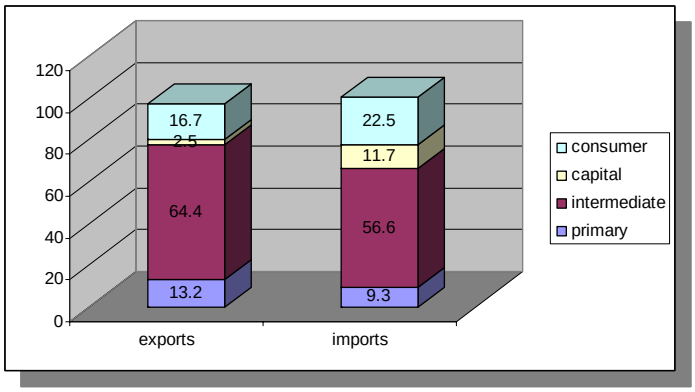
Corresponding to general trends observed in other transition economies throughout transformation, migration of its labor resources had to bring about certain challenges for the Kyrgyz economy. With a deep transformation of the Kyrgyz economy's production structure and, understandably, trade and foreign investment patterns, the labor force underwent appropriate changes in its composition. This implies that significant amounts of industrial employees had to emigrate, after these sectors had proved unviable in new economic conditions.[13] The search for better payments opportunities and possibilities of sending remittances could be counted as main incentives for outward migration.

[13] For instance, by the mid-1990s emigration of ethnic Russians and Germans exceeded the mark of 500,000 persons. This led to a rapid reduction of the country's labor force by more than one-tenth (Source: National Statistical Committee of the Kyrgyz Republic).

Technological edge

Technological content of its exports is one of important determining factors of the Kyrgyz economy's growth. Its recent growth recovery has been triggered, not least by a rapid expansion of resource-intensive exports. Taking into consideration its present trade profile, it may be induced that there are noteworthy differences between exports and imports in terms of their structural composition (See Figure 4.5).

Figure 4.5 Kyrgyz Republic: breakdown of exports and imports in line with stages of technological processing, 2005 (in percent)



Source: International Trade Centre database

Thus, as of 2005, the shares of primary and intermediate products in exports is larger than imports, whereas those of consumer and capital products are smaller. This disparity is also observed, when high-tech products are drawn into consideration. The share of this type of products in total exports of the Kyrgyz Republic equaled to 0.5 percent, while in the case of imports the value was 5.7 percent.[14]

In view of the above described distribution of its exports along with imports, it may be inferred that the current trade profile of the Kyrgyz economy is not likely to be growth-inducing. The reason for this is the following. Export revenues may be easily undermined due to, firstly, assumed lower values of income elasticity of demand and, secondly, frequent adverse price developments for exportable items. In addition, being resource-intensive, such exports may not be expanded constantly, since in the case of the Kyrgyz Republic these are non-renewable. Structural adjustment aimed at upgrading its exports technological content would enable to attain higher growth rates in the long-term perspective. Exports ought to be diversified towards light manufactured goods and intermediate products with higher processing degrees (Lücke, 2006).

[14] Source: International Trade Centre database.

Exchange rate regime

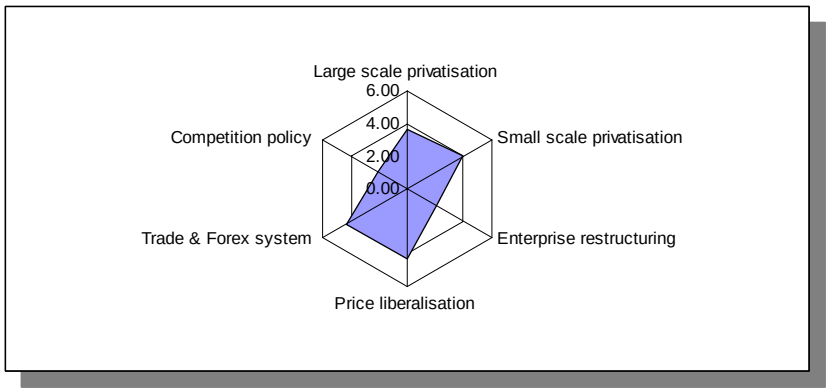
Being the first Central Asian economy to introduce its own currency, the Kyrgyz Republic has been maintaining managed floating exchange rate regime. Its general openness and high reliance on imports suggest that its exchange rate remain appropriately stable to secure purchasing power of the currency while retaining its economy's external competitiveness. With the exception of the early 1990s and the period of the Russian financial crisis, throughout the whole transition period, the Kyrgyz som has remained stable. In contrast to Kazakhstan, the Kyrgyz Republic does not face the challenge of substantially losing ground in terms of its external competitiveness, since it is not confronted with a windfall of foreign exchange stemming from its export activities (Catsambas et al, 1999).

Institutional framework

The Kyrgyz Republic had to bring its institutional frame in accordance with the requirements of the market environment to facilitate its economic restructuring together with an appropriate transformation of its trade and foreign investment patterns. Throughout the 1990s the Kyrgyz Republic has been the quickest in the Central Asian region, in terms of the pace of implemented reforms. The occurred changes touched on many aspects of its economy (See Figure 4.6). With the average value of its overall transition index equal to 2.52. In view of this, the republic's authorities have taken required steps to adjust its regulatory together with institutional frame to boost foreign direct investment.

A package of laws, enacted throughout transition, are intended to provide fair treatment for foreign investors and appropriate protection of investments made in the Kyrgyz Republic. Foreign investors are entitled to repatriate without any restrictions their formerly invested capital, earned profits from export or domestic production activities. These measures were in general intended to bring its regulatory frame into broad conformance with the WTO standards aimed at promoting foreign direct investment (Gleason, 2003).

Figure 4.6 Kyrgyz Republic: progress of transition, 2006



Note: minimum score "1.00" (complete lack of progress)
maximum score "4.33" (advanced market economy)
Source: EBRD Transition Report 2006

However, despite these changes in its institutional frame, the Kyrgyz Republic still has to improve its business and investment climate, since compared with other transition economies it lacks progress in many respects. Among twenty-eight transition economies, the Kyrgyz Republic has ranked sixteenth in the ease of doing business.[15] Therefore, its relatively poor growth performance should be attributed partially to "institutional" deficiencies.

4.3 Uzbekistan

Uzbekistan, the most populous country of the Central Asian region, has embarked on its transition path, which in many ways differed from those of other transition economies. It is supposed to stand out for one of the mildest output contractions among transition economies (For details see section 2.3.2 of Chapter 2), which was conditioned, among other things, by an array of favorable external conditions.

4.3.1 Trade

Unlike Kazakhstan and the Kyrgyz Republic, Uzbekistan has endured drastic changes neither in its production structure nor in its trade composition. This may be explained by its relatively conservative reform strategy made viable by its resource independence and well managed reorientation of its exportables intended to establish a self-sufficient and internally oriented economy (Gleason, 2003). What is more, its economy was the least

[15] Source: World Bank (2007).

industrialized one in the Soviet economy and, therefore, more less reliable upon other economies (Zettelmeyer, 1998 and Hansen et al, 2000).

Exports

In compliance with its enduring economic structure and its specialization within the Soviet regional labor division, in the early 1990s the make-up of Uzbek exports corresponded to that of pre-transition period, implying significant positions of cotton fiber, energy and gold therein. These items have been dominating its exports in recent years as well, though with some notable changes (See Table 4.11).

Table 4.11 Uzbekistan: exports by commodity group (in percent of total)

	1998	1999	2000	2001	2002	2003	2004	2005
Cotton fiber	38.6	27.3	27.4	28.3	26.6	46.3	44.5	25.7
Energy products	7.9	11.5	10.4	11.5	10.0	10.8	13.4	18.8
Metals	5.1	4.3	6.6	7.9	7.5	8.3	10.3	11.0
Machinery & equipment	4.2	3.2	3.4	5.0	6.0	6.5	8.0	11.0
Chemicals & plastics	1.5	3.1	2.9	4.8	1.8	4.5	6.0	9.7
Gold	9.6	n/a	n/a	8.3	11.8	6.8	6.2	8.0
Other	33.1	n/a	n/a	34.2	36.3	16.8	11.6	15.8

Sources: IMF country reports, International Trade Centre database

The share of *cotton fiber* in overall exports has been declining. This might be attributed to a combination of the following circumstances: decreased output levels, unfavorable price developments and its increased processing capacities of the home economy. Conversely other commodity groups but *gold* have increased their shares in total exports considerably during the considered period. Both in value and share terms, exports of *natural gas*, have increased substantially due to recently risen prices for this commodity. Exports of gold still represent a significant source of revenue despite losing ground in its significance in recent years.

Imports

On the whole, Uzbekistan's imports have not undergone drastic changes in terms of their structural composition throughout its transition period and endure further in the wake of the strategy of import substitution. Recent years exhibit this pattern as well (See Table 4.12). Uzbekistan's current import profile stands out for a clear dominance of *machinery* along with *chemical products and plastics*. Taken together, these categories have accounted for more than half of total imports in recent years. During the con-

sidered period, energy products have been increasing their weight. Conversely, the share of *foodstuffs* has been steadily decreasing.

Table 4.12 Uzbekistan: imports by commodity group (in percent of total)

	1998	1999	2000	2001	2002	2003	2004	2005
Machinery	47.2	44.8	35.4	41.2	41.8	47.5	45.7	43.4
Chemical products & plastics	12.4	11.7	13.6	10.5	15.3	12.9	12.2	13.1
Foodstuffs	15.6	13.1	12.3	13.3	12.6	7.8	7.9	8.2
Energy products	0.5	2.1	3.8	4.4	4.0	4.5	4.6	4.5
Other	24.3	28.3	34.9	30.6	26.3	27.3	29.6	30.8

Sources: IMF country reports, International Trade Centre database

Trade geography

Despite minor changes in the structural composition of trade flows, there have been notable changes in geographical distribution of its trade flows even in the initial years of transition. These changes have been characterized by a gradual decrease of the economies of the Former Soviet Union in Uzbekistan's trade turnover. For instance, the share of these economies in overall exports of Uzbekistan has decreased from 89.1 percent in 1990 to 41.5 percent in 1996 (Havrylyshyn and Al-Atrash, 1998: 9).

In the course of subsequent years, further diversification of both export destinations and imports sources has occurred. (See Table 4.13)

Table 4.13 Uzbekistan: main trading partners in 1994 and 2005 (in percent of total)

	1994		2005		1994		2005
Exports to:				**Imports from:**			
Russia	38.9	Russia	25.3	Russia	37.4	Russia	26.6
Italy	5.7	China	13.3	Germany	14.4	Korea	15.3
Tajikistan	3.8	Turkey	7.8	Korea	10.6	Germany	8.8
China	3.8	Kazakhstan	7.5	Kazakhstan	5.3	Kazakhstan	7.5
Turkey	3.6	Ukraine	6.1	US	4.0	China	7.1
Other	44.3	Other	40.0	Other	28.3	Other	34.7
Total	100.0		100.0	Total	100.0		100.0

Sources: International Trade Centre database, Asian Development Bank (ADB) - Key Indicators 2006

The changes are not so drastic, however. Thus as a destination for Uzbek exports, Russia's share in Uzbekistan's overall exports has declined. Other countries such as China, Turkey and Kazakhstan have gained ground as destinations for its exports by expanding their shares. There has been further diversification in place, as regards countries from

which Uzbekistan's imports originate. In the period from 1994 to 2005, despite retaining its leadership, Russia's shares have shrunk further. Germany has been overtaken by Korea. Kazakhstan and China have increased their shares as export destinations of as well as import sources for the Uzbek economy.

Notwithstanding such geographical diversification of trade flows, it is often suggested that Uzbekistan is still not fully utilizing its trade potential both in the regional and international scope (Raiser and de Tray, 2006). It is alleged that the country is undertrading[16] with much of the rest of South and South-East Asia, with China, which recently increased its economic presence in the region, and South Korea, which traditionally has been an important trade partner of Uzbekistan, as main exceptions. Such distribution of trade flows across its trade partners is not least connected with its trade regime.

Current account balance

In view of its pursued strategy of development based on import substitution, it is worth noting that Uzbekistan's current-account developments have been closely intertwined with its trade performance. Its imports were to be constricted, if Uzbekistan's export revenues had not been large enough. Recently boosted by favorable price developments for its exportables, Uzbekistan is alleged to have attained significant trade and current account surpluses. Thus, by the end of 2005 its current account surplus equaled to 10.6 percent of GDP.[17]

Trade regime

Compared with those of Kazakhstan and, especially, the Kyrgyz Republic Uzbekistan's trade regime is far less liberalized, what implies a wide presence of state in its external trade. This reflects its adherence to a strategy of industrialization through import substitution combined with managed export promotion since the mid-1990s.

Until the mid-1990s most of Uzbekistan's foreign trade was conducted on the basis of bilateral interstate agreements. Hence, no restrictions on imports from and exports to the CIS economies were in place, implying no customs duties in form of value-added or excise taxes applicable. While imports remained constricted, some liberalization of exports has taken place by the end of the decade. Despite such measures, the state retains further full control over its main exportables (i.e. cotton and gold), which

[16] Spatial distance from and economic weight of trading partners are considered as main criteria.
[17] Source: World Bank, for details see Annex 6, pp. 237-238.

are marketed through government agencies. Exports of many other items remain subject to approval of government bodies.

In view of its import-substituting policies, Uzbekistan's tariffs are deemed relatively high.[18] Besides import tariffs, there are numerous additional taxes of direct and indirect nature collected on an *ad hoc* basis, which make imported items more expensive. Therefore, within the region of Central Asia relatively high price differentials tend to emerge for similar products even between the economies' markets positioned close to each other (Grafe et al 2005). Such isolationist-directed trade policies tend to lead, among other things, towards lower than potentially attainable consumption levels in Uzbekistan, since a plenty of imported goods of higher quality are consumed at higher cost. What is more, its neighboring countries are also deprived of potential benefits accruable from increased transit through Uzbekistan.[19]

In this regard, it seems imperative for Uzbekistan to integrate its economy by liberalizing its trade regime if it is to make the most of increased trade with partners both within and beyond the region. This kind of liberalization would imply reduction and unification of tariffs along with harmonization of excise taxes on imported and domestic products. These in their turn may be implemented in the course of its accession to the WTO and a number of other regional integration initiatives.

Regional trade agreements and memberships

Upon gaining its independence in the early 1990s, Uzbekistan has been seeking for modes of economic cooperation with other states in many ways subordinate to its pursued policy of economic self-sufficiency. Therefore, despite being a member of the CIS, it has been passively taking part in its economic integration initiatives and making in fact its trade policy on its own and paying little attention to initiatives aimed at deeper economic integration. Hence, just a few important aspects of its international and regional activities will be mentioned below.

WTO

This option represents a versatile instrument for adjusting and harmonizing trade regimes across the region, since none of them but the Kyrgyz Republic thus far has attained its membership. In the mid-1990s, Uzbekistan applied for an WTO-

[18] As of January 2006, Uzbekistan had four principal tariff bands, with the highest tariff amounting to 30 percent, while the non-weighted one making 14.5 percent. (ADB, 2006: 26).
[19] Despite being one of the few double-landlocked countries of the world, Uzbekistan possesses momentous transit potentials due to its more favorable and central location.

membership, which, in view of its rather restrictive and protectionist trade policies, seems currently unattainable.

Regional Scope

At the regional level, no significant achievements have been attained yet, since being the most populous country and located in the middle of the region, Uzbekistan has showed thus far little interest in integration initiatives based on a deeper basis. In many ways, Uzbekistan's rather passive presence in the regional cooperation initiatives is explained by its sufficiently available resource endowment and the presence of easily and universally marketable exportables, such as precious metals and cotton. Although passively, Uzbekistan is currently taking part in a number of regional cooperation schemes such as Euroasian Economic Community (EAEC), Central Asian Economic Cooperation (CAEC), Central Asia Regional Economic Cooperation (CAREC), etc.

4.3.2 Capital flows

Being a late reformer, Uzbekistan exhibited investment patterns, which differed considerably from those of Kazakhstan and the Kyrgyz Republic. Much of its previously functioning investment schemes were still in place. These were still manipulated by the state, since no liberalization of its fiscal sphere had been implemented. Its rather small and almost self-sufficient industrial sector did not lack financial resources that badly, as it was the case in other economies of the region (e.g. Kazakhstan, the Kyrgyz Republic and Tajikistan).

Initially, international financial institutions along with donor countries have pledged substantial amounts of financial aid and soft loans. However, in view of the reluctance of the Uzbek leadership to implement swiftly market reforms, in the initial stages of its transition Uzbekistan received less financial resources, when compared with other reforming economies of the region (for instance, Kazakhstan and the Kyrgyz Republic) in terms of inflows of resources related to gross national product (GNP) (See Tables 4.4, 4.9, 4.14).

Capital flows were thus formed by a mixture of official and private flows. The latter has been primarily represented by FDI, short term and commercial loans. These in their turn were insignificant, when related to GNP values, since existing gaps in financing were covered through foreign exchange stemming from exports of its tradable commodities.

Table 4.14 Uzbekistan: net capital flows, 1992-1996 (in mln. US dollars)

	1992	1993	1994	1995	1996
Official Flows	61	460	-22	454	269
Private Flows	1	345	405	271	425
o/w: FDI	1	102	155	157	169
Portfolio	0	0	0	0	0
Short Term Debt	0	92	199	-79	-120
Commercial Debt	0	151	51	193	376
Total Flows	62	805	383	725	694
US$ GNP	20177	21880	22996	23110	23907
Total Flows/GNP (percent)	0.3	3.7	1.7	3.1	2.9

Source:Claessens et al (1998: 31)

Judging by amounts of attracted FDI, Uzbekistan's performance throughout its transition leaves much to be desired. In view of the size of its economy, it has attracted very modest volumes of FDI. Thus, as of 2005, the total volume of FDI stocks amounted to 964 mln. US dollars, or 8.2 percent of its gross fixed capital formation (See Table 4.15). Throughout the whole transition period, average values of capital inflows have been fairly insignificant both in terms of their absolute values and related to its GNP.

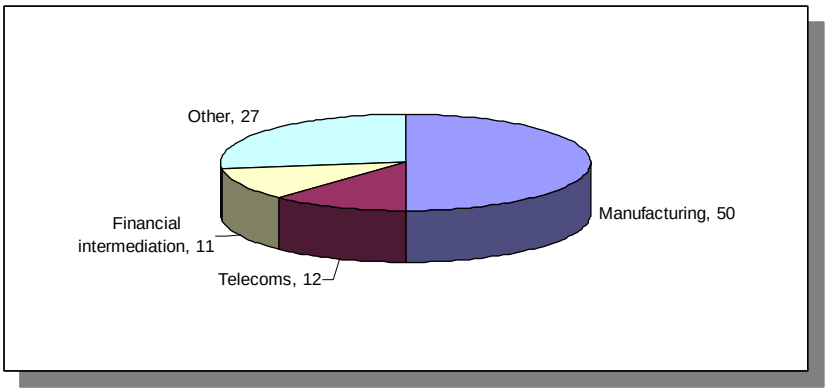
Table 4.15 Uzbekistan: foreign direct investment (FDI) overview, (selected years)

	1990-2000	2002	2003	2004	2005	1990-2000	2003	2004	2005
	(Millions of US dollars)					(as percent of gross fixed capital formation)			
FDI flows	(Annual average)					(Annual average)			
Inward	78	65	70	1	45	1.8	3.3	-	1.8
Outward	..	..	..	..	..	..	..	..	..
FDI stocks	**1980**	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
Inward	..	..	699	918	964	..	5.1	7.8	8.2
Outward	..	..	..	..	..	..	..	..	..

Source: UNCTAD, World Investment Report 2006

Turning to the sectoral breakdown of FDI flows, it is worth noting that distribution patterns reflect its pursued policies of economic development based on import substitution. While retaining control over main exportables (which are represented mainly by cotton and gold), Uzbekistan encourages foreign investment in sectors it aspires to develop or build up. Provided by its largest investors (Russia, the UK, the US and Germany) a major part of all accumulated FDI inflows, as of 2006, has been allocated to manufacturing (50 percent). The rest of the total stock was distributed among telecommunications (12 percent), financial intermediation (11 percent) and other branches (See Figure 4.7).

Figure 4.7 Uzbekistan: sectoral distribution of FDI stock, 2006 (in percent)



Source: Economist Intelligence Unit

On the whole, Uzbekistan's relative poor performance in attracting FDI might be attributed to an array of factors, which include – but not limited to – restricted convertibility of its currency, rather weak financial intermediation system and general low investment climate (more on these issues in section 4.3.3).

4.3.3 Other factors

Migration

In the course of its economy's transformation, Uzbekistan has experienced notable changes in the composition of its labor force due to outward migration. Large number of well qualified specialists, which were made up to a great extent by ethnic minorities, have left for other countries in search for better job prospects corresponding to their qualifications. These changes have been less profound, when compared to its neighboring economies. This is attributed, not least, to its fairly mild economic restructuring and initially rather homogenous population.[20] However insignificant, such loss of qualified human resources will undoubtedly affect adversely its economy's further development.

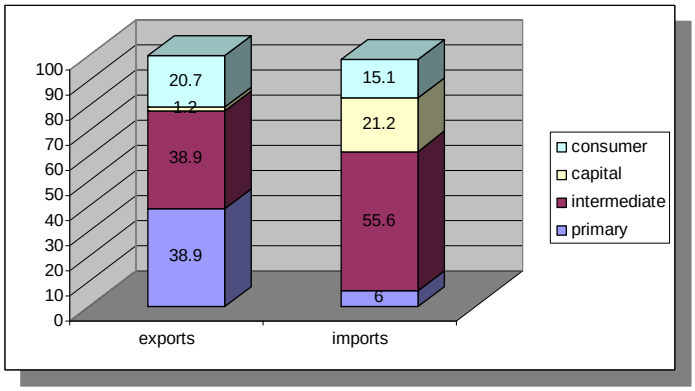
Technological edge

In view of its pursued strategy of economic development based on import substitution along with targeted export promotion, Uzbekistan represents an interesting case for consideration. Its further development path will depend upon whether it manages to change appropriately the composition of its trade flows. Thus far there has been a clear pattern. Uzbekistan has been financing its imports of capital and consumer goods mainly

[20] As of 1996, its title nation made up more than 75 percent of Uzbekistan's total population (Source: Economist Intelligence Unit).

through earnings stemming from exports of primary and intermediate products. This is well revealed in its export and import profiles (See Figure 4.8).

Figure 4.8 Uzbekistan: breakdown of exports and imports in line with stages of technological processing, 2005 (in percent)



Source: International Trade Centre database

As of 2005, its exports were dominated by primary and intermediate products, where the shares of each equaled to 38.9 percent. Both were followed by consumer goods, whose share was 20.7 percent. With their share equaling to 1.2 percent, capital products were negligible in their weight.

Different distribution of shares is observed, when Uzbekistan's imports are drawn into consideration. In terms of their share values, intermediate products dominated its imports making up 55.6 percent of all imports. Capital products made up the second largest group, making up over one-fifth of its overall imports. The share of consumer goods equaled to 15.1 percent. The category of primary products with 6 percent was the smallest in terms of its weight in total imports. Noteworthy was the distribution of shares of high-tech products in Uzbekistan's overall exports and imports. The share value of imports (7.3 percent) of this category of products has exceeded that of exports (5.5 percent) by a moderate margin.[21]

In view of the above, it may be inferred that distribution patterns of Uzbekistan's trade flows reflect its pursued strategies of industrialization through import substitution and economic self-sufficiency. Implying importation of goods required for covering the most needed consumer items along with required capital goods for sustaining and developing its industrial base, these strategies may be beneficial for Uzbekistan's economy in the long-term perspective. However, deriving from the experience of a number

[21] Source: International Trade Centre database

of Latin American economies in the 1960s, it is worth mentioning that industrialization through import substitution may incur high risks.

To prove successful, such strategies must be based on a right combination of export promotion with import substitution. In view of Uzbekistan's current composition of exportables it may be induced that its main exportable items – cotton fiber and precious metals – are subject to price movements and frequent changes of physical volumes of production. This fact entails high risks for its targeted export promotion strategy and may undermine intended goals of its pursued industrialization through import substitution. In addition, there is another fact that deserves special attention. In the short run, this strategy may depress consumption levels in form of deprivation of potentially importable items from abroad, which are of higher quality and/or have lower prices.

Exchange rate regime

The case of Uzbekistan provides a vivid example of how a state may exert influence upon its economy's export and import behavior and line up its foreign exchange policies in accordance with pursued economic development strategy. From the early 1990s onwards, Uzbekistan has been adhering to fairly different modes of its exchange rate regime. Since introduction of its own currency, the state has been always inclined to exert noticeable influence upon the exchange rate. Later, in response to a considerable decrease of export earnings in 1996 caused by unfavorable developments of its exportables' prices, Uzbekistan introduced a system of multiple exchange rates, which implied a simultaneous existence of four exchange rates applicable to different transactions.

The rationale for this measure was an intention to further back up the strategy of import substitution. With an official rate being lower than the market clearing one, a dearth of foreign exchange was commonplace. This regime induced the black market for foreign exchange to expand due to a perpetuating gap between the demand and supply of foreign exchange (Bétemps 2002).

What is more, these schemes of 'distorted' exchange rates meant implicitly subsidization of industries financed by the 'taxes' latently levied on agriculture. In this context, Rosenberg and de Zeeuw (2000) in their quantitative estimation concluded that Uzbekistan's multiple exchange rate regime was costly for some segments and the economy as a whole. The former represented by exporters incurred losses (up to 16 percent of GDP) as a result of transfer from 'latent' taxes imposed to finance subsidies for

importers or domestic producers of import substitutes and generated welfare losses (amounting to 2-8 percent of GDP) for the whole economy.

Therefore, these detached exchange rates were to be unified, implying among other things, substantial changes in the fiscal sphere, to eliminate losses incurred from inefficient distribution of foreign exchange. Thus, from 2003 onwards, Uzbekistan has committed itself to what has been called 'de facto conventional peg'. In accordance with this mode, the foreign exchange rate is to be determined on the open market combined with the central bank's frequent interventions aimed at maintaining the stable exchange rate of the national currency (within a 2-percent band vis-à-vis the US dollar) (IMF, 2007).

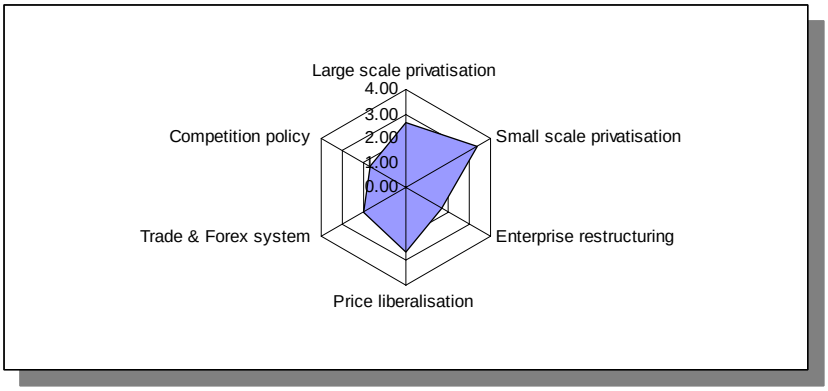
Institutional framework

Following other transition economies, Uzbekistan had to adjust its institutional framework in compliance with new economic conditions. For this purpose, during the 1990s numerous laws and legal acts have been put into effect aimed at improving investment climate and providing additional incentives for export activities. Its legislation guarantees all common privileges of foreign investors, which are in general free to choose any sphere of economic activity with some minor exceptions. Reflecting Uzbekistan's adherence to policies of import substitution, joint-ventures in manufacturing are strongly encouraged.

Its rather modest performance in attracting FDI (See section 4.3.2) points to the lack of incentives for investors to bring up large amounts of resources into the Uzbek economy. This is partially attributed to its insufficient reform progress (See Figure 4.9). With its overall transition index average equaling 2.07, it is one of the few transition economies lacking progress in many spheres of economy. Moreover, in international comparison it fares poorly by attaining twenty-eighth rank among twenty-eight transition economies in the ease of doing business.[22] All that implies that still much has to be undertaken to improve investment and business climate of the Uzbek economy. What is more, accelerated reform policies in both internal and external spheres of its economy are called for, if successful restructuring of the economy is to be sustainable (Ranaweera, 2003).

[22] Source: World Bank (2006)

Figure 4.9 Uzbekistan: progress of transition, 2006



Note: minimum score “1.00” (complete lack of progress)
maximum score “4.33” (advanced market economy)
Source: EBRD Transition Report 2006

Summary

Throughout their economic transformation, the economies of Central Asia have experience notable changes, as far as their trade and foreign investment patterns are concerned. This fact reflects their new position in the international labor division, which has been in part starkly modified in line with their currently given comparative advantage. The three economies of Central Asia have proved rather heterogeneous in many respects, what may be attributed to numerous, often, interrelated factors (e.g. initial structure of economy, transition mode, attained reform progress, etc). Accordingly, their trade performance varied significantly due to differing endowments with natural resources capable of attracting investment and being marketed abroad. Different approaches taken by these economies towards the mode of economic restructuring can serve as another reason explaining differences in their trade performance.

Their recent trade and foreign investment patterns depict the occurred – although to a differing extent – diversification of trade flows in terms of their geographical distribution and structural composition. This vividly reveals structural shifts in their economic structures, meaning they are induced to expand their exports, prevalently composed of primary commodities, to be able to sustain required imports of capital and consumer goods. These changes have been accompanied by further appropriate alterations in, for instance, regulatory framework, foreign exchange policies, trade regime, etc. The economies of Central Asia, currently on different development paths, will have to undergo further restructuring and upgrade their exports if sustainable growth rates are to be maintained.

Chapter 5 The Balance of Payments Constrained Growth Framework: the Baltics and Central Asia Compared

> It is difficult to imagine how growth rate differences between the countries can be explained without reference to trade, and without reference to the balance of payments position of countries…
>
> Thirlwall (2003:182)

A comprehensive application of Thirlwall's law to the economies of the Baltics and Central Asia is the subject matter of this chapter. For this purpose, the 'balance of payments constrained growth' model with its basic and extended versions is drawn into consideration. It is suggested that differences in growth rates across the economies concerned may be well explained through their trade performance reflected in their export capabilities and propensity to import. In addition, developments of terms of trade and exchange rate along with capital flows may have considerably influenced their attained growth rates.

These economies will be compared in terms of their external factors' contributions to economic growth. Therefore, aiming at providing a comparative analysis of the Baltic and Central Asian economies, this chapter is organized as follows. An opening part sets forth theoretical fundamentals of the model employed (section 5.1). The next one is devoted to the empirical investigation (section 5.2), which is followed by a comparative analysis of the countries of the Baltics and Central Asia (section 5.3). An intermediate summary providing some policy implications for the regions' economies closes the chapter (section 5.4).

5.1 The BPCG Framework: Theoretical Foundations

5.1.1 Background

It is generally accepted that in most macroeconomic models aggregate demand's interaction with aggregate supply determines an economy's output in the short run. How-

ever, once one turns to the issue of output growth in the long run, currently prevailing approaches appear to stress the importance of supply. For instance, the neoclassical model of Solow (1956) and some of the endogenous growth models (e.g. Romer, 1986; Aghion and Howitt, 1998) pay particular attention to the role supply plays in the process of economic growth and overlook that of demand.

In addition, these frameworks primarily consider growth-related issues from the perspective of a closed economy, where the importance of production functions is emphasized (Alonso and Garcimartín, 1998-99). Hence, existing differences in growth rates are explained through variations in the rate of accumulation of production factors along with productivity growth. Furthermore, in the long run it is implied that there is no lack of demand and, therefore, production potential is fully utilized.

However, it would be wrong to ignore the flip side of the whole phenomenon. Sufficient endowment with resources and availability of production factors cannot warrant high rates of growth, since an economy may appear to be abundantly endowed with factors of production and/or resources that could remain un- or underutilized (e.g. large-scale presence of idle capacities).

Against this background, another approach represented by the Post-Keynesian school underscores the significance of aggregate demand for economic growth (Harrod, 1933; Kaldor, 1966). According to this approach it is aggregate demand that determines the growth path of an economy, whereas supply tries to adapt to its changes. Moreover, as shortly mentioned above, while the neoclassical approach usually considers economies as operating with resource-constrained[1] growth or at full-employment levels of output, at least in the long run, the Post-Keynesian approach considers countries being by and large demand-constrained in their long-run growth. Hence aggregate demand does matter in the long run as well as in the short run.

Aggregate demand, normally composed of its domestic and foreign components, is relevant for both large and small economies, since both are involved in international exchange of goods and services along with factors of production. However, smaller economies are supposed to be more dependent upon their external sector due to their aspirations to maintain appropriately high levels of consumption (embodied in higher quality and larger variety of goods) and limited opportunities for accruing benefits from large-scale production. A sufficient aggregate demand – stemming either from the do-

[1] In this context resources are defined as inputs.

mestic economy or abroad or both – is, therefore, indispensable for fuller utilization of available inputs. Consequently, while analyzing growth dynamics of an economy an element of openness has to be brought into play.

Initially, quite a few reputed economists raised issues related to the relevance of international trade in goods and services for economic growth and development. Among these, for instance, was Harrod (1933) who asserted that the workings of the foreign trade multiplier could help to explain existing differences across industrial economies in terms of their output levels. In his view, exports were to be regarded as the most essential component of autonomous demand of an open economy. What is more, the balance of payments equilibrium constraint was alleged to set limits on economic activity of a country involved in international trade.

Kaldor (1966) in his turn, while pointing to the important role foreign demand played in the process of economic growth, stressed the importance of imports for enabling to increase consumption levels in an importing country. These contributions have become precursors of the 'balance of payments constrained growth' (hereafter BPCG) theoretical framework.

Thirlwall (1979) offered a formalized view of the dynamic version of the Harrod trade multiplier. This concept further enhanced the understanding of a wide array of issues associated with trade and growth. The worked out theoretical framework has even been dubbed 'Thirlwall's law' to denote the observed correspondence of predicted and actual growth rates. However, Thirlwall (1997) hinted that it should have been seen as a stylized fact rather than law. This theoretical concept, continuing the general Post-Keynesian line, underscores the implausibility of the neoclassical theory's simplified propositions, such as high degree of flexibility of prices and exchange rates, infinite elasticity of demand countries face in international trade, unlimited scope of capital flows and, hence, absence of trade gaps (McCombie and Thirlwall, 2004).

Through this model he proposed an explanation of economic growth in terms of the balance-of-payments constraint of an economy resulting from its ability to export compared with its necessity to import. In contrast to the explanations delivered by the neoclassical school, this approach corroborates the assumption that it is the disparities in income elasticities of demand for exports and imports that are responsible for the differences in growth performance across economies. Thus, the main inference to be obtained from this framework is as follows: long-term economic growth depends not only on a

country's resource endowment but also on its aptitude to satisfy both domestic and foreign demand. Therefore, a country intending to attain high growth rates should exhibit high growth rates of its exports and low values of income elasticity of demand for its imports (Thirlwall, 2003).

The character of economies' export and import behavior, which is closely related to their balance-of-payments position, is alleged to cause differences in growth performance across them. Provided real exchange rates are invariable and trade is balanced, so goes the argument put forward by Thirlwall (1979), a close correspondence between the growth rate of output and the ratio of exports growth to the income elasticity of demand for imports ($y=x/\pi$). It must be noted that this inference is in fact a dynamic version of the Harrod trade multiplier.

Additionally, the BPCG framework pays significant attention to monetary aspects of growth-trade mechanics and implies that the neoclassical assumption of trade equilibrium via real exchange rate is not plausible. It is asserted that…

> […] one major economic constraint is the availability of foreign exchange. If a balance of payments deficit, or foreign exchange shortage, is not automatically eliminated through a change in the relative prices of domestic and foreign goods, it immediately becomes a constraint on demand if the deficit cannot be indefinitely financed at a constant rate of interest, and will therefore affect the growth process.
>
> McCombie and Thirlwall (2004:1)

The monetary aspect of the present framework goes in line with the so called 'two-gap'[2] and 'three-gap'[3] models stressing the importance of earning foreign exchange via exports to finance imports. In line with the propositions of these models, the investment-savings gap and the foreign exchange gap along with the budget deficit may prove main obstacles preventing numerous developing countries from attaining higher growth rates. They need foreign exchange to finance imports required for sustaining appropriate levels of consumption and production. In this case, they may be provided with required foreign exchange either through exports or foreign debt.

Financing imports through export earnings is generally deemed more efficient when compared with a foreign debt alternative: the latter may bring about adverse ex-

[2] See, for instrance, Chenery and Bruno (1962); Bacha (1984).
[3] See, for example, Taylor (1989), Bacha (1990).

ogenous shocks and currency instabilities leading towards debt defaults. However, arguing in line with the Prebisch-Singer hypothesis, it may be inferred that financing development through loans my prove more sensible, if developing economies, intending to undergo structural transformation, have their export profiles dominated by resource-intensive products, which are in general subject to price volatilities and have low values of income elasticity of demand.

In addition, resembling the explanation scheme of income growth disparities across countries provided by structuralists (e.g. Prebisch, 1950; Singer, 1950; Seers, 1962), the BPCG framework, in fact, explicates existing income gaps and their trends in terms of the income elasticities of demand for exports and imports representing the non-price characteristics of goods and, thus, the structure of production (Thirlwall, 1997). Existing gaps in income are due to differences in the structural composition of economies. Poor and stagnant economies are inclined to produce inferior goods that have low income elasticity of demand (Engel's law). Therefore, one of the surest ways to increase an economy's long-term growth rate compatible with the requirement of the balance-of-payments equilibrium is structural transformation aimed at increasing its income elasticity of exports and reducing its income elasticity of imports (Thirlwall, 2002). Hence, the theoretical framework brings to the fore qualitative characteristics of competitiveness expressed in terms of income elasticities, rather than price or cost driven competition.

In view of the above mentioned aspects, it may be inferred that along with emphasizing the importance of external sector developments, the BPCG approach pays particular attention to the way an interplay of monetary and exchange rate policies influences an economy's investment and demand (Thirlwall, 2003). Apparently, such a versatile theoretical framework had to bring about the emergence of a wide array of studies. These were devoted either to the theoretical enhancement of the concept or empirical verification of the implied outcomes.[4]

Thirlwall and Hussain (1982) provided one of the essential enhancements of the model by including an element of capital inflows, which enabled to better the fitting of predicted and actual growth rates in the considered economies. The previous version of the model, based on the assumption that in the long run trade across countries is balanced, could not cope with enduring trade imbalances and, therefore, did not produce sought-for predicting results.

[4] For details see McCombie and Thirlwall (2004).

Foreseen by the extended version of the model, the breakdown of growth into contributing factors revealed certain differences across countries and their groups. In line with the BPCG framework, developed economies tended to owe greater share of their output growth to exports growth.[5] This implied that the simplified version of the dynamic foreign trade multiplier would cope with the task properly.

This was not the case, when numerous developing countries were drawn into consideration, whose growth potentials were constrained by the lack of external demand and, thus, sustained beyond the imposed limits thanks to substantial capital inflows. Therefore, an application of the basic version of the model led to underprediction (Thirlwall and Hussain, 1982). Additionally, the case of developing economies underscores the significance of other external constituents of economic growth. For instance, Perraton (2003) and Hussain (1999)[6] in their studies stressed the importance of terms-of-trade dynamics when considering growth performance of a number of developing economies. This implied that the extended version of Thirlwall's law, as a rule, suited better than the basic one.

Theoretical simplicity and fair predicting capacities of the BPCG framework, understandably, had to attract a certain amount of critique, which was in fact directed at both methodological approach and conceptual frame. It must be noted that there has been no critique stemming from economists representing mainstream economics directed at the BPCG theoretical concept, since they consider much of its conceptual frame to be unconventional to grasp. Instead major critique originated from a number of theorists belonging primarily to other schools of economic thought.

In general, early criticisms claim that Thirlwall's (1979) model failed to distinguish between traded and non-traded goods and to take into account non-price competition (McGregor and Swales, 1985, 1986). Later works have overcome this shortcoming.[7] Furthermore, it has been frequently suggested that such matching between actual and predicted values are allegedly due to the identities from which main parameters

[5] McCombie (1997) and Andresen (1993) find that the BPCG framework delivers good results for a number of developed economies of Western Europe and the US, whereas that of Japan is considered an outlier due to lower actual growth rates than those predicted. This is to be explained through rather high growth rates of exports and steadfast build-up of large balance of payments surplus.

[6] In a cross-country analysis of the economies of Africa and Asia he points to non-price characteristics of production and, therefore, sectoral composition of trade flows. A sluggish growth of African economies is closely linked to significantly smaller values of the dynamic Harrod trade multiplier, which in turn is caused by their prevailing reliance on primary commodities.

[7] See, for instance, Alonso and Garcimartín (1998–99).

stem.[8] To put it briefly, the line of argumentation goes as follows. The definitions of income elasticities of demand for imports and exports defined as $\pi=m/y$ and $\varepsilon=x/z$, respectively, should produce $y^* = x/m$.[9] Consequently, taking into consideration the required identity in the long run $x=m$; one must get the identity $y = y^*$. However, this kind of alleged 'tautology' is to be considered unfounded. On this matter McCombie and Thirlwall (2004) offer the following argumentation:

- First and foremost, π and ε are obtained from 'real world' import and export functions defined through demand and price parameters.
- There would be no relationship between y and y^* if a balanced current account were not a long-run requirement in the balance-of-payments and capital flows across countries had to play an important role in its adjustment.

Deriving from the above points, the matching of y and y^* does not imply any tautology. Instead this very framework points to the validity of the framework's original assumptions made to describe the 'real picture' of growth and trade interrelationship along with its main implications.

Moreover, Krugman (1989) was the one to state that the export and import elasticities – which were responsible for a good match of predicted and actual growth rates – are rather of exogenous nature and not endogenous. According to him it was fast growth triggered by the increase of the input of labor that led to a high export or low import elasticity or both. This argumentation line has been refuted by Thirlwall (1991), however. He argued that slow productivity growth was rather caused by the balance-of-payments constraints, what implied that export and import elasticities were endogenous.

Such intellectual debates have led to further extensions and enhancements of the BPCG framework bringing more aspects to the fore. The research work in this field has been conducted on both fronts – theoretical and empirical. Recent contributions have shed more light upon the rationale of disaggregation of the predicted growth rate.

Against this background, McCombie (1985) has provided one of further modifications of the BPCG framework. He has demonstrated that exports growth proves an important determinant of economic growth, even when large economies (e.g. the US and Japan) are drawn into consideration, notwithstanding their relatively insignificant

[8] See, for example, Bianchi (1994).
[9] The definition of variables is as follows: ε and π are income elasticties of exports and imports, respectively; x and m are growth rates of exports and imports; y and y^* are actual and predicted growth rates; z stands for world income growth.

shares of exports relative to GDP.[10] In addition, he has delivered a rationale for breaking down the growth rate of output into appropriate constituents of aggregate demand.

Furthermore, while drawing attention to the issues of international competitiveness, Blecker (1998) has proposed another extension, in which he combines the bedrock of Thirlwall's law with the concept of mark-up pricing (*à la* Kalecki) and exchange rate pass-through to emphasize interrelatedness of the balance of payments position and developments of relative wages. Therefore, in line with his view, an economy, exhibiting low competitiveness, is likely to face a trade-off between real depreciation (via price adjustment, as argued by the neoclassical school) and a slower growth rate of income (through quantity adjustment, as proposed by the Post-Keynesian school). Thus, in this context, maintaining high growth rates combined with full employment proves no easy task, provided trade balance is in equilibrium and exchange rates remain constant.

Considering further aspects of competitiveness, Alonso and Garcimartín (1998-99) have shifted focus to technological characteristics of economies' trade flows. In their empirical analysis, they have introduced a variable capturing structural change in export and import functions. According to their propositions, an economy has to upgrade the content of its export flows, if it is to attain higher growth rates.

At the same time, an array of issues related to economies' indebtedness have been brought to the fore. Elliot and Rhodd (1999) have further modified the extended model devised by Thirlwall and Hussain (1982) by including an element of debt servicing into the framework. Likewise, Barbosa-Filho (2001), while concentrating on the issues related to indebtedness and allowing for a sustainable accumulation of foreign debt, incorporates separation of interest rate payments from imports of goods and non-factor services. These extensions have further improved predicting capabilities of the model, especially in the case of numerous developing economies.

In addition, the BPCG framework has been sophisticated further in order to cover a range of issues related to uneven development. Thus, Dutt (2002) has proposed a modified version of the model, trying to explain existing asymmetries across regions. In this context, structural characteristics of economies along with produced and, hence, traded items are deemed crucial when considering economies' growth dynamics. Similarly, Araujo and Teixeira (2003, 2004), while integrating Pasinetti's concept of struc-

[10] In his empirical work Atesoglu (1993) has provided confirmation of this on the example of the US economy.

tural economic dynamics[11] into the BPCG framework, have argued that growth rates differ across regions due to dissimilarities in production capacities, demand characteristics and, hence, traits of trade goods across regions. Araujo and Lima (2006) in their turn have developed this theoretical scheme further and shifted focus on the sectoral composition of trade flows. They have suggested that it is the sectoral makeup of an economy's exports and imports that cause divergent growth paths across regions. Thus, aggregate demand characteristics along with the sectoral composition of an economy are to be drawn into consideration as well when its growth performance is scrutinized.

Furthermore, McCombie (1993) has extended the theoretical frame of the model by including trade interlinkages between economies. He has suggested that it is the character of trade conducted between nations that causes growth paths of their economies to diverge. As a result of such interaction, some countries may find their growth limited due to imposed balance-of-payments constraints. This may further result in 'competitive growth' schemes, in which such rivaling character of an interaction between economies (taking the form of exchange rates manipulation and import limitations) may further hamper growth in the economies. An option of 'complementary growth' attainable through cooperation should be considered as a way out of such mutually unfavorable interaction between countries.

While testing the above described theoretical scheme proposed by McCombie (1993), on the example of South Africa and its trading partners Nell (2003) points out the importance of an appropriate setup of a trade scheme for a trading block intending to induce growth in the economies involved in trade. In addition, he introduces an element of splitting up of growth rates into exogenous sources of income growth. The modification is thought to be useful when growth dynamics of tensely interlinked (through trade flows) economies are drawn into consideration.

5.1.2 The Model

The BPCG model has been developed on the concepts elaborated by the Keynesian school. Among these, the notion of a foreign trade multiplier is an essential one, since the main output of the model is represented in its dynamic version. In its turn, the foreign trade multiplier is one of the essential constituents of the total multiplier.

The foreign trade multiplier has an 'injecting' element – that is exports – and a 'leakage' (normally, expressed either as marginal propensity to import or a share of im-

[11] For details see Pasinetti (1981, 1993).

ports in output). The two equations below are identical to each other and represent a decomposition of output.[12]

$$Y = \frac{1}{s_p + m + t}(I_p + G + X) \tag{5.1}$$

$$Y = \frac{s_p}{(s_p + t + x)}\frac{I_p}{s_p} + \frac{t}{(s_p + t + x)}\frac{G}{t} + \frac{m}{(s_p + t + x)}\frac{X}{m} \tag{5.2}$$

where Y stands for income, I_p - private investment, G – government expenditure, X – export, and M – imports; the terms I_p/s_p, G/t and X/m are the direct multiplier effects on output of private investment, government spending, and export injections, with their overall impact divided by the corresponding leakages.

Such kind of decomposition enables to distinguish the items contributing to output (i.e. 'injections' – private investment, government expenditure and exports) from the ones leading to its decrease (i.e. 'leakages' – private savings, taxes and imports). Or to put it differently, this distribution helps to identify whether the constituent of demand in question leads to an expansion of aggregate demand or not.

Obviously, an economy will attain higher output growth, if contributing effects are large enough. The growth of exports plays a major part in the growth process since it stimulates demand and encourages savings and capital accumulation, and, because exports increase the supply potential of the economy, by raising the capacity to import. In other words, the larger the value of the direct multiplier effect of export, the more possibilities there are for increasing other constituents of aggregate demand.

It is now worth turning to Thirlwall's law, the concept closely associated with the foreign trade multiplier effect described above. The following equations represent the main building blocks of the BPCG model. These are defined and presented in the way done by Thirlwall (1979) and Thirlwall and Hussain (1982). They are ordered to reveal the factors that determine and exert influence upon economies' growth dynamics.

Equation (5.3) represents a demonstration of the basic version of Thirlwall's law. It is implied that the equilibrium growth rate of output equals to the ratio of exports growth related to the income elasticity of demand for imports.

[12] For details see Felipe and Lim (2005: 33).

$$y_t = \frac{x}{\pi} \tag{5.3}$$

where y_t stands for the predicted growth rate of output, x represents exports growth and π embodies the income elasticity of demand for imports.

Further equations (5.4 – 5.11) demonstrate how the extended version of Thirlwall's law is defined. Equations (5.12 – 5.14) reveal an important extension of the extended version of Thirlwall's law that includes the terms of capital inflows.

In line with the propositions of Thirwall's law, no country being an open economy can have higher growth rates, in the long-run perspective, than the rate consistent with balance of payments equilibrium on current account (Thirlwall and Hussain, 1982). This required condition of balance of payments equilibrium is expressed in the following way:

$$P_{dt} X_t = P_{ft} M_t E_t \tag{5.4}$$

where X_t denotes the quantity exports, P_{dt} stands for the price level of exports measured in home currency; M_t represents the quantity of imports, P_{ft} embodies the price level of imports measured in foreign currency; E_t indicates the exchange rate (i.e. foreign currency expressed in the units of home currency). The dynamic version of this identity may be expressed as:

$$(p_{dt} + x_t) = (p_{ft} + m_t + e_t) \tag{5.5}$$

where p_{dt}, x_t, p_{ft}, m_t, e_t stand for rates of change of the variables defined above.

Further follows the definition of the export function. The quantity of exports demanded is to be specified as a function defined by a set of the following variables: the price of exports denominated in units of foreign currency, the price of goods competing with exports, and the level of world income. Thus one would get:

$$X_t = \left(\frac{P_{dt}}{P_{ft} E_t} \right)^{\eta} Z_t^{\epsilon} \tag{5.6}$$

where X_t stands for the quantity of exports, P_{dt} is the price of exports measured in the units of home currency, P_{ft} is the price of goods rival to exports, Z_t denotes the level of

world income, E_t is the domestic price of foreign currency, η stands for the price elasticity of demand for exports ($\eta < 0$), and ε symbolizes the income elasticity of demand for exports ($\varepsilon > 0$).

Applying the same logic, the import function is defined by the following arguments: the price of imports expressed in units of home currency, the price of goods competing with imports, and domestic income. Accordingly, one obtains the following expression:

$$M_t = \left(\frac{P_{ft} E_t}{P_{dt}} \right)^{\psi} Y_t^{\pi} \tag{5.7}$$

where M_t stands for the quantity of imports; ψ is the price elasticity of demand for imports ($\psi < 0$); Y_t is the domestic income, and π is the domestic income elasticity of demand for imports ($\pi > 0$).

Subsequently, dynamic versions of both export and import functions may be expressed as follows:

$$x_t = \eta (p_{dt} - p_{ft} - e_t) + \epsilon (z_t) \tag{5.8}$$

$$m_t = \psi (p_{ft} + e_t - p_{dt}) + \pi (y_t) \tag{5.9}$$

where lower case symbols stand for rates of changes of the respective variables.

After that, putting in equations (5.8) and (5.9) into (5.5) and rearranging the new one,

$$p_{dt} + \eta (p_{dt} - p_{ft} - e_t) + \epsilon (z_t) = p_{ft} + \psi (p_{ft} + e_t - p_{dt}) + \pi (y_t) + e_t \tag{5.10}$$

one obtains the following expression:

$$y_t = \frac{(1 + \eta + \psi)(p_{dt} - p_{ft} - e_t) + \epsilon (z_t)}{\pi} \tag{5.11}$$

The parameters of equation (5.11) clearly point to the enhancements, when compared to the basic version of Thirlwall's law, since besides exports growth, there are price and terms-of-trade terms that come into play. These parameters shed light upon the issues of the structural composition of production and trade flows along with the position of the balance of payments of a country engaged in foreign trade.

Thus far all the equations above have been defined based upon the assumption that the current account equilibrium condition holds ($M_t = X_t$). However, in reality this is a seldom case, especially in the case of developing countries, which most of the time experience a distinct lack of foreign exchange. Furthermore, frequently developing countries (but also a number of developed economies[13]) are even inclined to accumulate and run large current deficits that are usually financed by capital inflows from abroad, which enable them to grow faster than it would be the case without them.

It is capital inflows that may make the difference in the case of numerous economies. In their turn capital inflows in form of borrowing can lead to increased indebtedness of borrowing countries which later are supposed to pay back the principal debt with interest rates.[14] That in turn leads to lower equilibrium growth rates. However, even provided that the capital attracted from abroad has been used sensibly and its contribution to growth has proved perceptible, potential gains from attracting additional capital may be lost through adverse effects of relative price movements.[15]

Taking into consideration an item of capital inflows, the original requirement of the balance of payments equilibrium will be modified.

$$P_{dt} X_t + C_t = P_{ft} M_t E_t \tag{5.12}$$

where in addition to the previously defined items P_{dt}, X_t, P_{ft}, M_t, and E_t a component of capital inflows C_t is introduced.

Accordingly, equation (5.5) will be altered and expressed as follows:

$$\frac{Ex}{R}(p_{dt} + x_t) + \frac{C}{R}(c_t) = p_{ft} + m_t + e_t \tag{5.13}$$

where lower-case symbols stand for growth rates of the respective variables; $\frac{Ex}{R}$ and $\frac{C}{R}$ represent the shares of import bill covered through export earnings and capital inflows, respectively.

[13] For instance, the US economy, being the biggest industrial nation, has been running substantial trade deficits for quite a long period of time being able to meet the gap thanks to capital inflows from abroad.
[14] However sometimes in case of some developing economies that suffer badly from high debt burden, it occurs that debts are either totally or partially written off.
[15] These issues have been discussed in details in Chapter 1.

In the equation below it is possible to see that the equilibrium growth rate is an outcome of the interplay of the following effects: the effect of relative price changes, the effect of real income growth abroad, and the effect of real capital flows growth.

$$y_t = \frac{(1+\frac{Ex}{R}\eta+\psi)(p_{dt}-p_{ft}-e_t)+\frac{Ex}{R}(\epsilon[z_t])+\frac{C}{R}(c_t-p_{dt})}{\pi} \qquad (5.14)$$

As shortly mentioned earlier, the extended version of the BPCG model is supposed to produce a better fitting of predicted growth rates with actual ones because it takes into consideration another set of factors that are neglected in the basic version of Thirlwall's law. The changes in these parameters may influence trade performance to a significant extent in terms of the structural composition and, therefore, terms of trade and price characteristics.

To put it briefly, the extension implies that if the export sector did not succeed to earn enough foreign exchange and access to foreign capital were limited, the economy might find itself trapped in a long-term path of slow economic growth. It is also quite evident that the deterioration of terms of trade could further hold back the prospects of sustainable high rates of economic growth. Inflows of foreign capital could provide assistance in financing and, thus, raising an actual expansion of income over and above the limit set by the basic 'balance of payments constrained growth' model.

5.2 Empirical Evidence

5.2.1 Rationale

It has been stated in the opening section of the chapter the BPCG framework provides a versatile platform for empirical testing. Indeed on the empirical front, the BPCG approach has been tested in a variety of ways. Such empirical studies have been implemented for individual countries as well as for their groups. There have been produced numerous studies devoted to developed along with developing economies.[16] However, for transition economies this type of empirical application is somewhat new and only a handful of studies devoted to the empirical investigation on the sample of transition economies have been produced.[17] The BPCG theoretical framework proves suitable for

[16] See for instance, McCombie and Thirlwall (2004).
[17] See, for instance, Hansen and Kvedaras (2004).

the analysis of external factor's contribution to economic growth of the economies in question, for its extended versions are apt to provide further breakdowns in accordance with the contributing measures of growth constituents.

Both versions of the dynamic foreign trade multiplier will be tested on the sample of the six transition economies of the Baltics (Estonia, Latvia and Lithuania) and Central Asia (Kazakhstan, the Kyrgyz Republic and Uzbekistan). The obtained values will be compared with actual growth rates of the economies in question.

5.2.2 Estimation of functions

In order to calculate the values of both versions of the dynamic foreign trade multiplier, it is imperative to define the values π and ψ, standing for income and price elasticities of imports, respectively. For this purpose, a general aggregate import demand function (as expressed in equation (5.7)) will be estimated for each economy. The logarithmically transformed function is expressed as follows:

$$\log M = \log a + \psi \log(P_f * E / P_d) + \pi \log(Y) \qquad (5.15)$$

Equation (5.15) represents a conventional import function specification that takes into consideration income and relative price effects.

The import function of each economy will be estimated by using the ordinary least squares method on the basis of annual data. The period considered is a twelve-year time span encompassing years from 1994 till 2005.[18] Before proceeding to the obtained results of estimations, it is worth mentioning some words about the data required for running regressions and calculation of relevant parameters.

5.2.3 Data

Most of the statistical data used for calculation of the sought-for values originate from the United Nations Economic Commission for Europe (UNECE) Statistical Database. The rest of the required data has been obtained from other sources, such as national statistics services of the respective countries, country reports and databases of the IMF and EBRD.

This notwithstanding, not all of the required data proved available for the whole period. In particular, this is related to the relative price index, an important item in the

[18] The data for earlier years of the 1990s suffer from inconsistencies due an all-embracing institutional transformation in these transition economies.

import function. Ideally, an index of terms of trade of each economy for the whole period would prove appropriate. Instead, a combination of two indexes has been employed – GDP deflator (representing price developments in the domestic economy) along with imports deflator (standing for price developments of imported items). These two indexes together with the developments of exchange rates are supposed to rightly represent the term of relative prices in the import function.[19] After running regressions, one gets the following values of coefficients (presented in the table below).

Table 5.1 Estimated income and price elasticities of imports: the Baltics and Central Asia, 1994 – 2005

	Autonomous imports	*Price elasticity, ψ*	*Income elasticity, π*	*R^2 and Adjusted R^2*
Estonia				
Estimate	0.359	0.186	1.539	0.975
t-statistics	(0.867)*	(1.171)*	(15.951)	0.969
Latvia				
Estimate	0.138	0.730	1.460	0.953
t-statistics	(1.879)	(1.324)*	(13.338)	0.942
Lithuania				
Estimate	0.004	-0.321	1.531	0.968
t-statistics	(0.530)*	(-1.180)*	(7.647)	0.960
Kazakhstan				
Estimate	0.132	-0.829	1.118	0.658
t-statistics	(0.301)*	(-1.725)*	(3.350)	0.580
Kyrgyz Republic				
Estimate	0.006	-0.383	1.908	0.629
t-statistics	(0.375)*	(-3.902)	(3.513)	0.547
Uzbekistan				
Estimate	0.001	-0.070	1.708	0.612
t-statistics	(0.124)*	(-1.124)*	(2.118)	0.483

Note: * denotes that the null hypothesis cannot be rejected at the 95 percent level of confidence.

[19] In this case Hussain (1999) suggests using either CPI or GDP deflator as a proxy.

5.2.4 Interpretation of results

The coefficients of price and income elasticities are deemed relevant for further calculations of the two versions of the dynamic foreign trade multiplier. It is worth noting that in the considered period the income elasticities of demand of all six economies have expected signs and their values exceed unity ($\pi > 1$), what implies that import demand is elastic.

Across the countries, the values of income elasticities of demand for imports range from 1.118 in Kazakhstan to 1.908 in the Kyrgyz Republic. What is more, the values for the Kyrgyz Republic and Uzbekistan approximate to 2. It may be inferred that both economies exhibit rather substantial potentials for further import growth. However, these are constrained either through the lack of export capabilities (the case of the Kyrgyz Republic) or limitations on imports (the case of Uzbekistan). In contrast, Kazakhstan with its income elasticity barely exceeding unity is supposed to have no constraints imposed by its balance-of-payments position primarily due to its high exporting capacities. The Baltic economies in their turn demonstrate higher degree of homogeneity in terms of the values of their income elasticities of demand for imports (1.539 in Estonia, 1.460 in Latvia and 1.531 in Lithuania).

The import functions of the economies proved price inelastic ($|\psi| < 1$). However, Estonia and Latvia appear to have positive values instead of negative ones, as one would normally expect.[20] The other four economies exhibit values of ψ, which are negative.

All things considered, the case of the transition economies of the Baltics and Central Asia suggests that relative prices prove a less important determinant of imports when compared with income. In fact, it is income that adjusts itself to maintain equilibrium in the balance of payments. Such an implication favors the Keynesian propositions on growth and suggests a serious alternative to the presently widespread supply-side approach (Atesoglu, 1993).

5.2.5 Calculation of effects

Upon defining the values of ψ and π of the import functions, it possible to determine the equilibrium growth rates in accordance with both basic and extended versions of Thirl-

[20] Large volumes of FDI-related imports, which have been continually increasing in the course of the recent structural transformation of the economies of Estonia and Latvia could serve as a plausible explanation.

wall's law. For the former, one needs two parameters – x and π, whereas the latter requires a presentation of growth broken down into its contributing factors – real terms of trade changes, growth of physical volumes of exports and growth of capital inflows. The expressions below demonstrate how these are calculated.

The effect of real terms of trade is expressed as: [21]

$$\frac{(1+\psi)(p_{dt}-p_{ft}-e_t)}{\pi}$$

The effect of export volume growth is defined as follows:

$$\frac{Ex}{R}\frac{x}{\pi}$$

Finally, the effect of real growth of capital inflows takes the following form:

$$\frac{\frac{C}{R}(c_t-p_{dt})}{\pi}$$

The table below presents calculated values of the above mentioned effects along with predicted and actual growth rates of the economies in question.

Table 5.2 Contributing effects, predicted and actual growth rates: the Baltics and Central Asia, 1994-2005 (in percentage points)

Country	Real terms of trade effect	Export volume effect	Real capital flows effect	Predicted growth rate, y^{**}	Predicted growth rate, y^{*}	Actual growth rate, y
Estonia	3.5	7.2	1.1	11.8	9.4	8.6
Latvia	-1.2	5.6	0.8	5.2	6.7	7.7
Lithuania	3.1	6.3	0.5	9.9	7.7	7.7
Kazakhstan	0.0	5.6	-0.1	5.5	6.1	5.8
Kyrgyz Republic	-4.1	3.1	5.4	4.4	5.3	4.1
Uzbekistan	0.7	4.4	-4.2	0.9	3.6	4.8

Note: y^{*} and y^{**} are average growth rates predicted by the model's basic and extended versions.

[21] Note that unlike the factor in the numerator of equation (5.14), this one does not contain an item of price elasticity of exports. For details see Hussain (1999). It is conventional to omit it, since only import functions are drawn into consideration.

5.3 Comparative and Descriptive Analysis

The data from Table 5.2 reveal the following. The growth rates, defined in line with the basic version of the dynamic Harrod foreign trade multiplier, of the three economies out of six (Estonia, Kazakhstan and the Kyrgyz Republic) are greater than their actual rates. The predicted growth rates of Latvia and Uzbekistan are less than their actual ones. In the case of Lithuania there is a perfect match of the predicted and actual growth rates.

As regards the extended version of the dynamic Harrod foreign trade multiplier, it is worth noting that three economies (Estonia, Lithuania and the Kyrgyz Republic) exhibit overprediction, whereas the other three economies (Latvia, Kazakhstan and Uzbekistan) have lower predicted growth rates than their actual ones. Since these growth rates are made up from the contributing effects, the details are relevant. Therefore, it is imperative to take a closer look at the items of the growth rate calculated in line with the extended version of the foreign trade dynamic multiplier.

Amongst the six economies, Estonia along with Lithuania stand out for their significantly higher contribution of the real terms of trade effect (with 3.5 and 3.1 percent each) with Uzbekistan (0.7 percent) following them. Kazakhstan's value of this effect equals to nil. This item is negative in the case of Latvia (-1.2 percent) and the Kyrgyz Republic (-4.1 percent).

Such a division among the economies in question is to be explained either through the dynamics of each country's terms of trade or that of exchange rates or both. Against this background, Estonia and Lithuania that maintain the regime of fixed exchange rates through their currency board arrangements[22] must have been 'profiting' from favorable terms-of-trade developments. The same is applicable to the economy of Uzbekistan in terms of its terms-of-trade developments and exchange rate regime.[23] Since Latvia has been maintaining stable exchange rates throughout the whole transition period, the negative contribution of the real terms of trade is to be primarily ascribed to unfavorable terms-of-trade movements.[24] In contrast to the Latvian experience, Kazakhstan's substantial 'losses' in the currency value have been leveled off by rather favor-

[22] For details see sections 3.1.3 and 3.3.3 of Chapter 3.
[23] Throughout most of the transition period Uzbekistan has been adhering to the policies of the de facto fixed exchange rate. See section 4.3.3 of Chapter 4.
[24] In fact, unlike Estonia and Lithuania, whose terms of trade have improved by 4 percent and 37 percent, respectively, in the period from 1995 to 2006, Latvia has experienced a setback equal to 13 percent (Source: own calculations based on IMF WEO database).

able developments of its terms of trade.[25] As regards the Kyrgyz Republic, it is evident that this significant negative contribution of the real terms of trade is due to the deterioration of its terms-of-trade compounded by the currency devaluation.[26]

In terms of the contribution of the export volume effect, the Baltic economies outperform those of Central Asia. In fact, in all the economies but the Kyrgyz one, this effect prevails regarding its contribution to the predicted growth rate when compared with the other two. This suggests once anew that it is the exports growth that relaxes the balance of payments constraint.

Turning to the effect of real capital flows, it is possible to ascertain the following. The Baltic economies exhibit positive signs of the term with the values ranging from 0.5 percent in Lithuania to 1.1 percent in Estonia. This implies that in accordance with the propositions of the BPCG framework, growth in the Baltic economies has been complemented by significant capital inflows (See sections 3.1.2, 3.2.3 and 3.3.3 of Chapter 3).

The Central Asian economies are not as homogenous as the Baltic ones, as far as the contribution of the effect of real capital inflows is concerned. This item's value for the Kyrgyz Republic seems impressively high, even when compared with those of the Baltic countries. In the initial stages of transition, much of its outstanding current account gaps has been primarily covered through institutional loans, which are assumed to have contributed considerably[27] (See Table 4.9 of Chapter 4). However, this has led to the build-up of substantial sovereign debt that has to be paid back (if not written off). This would lead to capital outflows and – compared to potentially attainable – lower growth rates. The negative values of the term of Kazakhstan (-0.1 percent) and Uzbekistan (-4.2 percent) imply that the former managed to complement institutional loans with other forms of financial resources attracted (e.g. FDI and private loans), whereas the latter relied principally on its exporting capacities without having made use of significant institutional loans.

In view of the above, however, it should be kept in mind that occasionally there are noteworthy discrepancies between predicted and actual growth rates. These are pri-

[25] Thus, from 1994 to 2005 Kazakhstan's terms of trade has improved by 51 percent (Source: own calculations based on data from IMF country reports).
[26] In the period from 1994 to 2005 the Kyrgyz Republic's terms of trade have deteriorated by 12.8 percent, whereas in the same period its currency has lost up to 286 percent of its value (Source: own calculations based on data from EBRD database and IMF country reports).
[27] Similar arguments were put forward by Ansari et al (2000) and Moreno-Brid and Pérez (1999) when explaining existing differences across the economies of South-East Asia and Latin America.

marily due to the issues related to statistical data[28] and regression along with calculation methods employed. In addition, these discrepancies are to be attributed to differing contributions of nontradables to growth. Furthermore, in this case one deals with the realities of the six transition economies, which have undergone fairly drastic changes in recent years. Therefore, when interpreting the obtained results, a certain portion of caution should be in place.

These considerations notwithstanding, the proposed scheme for distribution of contributing effects should be considered useful due to its aptness to look closer at constituents of economic growth. Moreover, such splitting up into contributing effects enables to identify impeding drawbacks and elaborate trade and industrial policies aimed at increasing of a given economy's competitiveness.

Depending upon the situation considered, increased competitiveness may lead to growth of export and domestic market shares owed either to price or non-price characteristics. Such shifts in the competitiveness levels will usually bring about structural changes in the composition of trade flows, which in their turn exert influence upon the economy's growth dynamics. Therefore, observed differences in growth rates between countries must be associated with the characteristics of produced goods which determine the income elasticity of demand for the country's exports and the country's propensity to import (Thirlwall, 2003). Hence, a country's import and export inclinations are of definite relevance when considering its growth and development patterns.

It may be suggested that differing performance of economies in foreign markets might be attributed to price setting power of their national producers along with different price and non-price characteristics of goods produced. *Ceteris paribus*, economies producing and exporting more sophisticated (i.e. knowledge- and capital intensive) goods are likely to benefit from more stable prices and increasing income of its trading partners, whereas countries specializing primarily in less sophisticated (i.e. resource- and labor intensive) products may incur losses from volatile prices and decreasing demand for their products.

Turning to the case of the transition economies of the Baltics and Central Asia, it is worth noting that their trade patterns (embodied in the structural composition of exports along with imports) may prove useful in explaining the relationship between the

[28] These issues have been thoroughly covered in section 2.1.4 of Chapter 2.

income elasticities of their imports, on the one hand, and their export performance, on the other. Both determine the magnitude of the dynamic foreign trade multiplier.

The table below provides a snapshot of trade profiles and shows exports and imports of the economies of the Baltics and Central Asia broken down according to stages of processing. Note that generally it is assumed that the values of income elasticties ascend from left to right with primary goods considered as having the lowest values and capital and consumer goods the highest.[29]

Table 5.3 Distribution of exports and imports in line with stages of processing: the Baltics and Central Asia, 2005 (in percent)

Country	Exports / Imports	Share of primary goods	Share of intermediate goods	Share of capital goods	Share of consumer goods
The Baltics					
Estonia	Exports	6.0	55.1	15.6	22.8
	Imports	3.8	53.9	17.7	24.5
Latvia	Exports	10.7	53.8	6.8	25.7
	Imports	4.8	47.4	16.1	28.2
Lithuania	Exports	5.2	56.7	9.0	28.3
	Imports	25.4	34.7	15.8	22.6
Central Asia					
Kazakhstan	Exports	71.7	26.6	0.5	1.1
	Imports	8.7	45.5	27.6	18.3
Kyrgyz Republic	Exports	13.2	64.4	2.5	16.7
	Imports	9.3	56.6	11.7	22.5
Uzbekistan	Exports	38.9	38.9	1.2	20.7
	Imports	6.0	55.6	21.2	15.1

Source: International Trade Centre, UNCTAD/WTO database

[29] This assumption goes in accord with the Prebisch-Singer thesis.

It can be ascertained from Table 5.3 that the countries differ both within and across the regions. There are yet some noteworthy patterns. The Baltic economies have higher export shares of capital and consumer goods, when compared with those of Central Asia. Conversely, it may be inferred that the economies of Central Asia exhibit higher export shares of primary goods vis-à-vis the Baltic economies. Amongst the Baltic economies Estonia stands out for its higher share of exports of capital goods (15.6 percent), while Latvia and Lithuania lag behind (6.8 and 9.0 percent, respectively). Keeping in mind that each of the Baltic economies runs rather large trade deficits, it is clear that imports of capital goods (equipment) outweigh – though to a different extent – their exports.[30] In terms of both exports and imports of consumer goods the Baltic economies do not exhibit substantial differences with the relevant shares ranging from 22.8 to 28.3 percent and from 22.6 to 28.2 percent, respectively.

Exports of the economies of Central Asia are dominated by primary products. Kazakhstan's exports are surely dominated by exports of minerals.[31] Across all economies of the region the share of capital goods imports exceed overwhelmingly their exports. In terms of their foreign trade in consumer goods, it is evident that unlike Kazakhstan and the Kyrgyz Republic, Uzbekistan's share of exports is higher than that of imports, what vividly reflects its pursued policies of import substitution.

Interestingly, the same applies to the group of products classified as high-tech products. Among the Baltic economies, Estonia leads the field with 9.7 percent of its exports share and 9.6 of imports, whereas the respective values of Latvia (2.2 and 4.4 percent) and Lithuania (2.3 and 5.5 percent) are considerably lower. The Central Asian economies exhibit the following values in this respect: Kazakhstan (1.5 and 6.4 percent), the Kyrgyz Republic (0.5 and 5.7 percent) and Uzbekistan (5.5 and 7.3 percent).[32]

Deriving from the values of the effects of real terms of trade and exports growth (whose sum produces the net exports effect) and structural composition of trade flows, one ascertains that there is an obvious correlation between them. Therefore it may be suggested that the higher the income elasticity of a country's exportables, the higher its exports growth rates are expected to be. Against this background, the values of net ex-

[30] This favors the implication that recently risen productivity levels are primarily due to increased imports of capital goods. Thus, such experience of the transition economies of the Baltics rebuts the argument put forward by Krugman (1989), where he implies there is a causation from domestic productivity growth to exports growth (Verdoorn's law)

[31] The Kyrgyz and Uzbek exports of precious metals are classified as intermediate goods. Were these classified as primary goods exports, the shares thereof would have been even higher.

[32] Source: International Trade Centre, UNCTAD/WTO database.

port effects of the Baltic economies exceed those of Central Asia not least due to larger shares of more sophisticated goods in their exports.

As Burgess et al (2003) argue a successful trade performance of the Baltic economies throughout their transition period is well explained through the structural composition of their trade flows. The Estonian economy has done well in expanding its exports due to its specialization in production activities of exportables exhibiting rather high income elasticities. A more moderate expansion of Latvia's exports is ascribed to fairly high export concentration on wood, while sufficiently high degree of diversification of its exports explains Lithuania's success in expanding its export markets. The calculated values of the net export effect for each of the Baltic states (10.7 percent for Estonia, 4.4 percent for Latvia and 9.4 percent for Lithuania) reflect these trends.

The economies of Central Asia, relying mostly on exports of items, which are deemed susceptible to price changes and exhibit low income elasticities, have performed worse than those of the Baltics. Accordingly, the calculated values of their net export effects are fairly moderate (5.6 percent for Kazakhstan, -1.0 percent for the Kyrgyz Republic and 5.1 percent for Uzbekistan) and correspond to their export profiles.

Furthermore, contrasting growth and trade performance of the Baltic and Central Asian countries provides further arguments in favor of the following assertion. The evolution of the structural composition of an economy's trade flows are of definite significance, when its growth performance is drawn into consideration (Araujo and Teixeira, 2003, 2004).

5.4 An Intermediate Summary

While complementing other approaches in explaining differences in growth rates across the transition economies under consideration, the BPCG framework provides valuable insights in terms of characteristics of their trade flows. In the preceding analysis, both versions of the dynamic Harrod foreign trade multiplier have been applied to the transition economies of the Baltics and Central Asia. Such an application has produced rather mixed results. Only in the case of the three economies (Estonia, Kazakhstan and the Kyrgyz Republic) out of six, the extended version – which includes the effects of real terms of trade and capital inflows – produced better results than the basic one. The basic

model performed well in the case of the other three economies (Latvia, Lithuania and Uzbekistan).

It has been suggested that a country's exports capacities combined with its necessity to import determine its growth rate. Deriving from the descriptive analysis of exports and imports of the economies of the Baltics and Central Asia, it may be inferred that the observed differences in the predicted growth rates of the economies of the Baltics and Central Asia might be due to their differently setup trade behaviors.

In line with the propositions of the BPCG framework, an economy may increase its growth rates through attracting capital inflows (and, thus, importing and consuming more than it would otherwise be the case) and/or manipulating its exchange rates. However, such measures are likely to be efficacious in the short-term perspective. To attain higher growth rates in the long run, an economy has to undergo structural changes, which should bring about or expand sectors putting out goods with higher income elasticities either for its domestic market (e.g. import substitution) or overseas markets (e.g. export promotion) or both. These steps would increase the value of the Harrod dynamic trade multiplier and, thus, increase the contribution of the so called external factors into economic growth of the given economy. Therefore, such structural changes within the economy imply changes in the structural composition of its trade flows that lead to the increase of an economy's sectors' competitiveness (Posner, 1961; Alonso and Garcimartín, 1998–99).

Against this background, the economies of the Baltics and Central Asia provide splendid case studies for such a comparison due to the differences both in growth and trade performance. Arguing in line with the BPCG framework, it would be logical to infer that the Central Asian economies have lower values of the dynamic Harrod trade multiplier – when compared with those of the Baltics – due to their prevalent reliance upon exports of items with lower income elasticities. Accordingly, larger shares of contributing effects of terms of trade and exports growth in the Baltic economies are direct consequences of their specialization in the production and exports of more sophisticated products compared with the production and trade profiles of the Central Asian economies.

In view of this, the Baltic economies will be impelled to climb further up the technology ladder to retain their competitiveness edge, which is currently based primarily on lower costs of production of labor- and resource-intensive exports. This endeavor

will necessitate appropriate supplies of required inputs, especially well-qualified workforce. If the Baltic economies do not cope with the task, they are likely to face a tradeoff between slower growth and lower wages (Blecker, 1998).

The recent resurgence of the Central Asian economies is primarily due to favorable developments of their exportables' prices, which are deemed rather unstable in the long run. It is evident that the economies of Central Asia will have to diversify their production and exports. Production diversification and development of branches producing goods with higher income elasticity could insure against possible vulnerabilities. The measure is required to secure stable export revenues and, perhaps, escape from high dependence upon imports of certain consumer and capital goods, which they themselves might produce.

Going hand in hand with the external trade's developments, structural changes leading towards 'technological upgrade' have essential implications for the domestic economy's growth and development dynamics. In this context, the values of elasticities, obtained with the help of the BPCG framework, might be used for *ex-ante* analysis and elaboration of trade and industrial policies in the countries of both regions.

Since the economies of both regions are relatively small, they are prompted to rely upon their trade links, most of which take the form of regional trade agreements. Such interrelatedness of economies may lead to frictions among them, since, hypothetically, any economy may aspire to ease its balance-of-payments constraint through a variety of means (e.g. exchange rate manipulation, imposing limits on imports of certain goods[33]) to the detriment of growth in its trade partners (McCombie, 1993).

An option of the so called 'complementary growth' implying coordination within the regional trading block may prove the way out from this trap (McCombie, 1993; Nell, 2003). In this case, an expansion of trade would induce growth of exports to and imports from neighboring countries and, hence, enable to attain higher rates of economic growth, further development and widen the market for producers of the countries of the whole trade area.

What is more, an economy may benefit substantially from its participation in a trading block or integration alliance and undergo the structural transformation and increase growth rates. In fact, this is relevant for the economies of the Baltics and Central

[33] For instance, such practices have often been applied by Uzbekistan, while following the path of domestic-demand-oriented development, the scheme favored by Palley (2002).

Asia, where in the case of the former the EU enlargement is supposed to have played a significant part, while the latter still need to find an integration form that would be mutually beneficial and growth encouraging. An array of issues related to the processes of economic integration of the two regions' economies will be discussed in a more detailed manner in the next chapter.

Chapter 6 Regional Integration Processes

The Baltics and Central Asia, being formerly integral parts of the Soviet economy, have diverged significantly in many respects since the onset of transition processes in the early 1990s. To secure their further development perspectives, the economies of both the Baltics and Central Asia had to rearrange their economic links with other economies in a new manner. Different paths of their economic development are to be attributed, not least to contrasting outcomes of their integration endeavors. These two regions provide a good example for analysis, since their dissimilarities help reveal an important role that integration may play in an economy's development process. The chapter is structured to cover main aspects of integration processes in the two regions in question – the Baltics (section 6.1) and Central Asia (section 6.2).

6.1 The Baltics and the European Union

Much of their accomplishments during transition the Baltic economies owe to a well performed reorientation of their external trade links. This reorientation has been accompanied by an array of interdependent phenomena such as general globalization trends, increasing integration with the EU markets and transformation of their economic structure along with trade profile. These shifts have taken place in the wake of their aspirations to the EU membership, which served as a strong incentive to proceed with economic restructuring and institutional reforms. Recently gained membership in the EU validates achieved progress of the Baltic economies.

6.1.1 Integration rationale and initial options

Upon gaining their economic independence the state of the Baltic economies left much to be desired in many respects. Among other things, they were characterized by comparatively low real incomes due to low productivity, obsolete and excessive stock of physical capital and outdated technology employed.[1] To increase their income levels by fixing mentioned deficiencies, the Baltic economies were no doubt to rely significantly on their external sector, i.e. foreign trade along with investment. Taking into consideration their endowment with relatively high qualified human capital, increasing capital

[1] Thus, as of 1993, the Baltic economies had following per capita GDP levels: Estonia – 1168 US dollars, Latvia – 940 US dollars and Lithuania – 727 US dollars (Source: EBRD database).

stock and upgrading technology would be no difficult task, if foreign direct investment (FDI) along with other capital flows were sufficiently provided.

Rather small sizes of their economies in conjunction with a spatial proximity to the rich economies of Western Europe left few alternatives to their option to seek closer integration with the EU economies.[2] What is more, the sought integration with Western Europe enabled them to accelerate the whole process of transformation through additional impetus given to the domestic sector of their economies. This is well reflected in high values of their overall transition indices (for details see sections 3.1.3, 3.2.3 and 3.3.3 of Chapter 3). In addition, closer integration with the EU was to bring about an emergence of new and partial redirection of existing trade flows, inducing further rationalization of their production and trade structures and fostering further convergence of income levels and demand structure (Papazoglou et al, 2004). These in turn would pave the way for an expansion of intra-industrial trade, product differentiation and increased quality of goods.

At the outset, however, the Baltics' prospects for such a swift integration into the then European Economic Community seemed anything but secured. Unlike other economies of Central and Eastern Europe (CEE), they had been previously more tightly integrated into the Soviet economy and inherited, therefore, a structure with many industries dependent upon supplies from the economies of the Former Soviet Union (FSU) in the early 1990s.[3] In this context, the Baltic economies had to weigh net effects resulting from trade creation and trade diversion, which were unavoidable because of rather rapid pace of restructuring and pursued reorientation of trade flows. The Baltic economies were, therefore, to temporarily maintain certain old industries (such as machinery or oil refining) to lessen costs of their economic restructuring resulting from price liberalization and structural adjustments of their trading partners. These constraints did not prevent, however, from far-reaching orientation towards Western economies, realized in gradual steps beginning from the so called Association Agreements in the mid 1990s to the full EU membership in 2004.

[2] By 1993 their combined economic weight merely exceeded the value of 6.2 bln. US dollars (Source: author's calculations based on EBRD database).
[3] For instance, the shares of their exports in 1990, destined to other republic of the Soviet Union, equaling in average to nine-tenth were significantly higher than for other transition economies, which varied between 15.3 and 25.9 percent (Source: Havrylyshyn and Al-Atrash (1998: 8-9)).

Regional trade agreements

The integration of the Baltics has been launched primarily through regional trade agreements and other trade arrangements. These were to secure benefits for participating countries. The Baltic economies were, thus, along with other CEE countries were to accrue benefits resulting from allocative (static) and accumulation (dynamic) effects (Baldwin et al, 1997). The former allow to increase the efficiency of available inputs and reach higher attainable points on the presently given production possibilities frontier, whereas the latter enable to increase the stock of available inputs and, hence, shift the frontier of production possibilities outwards leading to a larger amount of producible goods.

This kind of trade arrangements might be beneficial when engaged economies complement each other. This complementarity is to a great extent determined by comparative advantage based upon endowments with production factors. Against this background, the Baltic economies, being relatively well endowed with labor and natural resources and less well with physical capital, resemble other CEE economies (Sorsa, 1994). This implies that, on the whole, they would compete in certain industries against each other exhibiting general compatibility with the economic structure of the EU.

BFTA, Europe Agreements

Accordingly, the Baltic states along with other countries of Central and Eastern Europe have become signatories of individual Association Agreements with the EU, which are often referred to as the Europe Agreements regulating trade and related schemes conducted on a bilateral basis. In the early 1990s the CEE economies were induced to create the Central European Free Trade Area (CEFTA), whose signatories were Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia. The Baltic economies followed suit by establishing the Baltic Free Trade Area (BFTA) in 1994. Despite rather insignificant scope and volumes of trade conducted through these arrangements, these are thought to contribute to a reduction of effects resulting from a 'hub-and-spoke' scheme in trade between the economies of CEE and the EU, since they, according to De Benedictis et al (2005), induce an expansion of an 'intra-periphery' trade.[4]

[4] With respect to the Baltic region, this trend has been strengthening – although to an insignificant degree – during recent years.

A swift inclusion of the Baltic states in the mid-1990s into these agreements, despite their former 'membership' in the Soviet Union, has been motivated, among other things, by foreign policy considerations. By that time, the Baltic states had already established free trade relations with EFTA members – Finland, Sweden, Norway and Switzerland. Among these the first two had already applied for EU membership and were interested in deep trade relations with the Baltic economies on a consistent basis. This has contributed to a rapid expansion of trade turnover among the economies of the Baltics and Nordic EFTA members (Kaminski, 1996).

Option "East"

When compared with those of other transition economies of Eastern Europe, the Baltic economies' industries had to incur greater losses from their rapid switching to Western economies, since they were still in many ways dependent upon supplies from economies of the East, in particular Russia, whose shares in the Baltic imports were significant.[5]

Therefore in the early 1990s, despite keeping themselves outside the CIS – an institutional body formed by all constituent republics of the Former Soviet Union apart from those of the Baltics – options for temporary trade arrangements with Eastern counterparts were open for the Baltic economies. However, even despite seemingly reasonable options to secure export markets in and supplies from the East, no special trade arrangement with it proved indispensable. An array of several circumstances might serve as rationale of rejection of this option.

Firstly, having embarked upon their transition, the CIS countries were to undergo substantial restructuring of their economies and, hence, were no more able to secure supplies to along with imports from the Baltic economies. Secondly, attempts of the Baltic economies to retain old industries would have been economically unreasonable in the long run due to unavoidable trade-offs. Further maintenance of old industries – by latently subsidizing them (Sorsa, 1994) – would have precluded the emergence of the new ones more viable in the long run and capable of attracting additional resources from the domestic economy and abroad. In addition, such temporary trade arrangements may bring about an emergence of pressure groups capable of hindering further restructuring and limit aspired positive effects.

[5] For instance, the share of Russia in total imports of Estonia equaled to 28.4 percent in 1993, whereas, as of 1994, these values for Latvia and Lithuania were 23.6 percent and 39.3 percent, respectively (Source: EBRD database).

Intraregional Option

Besides the above considered possibility to (re-)integrate with the East, the Baltic economies had an option to foster their intra-regional integration. As shortly mentioned, the Baltic economies established in 1994 their regional trade arrangement, the BFTA, which was later on modified by an extension to agriculture. Even though this trade arrangement is in place, the intra-Baltic trade is not conducted on a large scale basis in spite of its recent expanding trend. In recent years this trend has been strengthening in the Baltics, what has been brought about by steady growth rates of overall exports and imports combined with an increase of their shares in trade flows directed to each other. This notwithstanding, the shares of their mutually conducted trade remain relatively insignificant, when all trade flows are drawn into consideration.

This may in part be due to numerous similarities in their economic structures and trade pattern. Because they exhibit comparative advantage in similar industries (when considered in terms of their technological sophistication), they are generally supposed to compete with each other in a number of sectors. Hence, no rapid changes in the mutually conducted trade have emerged. Larger intensiveness in trade is logically observed between the adjacently located economies,[6] implying that trade between Estonia and Lithuania is less intensive.[7]

Mälk (2002) asserts that the Baltics should not be considered as a tightly integrated economic region, although they are similar in their endowments with production factors and exhibit large potentialities for closer cooperation in certain economic spheres. Given their similarity in factor endowment merely intra-industrial trade could prove a viable option, which is presently undermined by their relatively modest incomes. Additionally, the current structure and production pattern of the Baltic economies are to be considered as impediments for a considerable expansion of intra-industry trade between them.

According to Sorsa (1994), intra-industry trade based on differentiated goods or scale effects is less likely in the industries such as clothing, wood products, footwear, textiles and the like, in which the Baltic economies exhibit comparative advantage.

[6] For instance, Latvia, bordering with both Estonia and Lithuania, saw its trade turnover expand with the two economies. Taken together, the two economies' share in total Latvia's exports (imports) has increased from 14.4 (16) percent in 2002 to 27.2 (20.7) percent in 2006 (Source: Central Statistical Bureau of Latvia).

[7] As of 2005, Estonia and Lithuania were not among each other's five as largest trade partners (Source: International Trade Centre database).

However, in contrast to the mentioned items, trade in mineral products may offer high potentials for intra-industrial trade within the Baltics, mainly based on feasibly large scale effects. For instance, inherited from the Soviet times, high specialization of Estonia and Lithuania in oil-refining and, thus, exports of mineral products may prove appropriate basis for an expansion of trade within the region.[8] It should be noted, however, that this sort of trade does not necessarily imply creation of a trading block leading towards deeper economic integration, since it may be regulated by multilateral (in this case trilateral) agreements.

Therefore, a stage of integration, represented by a free trade area within the Baltics, has not evolved into advanced structures, for instance, in form of a customs union, to which Latvia had been adhering most of all. Such aspirations were undermined, not least, by ever strengthening economic links with the economies of Western Europe.

Option "West"

Initially seen rather less viable, an option of a swift and large-scale reorientation towards Western Europe is justifiably considered to have brought the greatest part of benefits to the Baltic economies. First regional trade agreements with Europe have substantially facilitated the process of (re-)integration of the Baltics into the world economy by fostering foreign trade. This process has been complemented by significant capital flows, which eased the process of economic recovery along with restructuring in the Baltic economies.[9]

Closer integration with the economies of Western European induced the Baltics to grow at a rapid pace, encouraging more effective resource allocation, and, thus, lay foundations for stable long-term growth (Henrekson et al, 1996). In addition, regional integration of the Baltics with the EU economies was accompanied by its simultaneous integration into the world trading system. Both were to result in higher growth rates and increased welfare. In this context, Waltz (1997) and Badinger (2005) point out that it is the combination of regional and global integration that allowed most CEE economies to recover and attain higher growth paths. Broad-scale external liberalization, which has gone hand in hand with the Baltic economies' integration with the EU, may have been

[8] In fact, mineral products represent one of major commodity groups in trade profiles of Estonia and Lithuania. Thus, as of 2006, the share of this category in total exports (imports) of Estonia and Lithuania equaled to 16.2 (14.6) percent 27.3 (17.8) percent, respectively (Source: own calculations based on data from Statistical Office of Estonia and Department of Statistics of Lithuania).

[9] As of 2005, the total stock of FDI accumulated by all three Baltic economies equaled to 23.5 bln. US dollars, the greatest part of which originated from the EU economies (Source: UNCTAD, World Investment Report 2006).

even more relevant for stronger growth when compared to participation in RTAs (Vamvakidis, 1999).

It is suggested that at the outset these RTAs have led to less than hoped export-related FDI, since sectors, in which the Baltic economies exhibited higher competitiveness (mainly due to lower costs) were just limited to agriculture and fisheries, textiles and certain services (Sorsa, 1997). These sectors were excluded from the arrangements with the EU for they were deemed sensitive and traditionally enjoyed high protection from foreign competition in the economies of the EU. Being deprived of this option, they had to seek other export markets for these products, which previously made up substantial shares of their exports.[10] Therefore, these agreements in part considerably influenced the way economic restructuring proceeded in the economies of the Baltics. This circumstance, enabled (or even impelled) the Baltics to specialize in and develop other sectors. Thus, Estonia built up production of telecommunications equipment, Latvia expanded its production of wood and wood products, and Lithuania increased its production capacities in textiles, while retaining petroleum products further as a key export item (For details see tables 3.2, 3.8 and 3.14 of Chapter 3).

In the course of subsequent years, their newly (in terms of their composition) modified export flows, boosted by substantial FDI inflows, have been growing at nearly two-digit rates.[11] This kind of intensification of foreign trade of the Baltics with the considerably richer core of the EU may incur certain risks stemming from the so called 'hub-and-spoke' trade scheme, in which old EU members represent the core, whereas the Baltics is placed in the periphery.

Such changes in the geographical distribution of trade flows may be well handled by the so called gravity model,[12] which posits that volumes of trade flows are positively correlated with the 'mass' and negatively with the 'distance' between the economies. The former is embodied in the income and population of the economy, whereas the latter may be represented by factors denoting various proxies of the distance between the trading economies. For instance, in the course of undergoing integration, due

[10] In part these exports continued to be marketed in Eastern markets, i.e. countries of the Former Soviet Union.
[11] In fact, in the period from 1996 to 2005, growth of exports of Estonia averaged to 11.7 percent, while these values for Latvia and Lithuania were 9.2 and 10.2 percent, respectively (Source: author's calculations based on data from EBRD database).
[12] The model was originally introduced by Linder (1961) and Linnemann (1966) to explain intensity of trade between countries through a number of factors (e.g. income levels, income growth rates, geographical distance, cultural affinity, etc.)

to its largest economic weight in the EU and close location to the Baltics, Germany is assumed to distract trade flows from potential markets located in the periphery. In the same manner, due to its linguistic, cultural affinity and spatial closeness, Finland is supposed to conduct trade with Estonia in a more intensive way, provided one neglects other factors apt to influence trade intensity.

An important trait of this intensification of trade of the Baltic economies with those of the EU is the difference in the dynamics of exports and imports.[13] On the whole, this expansion of trade was characterized by increased demand of the Baltics for imports from and its staggering growth of exports to these economies, what led to extended trade deficits.[14] In the mid-1990s, these gaps were in turn compounded by in part increased imports from the CIS (caused by price liberalization of exportables). These trade gaps were set to rise throughout pre-accession period and beyond it (Papazoglu et al, 2006). Therefore, the Baltic economies necessitated substantial capital inflows to cover the gaps or keep them at acceptable levels.

Furthermore, it is worth mentioning that a substantial share of these gaps is due to increased imports of capital goods, which contribute to the increase of productivity levels and, thus, will enable to decrease these gaps in the coming years (Lutz, 2006). The task of decreasing trade deficits will be substantially eased, if the economies in question manage to modify their trade flows' make-up, appropriately increasing income elasticity of demand for their exportables. This seems attainable in the long run.

6.1.2 Accession benefits

for EU incumbents

The enlargement of the EU is supposed to be beneficial not only for its newly acceded members, but also for incumbents of the club, which accrue benefits stemming from expanded trade with new members. Due to existing income gaps between integrating economies of the EU, there are growth potentials for both richer and poorer economies (Haveman et al, 2001), which in turn, as more integrated entities, become more interdependent, benefiting from externalities stemming from integration (Garcia-Vega and Herce, 2002).

[13] Thus in the period from 1996 to 2005, Estonia's imports have been rising in average by 0.4 percentage points faster than its exports. In the case of Latvia and Lithuania this difference in growth rates equaled to 2.2 and 2.1 percent, respectively (Source: author's calculations based on data from EBRD database).
[14] By 2005, Estonia's trade deficit reached the mark of 1.845 bln. US dollars, whereas those of Latvia and Lithuania were 3.02 and 2.94 bln. US dollars, respectively (Sources: Bank of Estonia, IMF, International Financial Statistics and Bank of Lithuania).

Owing to a unified external trade policy and single market, the trade within the EU becomes less expensive leading to lower prices and increased variety of tradable goods. Furthermore, general institutional harmonization results, among other things, in higher compatibility of financial markets and, hence, lower country-risk premiums. This substantially improves income opportunities of the EU incumbents from investments made in the new EU members.

Most of the implied gains are to be attained in the long run and relate to economic development in the new member countries. Since the EU enlargement presupposes limitless movements of goods and services, capital and labor force, the EU incumbents are to gain from such increase of mobility through the workings of agglomeration processes (Baldwin and Forslid, 1997). These in their turn, depending upon the type of production activities, are supposed to benefit both the core, i.e. the old EU members, and the periphery, i.e. the newly acceded CEE economies.[15]

It must be noted, however, that resulting benefits are supposed to be distributed unevenly among the old members of the EU. In line with estimations made by Baldwin et al (1997), Germany, France and the UK were projected to get about two-thirds of the total gain, with Germany alone claiming one-third thereof.

Last but not least, favored by their geographic location and recent enlargement rounds, the core EU economies are supposed to more easily compete with other economies of the industrialized world in and, owing to the Baltics, have better access to the CIS markets.

for the Baltics

Growth and Technology

The economies of the Baltics, having integrated themselves into the regional labor division within the EU, managed to make the most of existing potentials for their trade and foreign investment. Their impressive growth rates among the new entrants of the EU confirm this, implying that their income levels are converging towards those of the old EU members at a rapid pace.[16] It may be inferred that intensification of trade with economies of the EU, having triggered notable changes in their economic structure (as

[15] In line with considerations of Myrdal's institutionalism and the new economic geography approach, agglomeration may prove, however, destabilizing due to its backwash effects, which result in benefits for the core and costs for the periphery.

[16] Thus, as of 2006, Estonia with 10386 US dollars exhibited the third highest per capita GDP values across transition economies. Latvia with 6860 US dollars and Lithuania with 7603 US dollars were not far behind (Source: EBRD database).

shortly discussed in section 6.1.1), provided sizeable benefits for the Baltic economies. These benefits have been thus far accrued primarily from static effects resulting from integration with the economies of Western Europe.

In view of small sizes of the Baltic economies, the attained progress has been made possible by their specialization in sectors deemed competitive in the EU single market. However, as Deardorff (2002) puts it, the newly acceded Baltic economies might find the scope of their benefits constrained by the nature of their specialization in the sectors that provide limited potentials for scale effects. This assertion conforms with the argument of Sorsa (1994) stating that at least in the short to medium term, the Baltics are not able to specialize in promising sectors.

In the long-term perspective, however, potential gains stemming from dynamic effects are likely to outweigh those from static effects. This fact has a direct implication for further possible structural shifts in their economies and export profiles. It is obvious that the Baltic economies will have to climb up the technology ladder to increase their gains by attaining sustainable growth rates. In this context, their tight trade links with the richer economies of the EU provide ample opportunities for inducing appropriate changes in the structure of their economies and, hence, trade flows.

This may be easily attained in view of relatively high-qualified and workforce available in the economies of the Baltics.[17] Boosted by significant amounts of foreign investment, they would easily bring about changes required for an upgrade of their export flows. In fact, their present technological handicap may present an advantage in certain industries. Currently exhibiting an 'advantage of backwardness', they may easily build up new industries through leapfrogging preceding technological stages and, thus, faster climb up the technology ladder (Zaghini, 2005). In part, this has already taken place in the Baltic economies, notably in Estonia, which managed to build up production of telecommunications equipment. Whether such potentials will be attained by the Baltic economies depends on factors such as competitive pressure and market forces within the EU.

[17] Throughout transition, the number of enrolled students has exploded, despite shrinking numbers of their populace. For instance, the number of students in Estonia and Latvia in 2006 compared to 1990 has increased by 175 and 185 percent, respectively. As for Lithuania, the increase equaled to 138 percent between 1996 and 2005 (Source: author's calculations based on data from Economist Intelligence Unit).

Institutional Harmonization

Recently attained high growth rates in the Baltic economies are commonly attributed to a combination of improvements in technology, expanded trade flows and substantial capital flows. These have been compounded by encouraging institutions representing another possible important determinant of growth.

The EU membership from the beginning implied for acceding countries essential alterations in their policies and institutional framework (Baldwin et al, 1997). Such changes touched upon spheres such as general liberalization of trade regimes (elimination of tariffs along with quantitative restrictions combined with the adoption of the universal EU external tariff).

The Baltic economies have implemented required changes in a swift manner, since they had already been well familiar with the fundamentals of what later would build the basis of economic and regulatory systems of the EU (Laaser and Schrader, 2004). This rather rapid adjustment of institutions enabled them to accomplish economic restructuring and reorientation towards Western Europe through intensification of trade links and establishing market institutions. Most of the institutional transformation has been accomplished by the Baltic economies during their pre-accession period.

Finance

The process of institutional transformation of the Baltic states has been facilitated by a generous financial support from the EU. Since the EU is in its rather advanced stage of economic integration, it has been maintaining a number of funds intended to cope with various tasks. The biggest chunks of the EU budget's spending are represented by the Common Agricultural Policy (CAP) Fund and Structural Funds. The latter are conceived to provide large financial transfer to the poor regions of the EU and explicitly intended to foster convergence of per capita income among its members.

These financial transfer schemes of the EU are alleged to stimulate the long-term economic growth of the funds recipients. For instance, Crespo-Cuaresma et al (2002) state that the funds are found to have contributed to the receiving countries' GDP from 0.5 up to 0.7 percentage points. The Baltic economies in their turn, as new EU entrants, are entitled to the EU structural and cohesion funds' resources. Complementing their budget resources, these funds are disbursed to improve infrastructural facilities, upgrade

social and human capital.[18] Thus, the EU assignments improve the demand capacities of their economies without leading to balance-of-payments difficulties.

Transport and Transit

The Baltic economies, like other new EU members, are expected to increase their gains from deeper integration into the EU due to increased export capacities and improvements of their transportation efficiency. Thus, in line with estimations made by Broadman et al (2006), the former would generate up to 70 percent of overall benefits from trade, whereas the latter contributes the remainder. These gains would substantially ease currently rather large and in the long run unsustainable current account deficits of the Baltic economies.[19]

The enhanced transportation system would definitely increase transit potentials of all three economies of the Baltic region. Located between the EU and the CIS economies, they may expand their revenues substantially from transit-related activities. These trends are most likely to get intensified, as the CIS economies start their recovery and increase their imports from the EU economies. This clearly stresses the importance of geography as an important factor in the economic development of the Baltic countries.

Currency and Monetary Union

Another important step of the Baltic economies in further integration with the EU would be their accession to the Eurozone, what implies an adoption of the common European currency, the euro. For this purpose, they, like most of the newly entered EU members, were to join the EU exchange rate mechanism (ERM2)[20] for at least two years and fulfill certain criteria before being eligible to introduce the euro. The overall institutional developments in this sphere were rather similar in the three countries. Their exchange rates have been thus far tightly pegged to other hard currencies (for details see sections 3.1.3, 3.2.3 and 3.3.3 of Chapter 3).

Joining the European currency union would bring about further intensification of foreign trade with other EU members. In addition, joining the currency union promises further gains in terms of lower interest rates and, thus, cheaper loans, what would fur-

[18] Thus, in the period from 2004 to 2006, Estonia has absorbed 52 percent of the whole pledged volume of EU Structural Funds. The values for Latvia and Lithuania are more moderate and equal to 22 percent and 25 percent, respectively (Source: Eurostat).
[19] By 2006, related to their GDP, current account deficits of Estonia, Latvia and Lithuania were equal to 10.3, 12.5 and 7.0 percent, respectively (Source: EBRD database).
[20] Estonia along with Lithuania joined the ERM2 in June 2004, whereas Latvia did so in April 2005.

ther foster foreign investment in the Baltic economies, which hitherto have been maintaining very stable exchange rate regime capable to withstand various pressures. However, the introduction of the euro should be put in line with the general objective of retaining appropriate competitiveness of their industries, what necessitates general transformation of the their exports' structural composition.

6.2 Economic Integration in Central Asia

Since the early 1990s, the economies of Central Asia have undergone significant changes in terms of the structure of their economies and trade patterns. Their transformations have taken place simultaneously with the disintegration of the Soviet economy and somewhat moderate reintegration into the world economy. The latter has proved rather elemental despite numerous attempts to foster integration processes between the economies both within the region and beyond it. It is suggested the region's further economic development based on sustainable growth rates is likely to depend upon a well combined integration schemes at both intra- and interregional levels.

6.2.1 Integration rationale and initial options

Vast and landlocked, the region of Central Asia comprises five republics of the Former Soviet Union. Their economies are deemed rather small, taking into consideration their weight in the world economy.[21] This circumstance implies they are price-takers in international markets, what substantially influences developments in their domestic sectors due to their high reliance upon a handful of exportable commodities. Small sizes of the region's economies preclude them from accruing benefits stemming from economies scale effects.

In many respects, the economies of Central Asia are very interdependent due to their close and adjacent geographic location. Being formerly considered as one economic region within the Soviet economy, they prove very much interrelated. Thus, water and energy resources are to be distributed and utilized on a participatory basis. The downstream countries (Turkmenistan, Uzbekistan and, in part, Kazakhstan, are dependent upon water supplies from the upstream ones (the Kyrgyz Republic and Tajikistan),

[21] Thus, as of 1995, the economies of Central Asia exhibited following economic GDP values (in bln. US dollars): Kazakhstan – 20.4, the Kyrgyz Republic – 1.7, Tajikistan – 1.2, Turkmenistan – 2.5 and Uzbekistan – 13.4 (Source: World Bank).

which in turn have to import much of energy resources from their neighboring countries in the region.

The economies of Central Asia, being relatively similar before the onset of economic transformation, could be considered rather open in terms of trade volumes. However, this kind of openness may be explained by imposed specialization and, accordingly, trade patterns. Furthermore, because of their main specialization in upstream activities, the Central Asian economies were more tightly integrated with other Soviet republics than with the CMEA economies, letting alone the rest of the world.[22] However, in the course of just few years their trade flows has been diversified significantly, in terms of their geographical distribution.[23]

Starting their transformation as being relatively poor – though to a different extent across the region[24] – they had to put up with considerable output contractions in the coming years. The scope of output contractions in the period from 1991 to 1995 ranging from 17.5 percent in Uzbekistan to 56.5 percent in Tajikistan[25] further deteriorated living conditions in the region.

The countries of Central Asia owe their recent economic recovery primarily to an expansion of their resource-intensive exports, which in the long run are not likely to secure stable growth rates. It is asserted that the processes of economic integration – both within the region and beyond it – promise substantial welfare gains, which may be attained through increased growth rates sustained on a long-term basis.

The above mentioned makes a rationale of economic integration in the region evident. Closer integration promises numerous advantages for the economies of the region in many respects. In view of new and different economic setting of the early 1990s, the economies of Central Asia had to disintegrate from the formerly given economic structure of the Former Soviet Union in order to then reintegrate in line with their given comparative advantage. Accordingly, to take the right path, an economy is impelled to define its net benefits accruable from this or another integration opportunity. The choice

[22] In 1990 an unweighted average share of exports of five Central Asian republics destined to other republics of the Soviet Union was 90.5 percent (Source: Al-Atrash and Havrylyshyn, 1998: 8-9).
[23] Thus, in the period from 1988 to 2004 the share of the FSU economies in total trade turnover has decreased from 89 to 32 percent in Kazakhstan, from 86 to 54 percent in the Kyrgyz Republic, from 87 to 53 percent in Tajikistan, from 86 to 45 percent in Turkmenistan and from 89 to 36 percent in Uzbekistan (Source: ADB).
[24] For instance, in 1992 Kazakhstan's GDP per capita was 350 US dollars. The values for the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan were (in US dollar terms) 171, 52, 352 and 72, respectively (Source: EBRD database).
[25] Source: Interstate Statistical Committee of the CIS.

is often subject to the influence of the currently given factor endowment and pursued policies based on intertemporal considerations. Against this background, unlike most economies of Central and Eastern Europe and very much resembling other CIS countries, the countries of Central Asia had no clear integration pattern. Instead there were vague options for multilateral and regional integration. Consequently, developments of trade and external sector occurred at the background of attempted multilateral as well as regional economic integration schemes.

WTO

Generally, economic transition implied wide-ranging liberalization of external trade regime. At the outset the economies of Central Asia were like many other transition economies characterized by the dominant role of state in foreign trade transactions. This has been altered across the region, although to a differing extent.[26]

In this context, one and, possibly, the appropriate, way to conduct a broad-scale liberalization of external trade regime is accession to the WTO. The membership in this organization would validate reduction of tariff and non-tariff barriers. Consumers would directly gain from the WTO membership due to increased consumption opportunities. In addition, there could be indirect gains to be accrued from further institutional transformation. In this context, Jensen and Tarr (2007) show on the example of Kazakhstan that its WTO accession would induce impressive increases of consumption in the medium and long run, caused by improved market access. These measures would boost trade both within and beyond the region.

Touching upon the trade beyond the region, there would be also substantial benefits, since the economies of Central Asia along with other CIS economies have been experiencing setbacks in the 1990s, when attempting to penetrate markets in the developed world. There were non-tariff barriers imposed against the so called non-market economies motivated by anti-dumping activities. The WTO membership provides certain protection against such measures.

Apart from Turkmenistan, all economies of the region have been aspiring to the WTO membership but have made rather moderate progress to attain the membership. The only exception is the Kyrgyz Republic, one of the smallest economies of the region, which managed to accede to the organization in 1998.

[26] For instance, by 2006, the values of the EBRD index of liberalization of Trade & Forex system ranged from 1.0 in Turkmenistan to 4.33 in the Kyrgyz Republic. The values for Kazakhstan, Tajikistan and Uzbekistan equaled to 3.67, 3.33 and 2.0, respectively (Source: EBRD database).

A soon accession of the Central Asian economies would substantially liberalize their foreign trade regimes and ease the access to each other's markets (Vamvakidis, 1999; Pomfret, 2000b). It may even precede their further activities related to fostering integration through regional trade arrangements, since in this case the scope of accruable gains is likely to be greater than otherwise (Tumbarello, 2005).

Regional trade agreements

Parallel to the attempts of broad liberalization, there were initiatives aimed at establishing regional trade agreements envisaging further stages of economic integration. It must be noted, initially, Kazakhstan and the Kyrgyz Republic have been participating actively more actively than other three states. Uzbekistan has been in fact disinterested in closer integration. While Tajikistan's participation has been hampered by a civil war, Turkmenistan has abstained altogether due to its policies of neutrality.

CIS-based Groupings

After the break-up of the Soviet economy, its former constituent republics had several options open for arranging their economic relations anew. Among such options was surely the one based on the CIS, an institutional body founded by twelve successor states of the Former Soviet Union. Most of the CIS-based multilateral agreements were motivated by the formerly existent production structure and links. Although these attempts to restore or 'conserve' old trade patterns and production links could not be considered as progressive steps, there was a clear rationale behind them. They were supposed to induce rather smooth economic transformation and, thus, lessen costs of economic transition in terms of overall output and unemployment.

Since it proved difficult to establish such integration groupings on a multilateral basis, there occurred further fragmentation among the CIS economies. These options included Russia-centered and decentralized ones. One of the main Russia-centered integration blocks is the Eurasian Economic Community (EAEC), which was established in 2001. This organization has succeeded a Customs Union, founded by Belarus, Kazakhstan, the Kyrgyz Republic and Russia in 1995. EAEC has recently absorbed the Central Asian Cooperation Organization (CACO), an organization formerly solely regional in its scope. Presently EAEC includes besides Russia Belarus Kazakhstan, the Kyrgyz Republic, Tajikistan and Uzbekistan.

Intraregional Initiatives

Additionally, there appeared opportunities for fostering economic cooperation at the regional level. These integration endeavors pursued by the economies of Central Asia were supposed to address constraints imposed by small sizes of their economies and poorly developed transportation infrastructure of the region.

In the early 1990s there have been made few attempts to form an integration grouping in the region of Central Asia. In June 1990, all five republics of Central Asia (at that time still within the Soviet Union) signed an agreement on regulation of economic integration processes in the region. Later on, by 1993, Kazakhstan, the Kyrgyz Republic and Uzbekistan founded a Central Asian Union (CAU), which envisaged, among other things, a creation of a single regional market along with governing structures. By the end of the 1990s with Tajikistan's accession, the grouping was renamed the Central Asian Economic Community (CAEC). In 1999, Uzbekistan was accepted as a member and the grouping was renamed the Central Asian Cooperation Organization (CACO). With Russia's membership in 2004, the organization seized its operation as a regional one. Afterwards, as Uzbekistan attained its membership in EAEC, a process of merger was launched.

Other Initiatives

Besides the groupings described above, Kazakhstan, the Kyrgyz Republic, Uzbekistan and Tajikistan have been taking part in a number of other regional initiatives, which in their scope were wider. Among them is the Central Asia Regional Economic Cooperation (CAREC), which also include members such as Azerbaijan, Mongolia and Xinjiang Uygur Autonomous Region of China. It aims at fostering economic integration of the region through trade facilitation and development of the regional transport network.

In addition, the Central Asian countries along with China and Russia established the Shanghai Cooperation Organization (SCO). Initially its objectives included settling border disputes and facilitation of the regional trade. Afterwards, an element of security was brought in scope of issues covered. All Central Asian countries are also members of the Economic Cooperation Organization (ECO). It was established in 1992 and includes countries adjacent to the region of Central Asia such as Turkey, Iran, Pakistan, Afghanistan and Azerbaijan.

6.2.2 Attained progress, potentials and policy implications

Despite numerous attempts to foster integration within the region through establishing integration groupings, thus far they have not proved efficient enough and, therefore, no significant achievements have been attained yet. An array of closely interrelated factors have precluded from attaining intended goals of integration endeavors in the region.

The lack of progress might be attributed, among other things, to a relatively low degree of complementarity in their production structure, what is well reflected in their given revealed comparative advantage. Most of the Central Asian economies' export revenues stem from a few relatively easily marketable commodities (e.g. mineral products, precious metals, cotton fiber and the like) (See Tables 4.1, 4.6, 4.11 of Chapter 4). Their imports are primarily made up by capital and consumer products originating from other regions of the world[27] (Pomfret, 2000b).

It may be inferred that their currently prevalent trade profiles leave few options for fostering trade at the regional level between the region's economies. Moreover, going in line with their initial nation-building activities throughout the 1990s, most of the regional integration initiatives were primarily motivated, as it turned out, by political considerations rather than economic rationale (Pomfret, 2003a). Redundant in their numbers, trade arrangements of the region's economies were often overlapping and contradicting in their character and scope. Such an abundance of trade agreements in the region, resembling a 'spaghetti bowl'– to use a term proposed by Bhagwati[28] – has discouraged further trade developments in the region.

Furthermore, volumes of trade conducted both beyond and within the region are considerably constrained by high transportation costs (Grafe et al, 2005). These are the result of not only remoteness of the region from sea ports and complex relief but also of a poor state of its transportation infrastructure. In addition, much longer transportation times are to be taken into consideration (Lücke and Rothert, 2006; Babetski et al, 2003). The scale of regional trade is also limited by a presence of the so called man-made trade barriers along the borders of the countries of Central Asia. For instance, Uzbekistan, located in the middle of the region, due to its isolationist trade policies substantially decreases potential benefits from increased trade turnover in the region.

[27] Spechler (2000) has even dubbed a foreign trade strategy of the Central Asian economies 'export globalism', which implied expanded exports of minerals and imports of capital and consumer products with no priority given to any trading partner through participation in RTAs.
[28] For details see Bhagwati and Panagariya (1996).

The viability and feasibility of the integration options, discussed earlier, were to a large extent determined by existing along with potentially attainable comparative advantage of the region's economies. Deriving from the region's affluent endowment with natural resources, it may be inferred that its comparative advantage is in resource-intensive production activities.

Such patterns of foreign trade could point to the path of further export expansion strategies for the economies of the region (Lücke and Rothert, 2006). Further expansion of exports is attainable by all economies of the region without incurring losses from unfavorable price movements caused by the expansion of their exports, since their export flows are still insignificant and compete merely against each other in international markets.

However, current comparative advantage and foreign trade patterns do not seem to be an optimal option for the long-run economic growth and development of the region. They are not capable of absorbing previously released labor force, as a result of the undergone transformation and contracted industrial sector in each republic's economy. Therefore, a high reliance on exports of primary commodities is no viable alternative, if the economies are to attain sustainable growth rates. It may be suggested that this objective is realizable through development of labor-intensive productions. In view of still reasonably high level of human capital (when compared with other economies of the same income groups[29]), the economies of Central Asia exhibit substantial potentials in low-tech and labor-intensive production activities (e.g. less sophisticated manufacturing, light industry, etc.)

There exist significant potentials for establishing capacities in production of certain products, which are imported into the region but could be produced within it (Bétemps, 2002). These production potentials are revealed from the Central Asian economies' export capacities and the region's demand absorption. For instance, the sector of agricultural products and food processing, textile and chemical and steel industries are to be included into the category of production activities that exhibit high potentials for the region.

[29] By 2006, Kazakhstan and Turkmenistan, classified as low-middle income countries, exhibited literacy rates of population (aged over 15) equal to 100 percent and 99 percent, respectively. This rate was 99 percent in the Kyrgyz Republic, Tajikistan and Uzbekistan, which are classified as low income economies (Source: World Bank).

Lücke and Rothert (2006) point out two possible paths for implementing initial stages in the establishment of industrial capacities in the region. The first one implies that the economies of Central Asia, being resource abundant, may aspire to integrate into vertical schemes of value added chains of Western European economies, while specializing primarily in upstream activities. The second one envisages establishing production capacities for processing currently exported items (i.e. raw materials and commodities). This option goes in line with the scheme of climbing up the technology ladder (e.g. refining of oil and gas, further processing of cotton yarn along with an expansion of the textile industry). Both paths seem hardly realizable due to rather significant spatial remoteness[30] and, hence, high transport costs and low productivity levels (in the case of the first option) and lack of required expertise in operating and managing such production facilities (in the case of the second option). The region of Eastern Europe is much better placed in both terms, when compared with that of Central Asia.

The endeavor of launching new kinds of production would naturally imply a well managed combination of export orientation and import substitution strategies aimed at satisfying the needs of region's economies. Such newly created production capacities would imply lower costs stemming from economies of scale and, therefore, higher demand for local production, certainly all other things being constant.

Additionally, products of these industrial capacities might be marketed in the countries of South-Asia (e.g. Afghanistan, Pakistan, etc.), which due to the lack of skills cannot produce certain demanded products and have to import them from somewhere else. These are often supplied by international aid agencies, which could induce further development in the region by redirecting their procurement schemes in favor of Central Asian producers.

Transport and Transit

The objective of developing new or restoring lost industries will be attained even more easily, provided transport infrastructure of the region will become one of the main pillars of such a development strategy. Against this background, Kazakhstan's recent economic revival in part confirm propositions of the 'staples thesis', in which special attention is paid to the importance of transportation in the process of economic development.

[30] For instance, the distances from Brussels to the Central Asian countries range from 4414 km (Turkmenistan) to 5218 km (the Kyrgyz Republic). For details see Table 2.1, p. 40.

In this context the region of Central Asia could substantially increase the volume of trade by improving capacities of the transport infrastructure and reducing impediments. Especially the smaller economies of the region (the Kyrgyz Republic, Tajikistan and in part Turkmenistan) are to benefit greatly from expanded trade. Potentials are rather significant. Raiser and de Tray (2006) show on the example of Uzbekistan that it is currently under-trading even with its neighbors because of its restrictive trade policies. Moreover, the larger economies would be able to reap substantial benefits from transit of traded items. Despite being double-landlocked,[31] Uzbekistan could substantially benefit from providing transit opportunities for adjacently located economies due to its less complicated topography. Potential benefits are not attainable due to its currently pursued policies of economic self-sufficiency and import substitution.

Thus, an emergence of new industries and development of the regional transport networks, going hand in hand, would enable to increase complementarity of the economies of Central Asia and induce trade within the region. This in turn would necessitate an appropriate regional coordination of activities in manufacturing investment and imply an easier transfer of capital across the economies of the region. These aspirations to tighter regional cooperation and economic integration are to be synchronized with further economic reforms in the countries that lag behind. State deregulation and fostering competition would induce the newly emerged producers to increase their productivity.

The above mentioned implies the necessity for harmonization of trade and related regulatory framework. The economies currently lagging behind are to catch up with the more advanced economies. The appropriate set of policies would significantly influence the institutions and induce regional cooperation and trade, which are of great relevance for the region's long-term economic development.

Institutional Harmonization

The process of unification of the institutional framework could be considerably eased if there were supranational institutions. These would be needed to limit sovereign attempts to protect domestic stagnant industries from the outside competition. The experience of the EU evidently demonstrates that, once created, supranational institutions may catalyze integration processes in the region and encourage further economic transformation.

A large number of already established integration groupings have their governing bodies, whose resolutions are optional rather than compulsory. In this context, Starr

[31] This means that each of its neighboring countries is itself land-locked.

(2004) emphasizes the central role of ‘mutual trust and political will’ for the successful outcome of economic integration in the region. These two constituents will determine how successfully the region will cope with its rather unfavorable geographic location implying high transport costs and seeking complementarity elements for integration of the economies.

Summary

This chapter focused on the role of economic integration in the development of small (to different extent) open economies of the Baltics and Central Asia. Integration experiences of the Baltics and Central Asia, taken as economic regions, point to, among other aspects, differently viable integration modes under their given conditions (geography and institutions).

The Baltics’ integration into the world trading system has been dominated by its integration with other EU economies. In this course initial regional trade arrangements have given way to deeper integration, which in part has been achieved through their accession to the EU. This integration entails considerable gains for both newly acceded Baltic countries and incumbents of the EU, part of which, mainly static ones, has been already accrued. The more considerable gains, however, are of dynamic nature; their attainment will depend upon further developments, not least in the trade sector of the Baltic economies.

Central Asia’s integration experience is in stark contrast to that of the Baltics. Having diverged significantly in terms of pursued policies, currently the economies of Central Asia exhibit seemingly small degree of complementarity due to their relatively similar comparative advantage (resource-intensive productions), what in conjunction with the region’s landlocked geographical location and underdeveloped transport infrastructure could explain the lack of progress in economic integration of and in the region. However, potential gains from trade expansion and further opportunities for production capacities point to an expediency and obvious rationale for an appropriate combination of integration at both levels – within the region and beyond it.

Conclusion

Currently enduring income gaps across countries and regions result from differing growth rates attained by their economies. Even though being negligible in terms of their annual increments, a difference in growth rates may produce over longer periods of time substantial discrepancies in income distribution and living standards across countries. Therefore, growth and development issues have constantly attracted increased attention of scholars who have produced over time an impressive amount of works devoted to the mechanics of growth and development across nations.

The bedrock of the modern growth theory is based upon a set of basic notions, each of which is stressed by one or another currently prevailing theoretical approach. For instance, the neoclassical model of growth pays particular attention to the importance of accumulation of production factors (Solow, 1956), theories of endogenous growth emphasize an innate trait of technological progress and a significant role that human resources play in the growth process (Romer, 1986; Lucas, 1988; Aghion and Howitt, 1998), presently institutional and geographical dimensions as fundamental determinants of growth start getting more and more attention (Acemoglu et al, 2002; Acemoglu, 2003). Therefore, while explaining differences in growth rates, one has to accentuate the essentials such as accumulation of production factors such as labor, human and physical capital, productivity determined by a combination of technology and efficiency, and fundamentals represented by geography and institutions.

In addition to the above mentioned aspects of economic growth, an element of openness of economies should be taken into consideration, since economies of today are tightly interlinked with each other in form of international trade along with an exchange of factors of production. This circumstance implies that an economy's growth dynamics may be influenced by a set of external factors depending on its openness degree.

Trade in goods and services, being one of the two forms of openness, entails certain gains to be accrued by trading countries (Weil, 2005). These gains may stem from static or dynamic effects and are apt to bring about increased welfare for integrating economies (Baldwin, 1997). In addition, trade may provide an essential outlet for an economy's output and trigger its development by bringing about further structural changes. This was the case in most currently industrialized economies. Thereby, as a rule, to prove successful, the very process of industrialization necessitates an appropriate combination of export promotion and import substitution strategies.

Furthermore, in the context of openness to trade, the process of economic development entails an array of issues related, for instance, to the role of institutions and natural resources. In accordance with the staples thesis' considerations, resources may prove an additional source for financing further development of infrastructure required for sustaining growth. In this case the importance of proper institutions is to be stressed, since otherwise revenues stemming from exports of resource-intensive items is not apt to maintain an appropriate framework.

Another form of openness implies an exchange of factors of production – labor and human resources, physical capital along with technology and knowledge (Weil, 2005). Moving across economies, they change their stocks of available inputs and, hence, influence growth and further development patterns.

The above mentioned aspects of growth and development came to the fore anew as the countries of Central and Eastern Europe and the Former Soviet Union embarked on their transition paths in the early 1990s. The countries of both groups, despite exhibiting certain resemblances in the way of running their economies, differed noticeably from each other in many respects before the onset of transition. These differences encompassed their income and productivity levels, stocks of available inputs, their endowment with natural resources, geographical location, etc. Not least due to their contrasting starting conditions combined with differing transition paths taken and reform strategies adopted, the countries' performance differed significantly, as regards their output recovery and attained growth rates (Campos and Coricelli, 2000; Havrylyshyn and Nsouli, 2001).

Throughout the early 1990s, liberalization along with stabilization measures were to give way to a sequence of reforms aimed at establishing market institutions. Simultaneously, there occurred substantial changes in terms of their economic structure and make-up of trade flows, reflecting their newly modified participation in the regional and international division of labor. In line with their at that time given comparative advantage, the CEE economies specialized prevalently in labor-intensive manufacturing, while the CIS had to focus on resource-intensive production. Such changes in the patterns of their economic links are also well reflected in their present foreign trade profiles (Kandogan, 2003a, 2003b, 2004) and foreign investment they attract (Tøndel, 2001; Campos and Kinoshita, 2003).

When compared with the CIS countries, on the whole, the economies of Central and Eastern Europe have been more successful, as regards, for instance, the scope and tempo of output recovery, trade and foreign investment performance. These differences my be attributed to an array of factors, which roughly could be broken down into main economic fundamentals – geography and institutions (both meant in their broader terms). Each transition economy's performance was to a certain extent determined by a set of inputs (stocks of physical and human capital along with technologies employed) and influenced by their 'geographical conditions' (e.g. proximity to rich economies with substantial potentials for exports and attracting foreign investment) and institutions (e.g. reform perceptibility with germane to it reform strategies, legal and institutional framework).

Resembling contrasting regions of CEE and the CIS, the Baltics and Central Asia would prove rather dissimilar regions, which were formerly integral parts of the Soviet economy. The Baltic economies, despite numerous inherited drawbacks and relatively poor starting conditions (when compared with other CEE economies), have undergone substantial changes in the course of transition since the early 1990s. During initial stages of their transition they had to incur large economic and social costs (i.e. output contraction and high unemployment rates). However, through comprehensively implemented reforms they managed to install new economic structures, based on market principles, instead of their old ones.

A swift economic recovery of the Baltic economies from the mid-1990s onwards has been due to a reallocation of existing inputs, i.e. increases in efficiency as a result of their economic restructuring (Blanchard, 1997). Thus, further growth of their economies will depend on how successfully they develop and upgrade their existing factors of production and employ advanced technologies.

The experience of the Central Asian economies has been somewhat different from that of the Baltic economies. In the early 1990s the newly established economies of Central Asia had to embark upon their economic transformation with rather different starting conditions. Having much in common, these economies were yet dissimilar in many aspects, which in turn, to a certain extent, influenced their further developments. Like other transition economies of the Former Soviet Union, the Central Asian countries had to experience substantial output contractions entailing high social costs. However, across the region the scope of these contractions varied considerably.

In terms of their approach to the reforms, they were quite different. While Kazakhstan and the Kyrgyz Republic opted for a more radical approach in reforming their economies, Uzbekistan adhered to a gradual strategy. Tajikistan's transition was hampered by its civil war, whereas Turkmenistan abstained from reforms altogether (Pomfret, 2000b). Accordingly, their accomplishments and reform records throughout the transition process differed substantially (Pomfret, 2003b). Their output levels have started to rebound from the end of the 1990s, not least due to favorable price developments and sustainable demand for their resource-intensive exportables.

Throughout their transition the Baltic economies saw their foreign trade and investment patterns change considerably as regards their geography and sectoral composition. Despite a few differences, on the whole, this transformation of trade and investment patterns across the three Baltic economies has been more or less uniform. While yet retaining few of their pre-transition trade links, they have managed to expand economic links with Western Europe, what has substantially contributed to the recovery of their output levels and triggered the catch-up process (Fabrizio et al, 2006).

Encouraged through trade arrangements, a swift reorientation towards Western European markets has eased further implementation of restructuring of their economies (Lücke, 2006). Expanded exports to Western markets have been complemented by substantial capital inflows of various types, among which FDI have become increasingly significant in terms of their shares in total volumes of capital inflows. Sectoral and geographical distribution patterns of attracted FDI very much resembles those of their foreign trade. The common feature of all Baltic economies is that inflow is substantially greater than outflow, since the economies are not mature and setting on their development (Lutz, 2006).

Appropriate alterations in their regulatory framework, foreign exchange policies, trade regime, etc. have accompanied this relatively rapid reorientation. For the most part, such changes have been implemented in the wake of the EU accession preparations implying general harmonization of their institutional frame's constituents. In spite of their accomplishments, the Baltic economies will have to further their economic transformation by upgrading the exports' structural composition, if stable growth rates are to be sustained further.

In the case of the economies of Central Asia, there have been notable changes as well, as far as their trade and foreign investment patterns are concerned. This fact re-

flects their new position in the international labor division, which has been in part starkly modified in line with their currently given comparative advantage. The three economies of Central Asia (Kazakhstan, the Kyrgyz Republic and Uzbekistan) have proved rather heterogeneous in many respects, what may be attributed to various and, often, interrelated factors (e.g. initial economic structure, transition mode, attained reform progress, etc). Consequently, their trade performance varied notably in part due to differing endowment with natural resources which could attract substantial investments and be a base of increasing exports. Different approaches taken by these economies towards the mode of economic restructuring can serve as another reason explaining differences in their trade performance and activities aimed at attracting foreign investment.

Their recently modified trade and foreign investment patterns depict significant changes in terms of their geographical distribution and structural composition. This vividly reveals noteworthy shifts in their economic structures, which imply they are induced to expand their exports, prevalently composed of primary commodities, to be able to sustain required imports of capital and consumer goods. These changes have been accompanied by further appropriate alterations in their regulatory frameworks, foreign exchange policies, trade regime, etc. The alterations have differed across the three considered economies substantially, since Uzbekistan lags behind, when compared with Kazakhstan and the Kyrgyz Republic. The economies of Central Asia, currently on different development paths, will have to undergo further restructuring and upgrade their exports if sustainable growth rates are to be maintained.

In view of a certain correspondence between an economy's structural composition and trade flows, it might be suggested that its growth dynamics is closely related to its external sector's developments. Therefore, it might be inferred that observed differences in growth rates within and across these two regions – the Baltics and Central Asia – may be in part attributed to the differences in their trade and foreign investment behaviors.

To determine the extent, to which economic growth in the economies of both regions is influenced by external factors, the 'balance of payments constrained growth' (BPCG) framework has been employed. Initially proposed by Thirlwall (1979) and later enhanced by Thirlwall and Hussain (1982) to include an element of capital inflows, this theoretical framework enables to link an economy's external sector developments with its growth dynamics.

Generally, in line with the propositions of the BPCG framework, an economy may increase its growth rates by expanding its exports (e.g. export promotion), or depressing its imports (e.g. import substitution) or both. What is more, its growth may be further increased by attracted capital from abroad, which would enable to increase its importing and consuming capacities.

Therefore, it may be hypothesized that differences in growth performance across the economies of the two regions may attributed to their differently setup trade behaviors. While complementing other approaches towards explaining growth differences across the economies (e.g. Iradian, 2007) and emphasizing the demand side, the framework is supposed to deliver on explaining growth differences between the economies of the Baltics and Central Asia.

Both versions of Thirlwall's law have been employed to determine contributions of external factors into growth of the economies in question. Omitting redundant details, it is worth mentioning essential points. The basic version of the dynamic Harrod multiplier, which primarily focuses on exports dynamics and import necessities of an economy, has produced better fitting for the economies of Latvia, Lithuania and Uzbekistan. The framework's extended version, which in addition introduces elements of capital flows and relative price developments, has performed well in the cases of Estonia, Kazakhstan and the Kyrgyz Republic.

Despite some minor discrepancies caused by statistical inconsistencies, the extended version enables to look closer at constituents of growth – relative price developments, growth of exports' physical volumes and capital inflows – of the countries. On the whole it may inferred that a better growth performance of certain economies in both regions may be explained by higher values of a composite of the above mentioned growth constituents. Thus, compared to those of Central Asia, the Baltic economies' higher growth rates may be due to high growth rates of their exports, favorable price developments for their exportables and substantial amounts of capital attracted from abroad. Furthermore, larger values of contributions of terms of trade and exports growth in the Baltic economies along with capital inflows may in part result from their specialization in the production and exports of more sophisticated products compared with the production and trade profiles of the Central Asian economies.

Notwithstanding numerous common features, the two regions in question have proved rather heterogeneous. Within the Baltics, Estonia has been thus far more suc-

cessful than its neighbors, not least due to occurred structural upgrade of its exports, growth of their physical volumes and rather substantial amounts of attracted FDI. Despite rather high growth rates of exports and substantial capital inflows, Latvia's more moderate growth performance may be explained, among other things, through unfavorable terms-of-trade developments in view of structural downgrade of its export profile. In spite of retaining its export profile and rather high exports growth throughout transition period, Lithuania's rather moderate growth performance may be ascribed to low values of capital inflows' contribution.

Turning to the region of Central Asia, the following should be emphasized. Kazakhstan's growth has been primarily based on its exports growth, while contributions of capital inflows and terms of trade throughout the considered period have proved rather negligible. Quite moderate growth rates observed in the Kyrgyz Republic may be attributed to insufficiently high growth of exports and unfavorable terms-of-trade developments. Additionally its further growth prospects are likely to be constrained in view of its accumulated debt as a result of high reliance upon debt-creating capital inflows. While being modest in its rates, Uzbekistan's growth has been primarily caused by moderate exports growth. The contributions of capital inflows along with relative price developments have been by far less than in other considered countries.

In addition, the BPCG framework, being a multipurpose platform, might be applied while considering economic issues other than the one on contribution of external factors into economic growth. For instance, in the context of the economies of the Baltics and Central Asia, it may be employed when scrutinizing an array of matters related, for instance, to the 'Dutch disease' phenomenon (e.g. Kazakhstan), indebtedness of an economy and its further growth perspectives (e.g. the Kyrgyz Republic), import substitution policies and development (e.g. Uzbekistan), retaining the competitive edge of an economy in view fixed exchange rates (e.g. the Baltic economies).

It seems clear that in order to maintain sufficient growth rates in the long-run perspective, all economies in question will have to upgrade their exports' composition. Among the Baltic economies, Estonia seems to have achieved some progress in this regard. The other two will have to climb up the technology ladder if they are to retain their competitive edge. The very task would prove rather difficult in view of rapidly rising wages in the Baltic economies. In their turn, the economies of the Central Asian region will have to diversify their exports, if they intend to attain sustainable growth

rates in the long run. Currently dominated by a handful of primary goods, their exports remain subject to price volatilities and are not likely to secure stable revenues needed to cover their import costs in the long-run perspective.

Structural transformation of the economies of the Baltics and Central Asia would imply certainly appropriate changes in the makeup of their trade flows. Throughout transition this has been observed in each economy under consideration. In the context of open economies, these changes may be brought about in a more swift manner by making the most of opportunities stemming from overseas markets. In this respect, the Baltic economies have benefited from their closer integration with Western Europe. In contrast, the economies of Central Asia have not managed thus far to utilize potentials, which integration opportunities might offer.

While considering external determinants of growth in the transition economies of both regions, it is worthwhile to pay closer attention to their integration paths, which are supposed to have influenced further developments of the economies. Comparing the Baltics and Central Asia in these terms, it becomes evident that a better growth performance of the former is to be attributed to its rather swift economic integration with the economies of Western Europe.

Generally, the Baltics' integration into the world trading system since the early 1990s has been dominated by its integration into the European regional division of labor. In view of spatial proximity of the Baltics to the richer economies of Western Europe and, hence, rather low transport costs, the economies of the Baltic region have been absorbed by their richer vis-à-vis. This is well reflected in the changed patterns of their foreign trade and investment.

Their integration is supposed to have brought numerous benefits for both the Baltics and the EU incumbent members. The benefits, accrued thus far, have stemmed predominantly from integration's static effects. The scope of accruable gains originating from dynamic effects is likely to be considerably wider. With their accession to the EU in 2004, the Baltic economies are going to further adjust their institutional frameworks. This process is supposed to facilitate their economies' further integration into the EU structures.

In stark contrast to the Baltic countries, the economies of the Central Asian region, in view of their remote and landlocked location, were confronted with manifold opportunities of integration into the world economy. The region's economies, differing

from each other in many respects, exhibited low degree of complementarity, as regards their production structures, at the outset of the 1990s. This common feature along with underdeveloped transport infrastructure of the region may serve as explanations for the lack of progress in integration within the region.

Taking into consideration high transport costs, an option of intraregional economic integration seems in the long run the most viable (Lücke and Rothert, 2006) compared with the thus far pursued strategy of export globalism (Spechler 2000). Such economic integration within the region could be initiated in the transport sector, which may facilitate creation of further production opportunities and, therefore, lay foundations for gradual climb up the technology ladder. Financed through earnings stemming from export activities of primary commodities, new production capacities might be established in line with the comparative advantage of the countries within the region.

Integration experiences of the Baltics and Central Asia, taken as economic regions, point to differently viable integration modes under their given conditions. In addition this comparison enables to reveal factors determining success (or failure) of an integration initiative. Taken in a broad sense these factors might be embraced by just two categories – geography (proximity to lucrative markets, size of an economy and the like), and institutions (type of pursued policies, regulatory frame, etc.).

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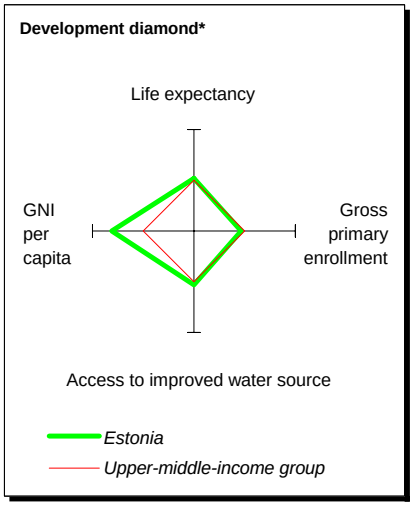
Annex 1: Estonia at a glance

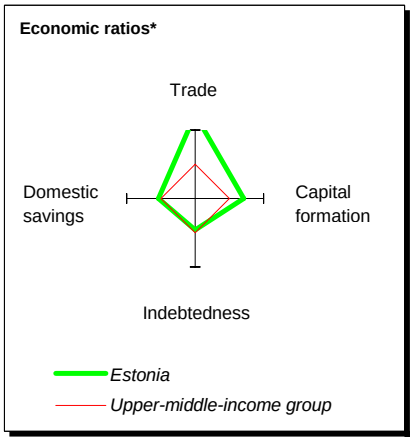
POVERTY and SOCIAL	Estonia	Europe & Central Asia	Upper-middle-income
2005			
Population, mid-year *(millions)*	1.3	473	599
GNI per capita *(Atlas method, US$)*	9,100	4,113	5,625
GNI *(Atlas method, US$ billions)*	12.2	1,945	3,368
Average annual growth, 1999-05			
Population *(%)*	-0.4	0.0	0.6
Labor force *(%)*	-0.2	0.6	1.2
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	69	64	72
Life expectancy at birth *(years)*	72	69	69
Infant mortality *(per 1,000 live births)*	6	28	23
Child malnutrition *(% of children under 5)*	..	5	7
Access to an improved water source *(% of population)*	100	92	94
Literacy *(% of population age 15+)*	100	97	94
Gross primary enrollment *(% of school-age population)*	100	104	107
Male	101	105	108
Female	98	102	106



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

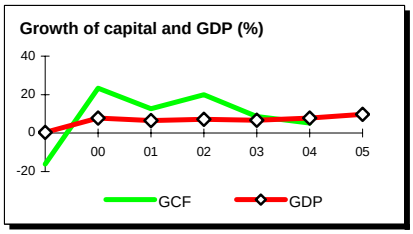
	1985	1995	2004	2005
GDP *(US$ billions)*	..	4.3	11.2	13.1
Gross capital formation/GDP	..	26.6	31.2	..
Exports of goods and services/GDP	..	68.5	78.4	..
Gross domestic savings/GDP	..	19.0	23.5	..
Gross national savings/GDP	..	22.5	18.7	..
Current account balance/GDP	..	-3.6	-12.7	-5.3
Interest payments/GDP	..	0.2	2.2	..
Total debt/GDP	..	6.6	89.1	..
Total debt service/exports	..	0.8	15.7	..
Present value of debt/GDP	..	..	85.3	..
Present value of debt/exports	..	..	103.7	..

	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	-4.6	6.3	7.8	9.8	..
GDP per capita	-4.0	6.9	8.2	10.1	..
Exports of goods and services	..	9.9	16.0	..	..

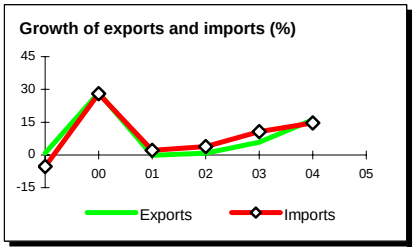


STRUCTURE of the ECONOMY

	1985	1995	2004	2005
(% of GDP)				
Agriculture	..	8.0	4.3	..
Industry	..	29.3	28.8	..
Manufacturing	..	17.9	18.4	..
Services	..	62.7	66.9	..
Household final consumption expenditure	..	53.6	57.5	..
General gov't final consumption expenditure	..	27.4	19.0	..
Imports of goods and services	..	76.1	86.1	..



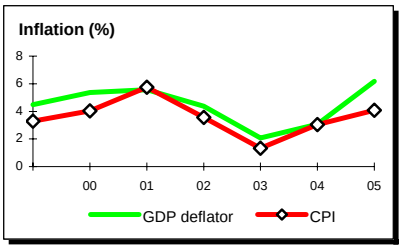
	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	-9.4	-1.3	1.6	..
Industry	-13.6	7.5	9.0	..
Manufacturing	..	9.0	10.7	..
Services	-2.0	5.9	7.2	..
Household final consumption expenditure	-5.8	6.6	9.0	..
General gov't final consumption expenditure	4.5	2.6	6.9	..
Gross capital formation	-13.5	9.7	5.2	..
Imports of goods and services	..	10.3	14.6	..



* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

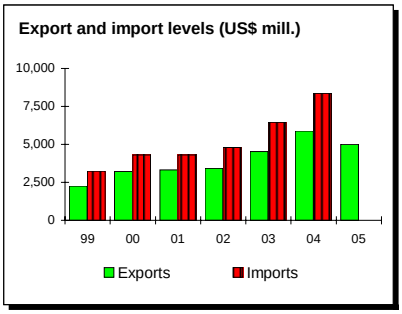
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	28.8	3.0	4.1
Implicit GDP deflator	-5.6	31.4	3.1	6.2
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	38.6	39.0	32.6
Current budget balance	..	3.6	4.8	3.7
Overall surplus/deficit	..	0.4	1.9	-0.4



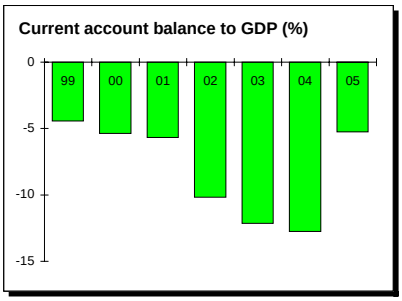
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	1,661	5,880	5,002
Food	..	272	450	362
Minerals	..	108	269	127
Manufactures	..	1,282	5,161	4,513
Total imports (cif)	..	2,394	8,360	..
Food	..	361	770	..
Fuel and energy	..	292	578	2,489
Capital goods	..	750	2,515	2,481
Export price index *(2000=100)*	..	76	144	146
Import price index *(2000=100)*	..	..	99	113
Terms of trade *(2000=100)*	..	..	145	129



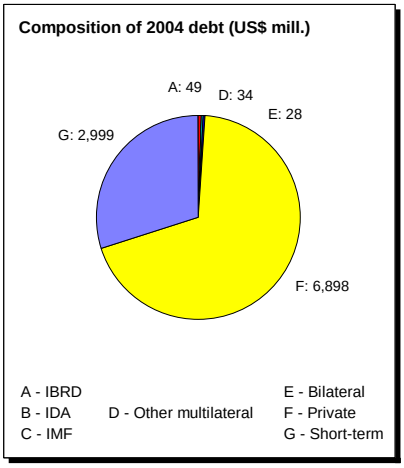
BALANCE of PAYMENTS

	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	..	2,574	8,795	8,061
Imports of goods and services	..	2,861	9,675	8,482
Resource balance	..	-287	-880	-422
Net income	..	3	-718	-457
Net current transfers	..	126	166	190
Current account balance	..	-158	-1,432	-688
Financing items (net)	..	264	1,711	776
Changes in net reserves	..	-106	-280	-88
Memo:				
Reserves including gold *(US$ millions)*	..	583	1,796	1,780
Conversion rate *(DEC, local/US$)*	..	9.9	12.6	12.6



EXTERNAL DEBT and RESOURCE FLOWS

	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	..	286	10,008	..
IBRD	..	50	49	38
IDA	..	0	0	0
Total debt service	..	21	1,451	..
IBRD	..	3	6	7
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	20	120	..
Official creditors	..	45	-6	..
Private creditors	..	-1	2,427	..
Foreign direct investment (net inflows)	..	201	1,049	..
Portfolio equity (net inflows)	..	10	176	..
World Bank program				
Commitments	..	20	0	..
Disbursements	..	18	0	0
Principal repayments	..	0	4	5
Net flows	..	18	-4	-5
Interest payments	..	3	2	2
Net transfers	..	16	-6	-7

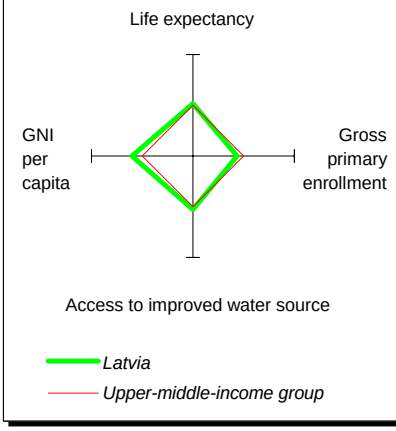


Source: World Bank

Annex 2: Latvia at a glance

POVERTY and SOCIAL	Latvia	Europe & Central Asia	Upper-middle-income
2005			
Population, mid-year *(millions)*	2.3	473	599
GNI per capita *(Atlas method, US$)*	6,760	4,113	5,625
GNI *(Atlas method, US$ billions)*	15.5	1,945	3,368
Average annual growth, 1999-05			
Population *(%)*	-0.6	0.0	0.6
Labor force *(%)*	-0.4	0.6	1.2
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	68	64	72
Life expectancy at birth *(years)*	71	69	69
Infant mortality *(per 1,000 live births)*	10	28	23
Child malnutrition *(% of children under 5)*	..	5	7
Access to an improved water source *(% of population)*	99	92	94
Literacy *(% of population age 15+)*	100	97	94
Gross primary enrollment *(% of school-age population)*	93	104	107
Male	94	105	108
Female	91	102	106

Development diamond*

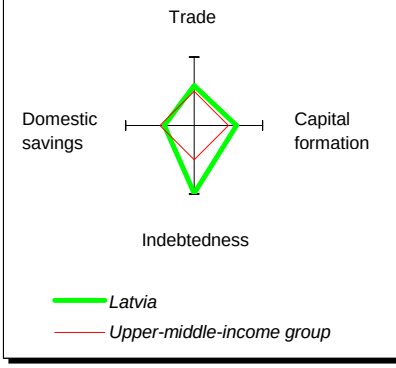


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1985	1995	2004	2005
GDP *(US$ billions)*	..	5.2	13.7	15.8
Gross capital formation/GDP	35.4	14.3	32.5	27.1
Exports of goods and services/GDP	..	42.7	44.1	35.0
Gross domestic savings/GDP	35.3	12.1	16.9	19.2
Gross national savings/GDP	..	13.9	14.7	18.3
Current account balance/GDP	..	-0.4	-8.8	-7.4
Interest payments/GDP	..	0.3	0.9	..
Total debt/GDP	..	8.8	92.3	..
Total debt service/exports	..	1.6	24.8	..
Present value of debt/GDP	..	..	90.7	..
Present value of debt/exports	..	..	224.2	..

	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	-6.5	6.8	8.5	10.2	6.0
GDP per capita	-6.1	7.7	9.1	10.8	6.8
Exports of goods and services	..	6.4	9.3	7.5	7.5

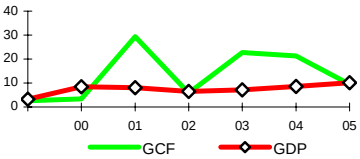
Economic ratios*



STRUCTURE of the ECONOMY

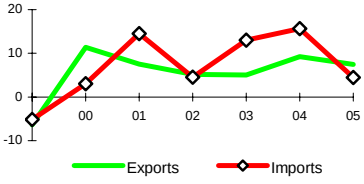
	1985	1995	2004	2005
(% of GDP)				
Agriculture	21.6	9.0	4.1	..
Industry	43.2	29.8	22.6	..
Manufacturing	37.1	20.2	13.4	..
Services	35.2	61.2	73.3	..
Household final consumption expenditure	55.6	63.5	63.2	64.3
General gov't final consumption expenditure	9.0	24.4	19.9	16.5
Imports of goods and services	..	44.9	59.7	42.9

Growth of capital and GDP (%)



	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	-7.6	2.5	4.3	3.5
Industry	-12.1	6.6	8.9	..
Manufacturing	-9.9	6.7	7.8	..
Services	-1.3	7.1	8.7	..
Household final consumption expenditure	-9.8	6.5	9.6	5.0
General gov't final consumption expenditure	2.6	2.5	2.1	18.5
Gross capital formation	-20.2	16.8	21.3	9.5
Imports of goods and services	..	8.8	15.6	4.5

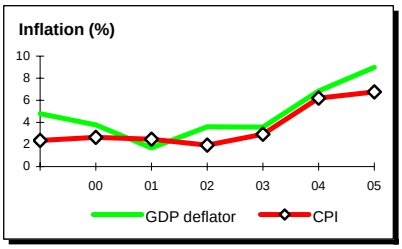
Growth of exports and imports (%)



* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

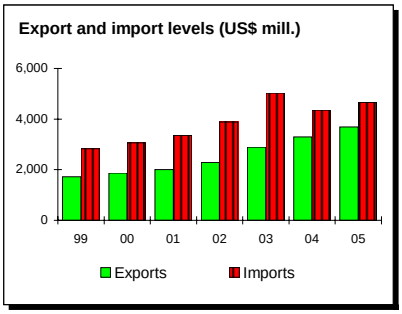
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	25.0	6.2	6.8
Implicit GDP deflator	-2.5	27.5	6.8	9.0
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	34.3	31.7	30.5
Current budget balance	..	-1.8	14.8	13.4
Overall surplus/deficit	..	-2.9	-1.4	-1.2



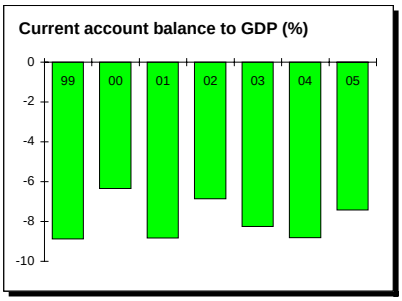
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	1,305	3,301	3,690
Commodity 1	..	..	..	..
Commodity 2	..	..	..	..
Manufactures	..	1,108	2,757	2,973
Total imports (cif)	..	1,749	4,356	4,654
Food	..	141	438	451
Fuel and energy	..	141	179	174
Capital goods	..	259	1,150	1,282
Export price index *(2000=100)*	..	98	115	119
Import price index *(2000=100)*	..	94	118	121
Terms of trade *(2000=100)*	..	104	97	98



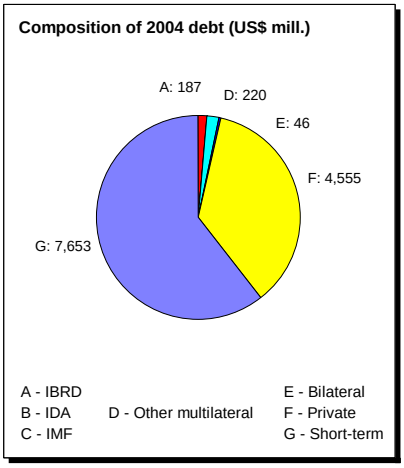
BALANCE of PAYMENTS

	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	..	2,087	5,098	5,670
Imports of goods and services	..	2,194	6,470	6,950
Resource balance	..	-108	-1,372	-1,280
Net income	..	19	186	78
Net current transfers	..	71	-24	30
Current account balance	..	-18	-1,210	-1,171
Financing items (net)	..	-14	995	1,279
Changes in net reserves	..	32	215	-108
Memo:				
Reserves including gold *(US$ millions)*	..	..	..	..
Conversion rate *(DEC, local/US$)*	..	0.5	0.5	0.6



EXTERNAL DEBT and RESOURCE FLOWS

	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	..	463	12,661	..
IBRD	..	55	187	111
IDA	..	0	0	0
Total debt service	..	34	1,375	..
IBRD	..	4	20	71
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	24	149	..
Official creditors	..	23	-252	..
Private creditors	..	46	1,633	..
Foreign direct investment (net inflows)	..	180	699	..
Portfolio equity (net inflows)	..	0	23	..
World Bank program				
Commitments	..	18	0	..
Disbursements	..	9	6	2
Principal repayments	..	0	14	64
Net flows	..	9	-8	-62
Interest payments	..	4	6	7
Net transfers	..	5	-14	-69

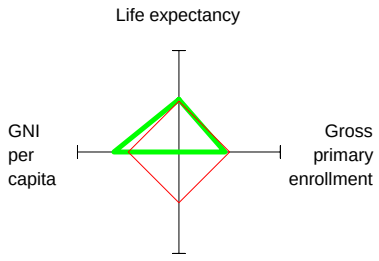


Source: World Bank

Annex 3: Lithuania at a glance

POVERTY and SOCIAL	Lithuania	Europe & Central Asia	Upper-middle-income
2005			
Population, mid-year *(millions)*	3.4	473	599
GNI per capita *(Atlas method, US$)*	7,210	4,113	5,625
GNI *(Atlas method, US$ billions)*	24.6	1,945	3,368
Average annual growth, 1999-05			
Population *(%)*	-0.6	0.0	0.6
Labor force *(%)*	-0.9	0.6	1.2
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	67	64	72
Life expectancy at birth *(years)*	72	69	69
Infant mortality *(per 1,000 live births)*	8	28	23
Child malnutrition *(% of children under 5)*	..	5	7
Access to an improved water source *(% of population)*	..	92	94
Literacy *(% of population age 15+)*	100	97	94
Gross primary enrollment *(% of school-age population)*	97	104	107
Male	98	105	108
Female	97	102	106

Development diamond*

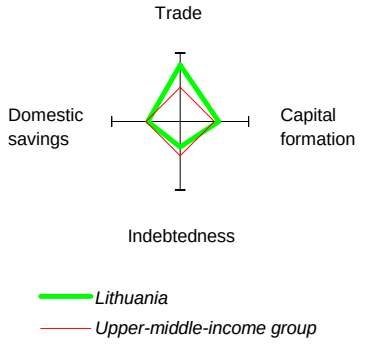


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1985	1995	2004	2005
GDP *(US$ billions)*	..	7.5	22.5	25.6
Gross capital formation/GDP	..	22.4	24.2	24.9
Exports of goods and services/GDP	..	49.9	52.3	52.9
Gross domestic savings/GDP	..	11.3	17.0	20.8
Gross national savings/GDP	..	12.8	15.8	21.7
Current account balance/GDP	..	-8.2	-5.8	-4.4
Interest payments/GDP	..	0.2	1.0	..
Total debt/GDP	..	10.3	42.2	..
Total debt service/exports	..	1.3	15.7	..
Present value of debt/GDP	..	..	42.3	..
Present value of debt/exports	..	..	84.7	..

	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	-12.0	5.6	7.0	7.5	6.0
GDP per capita	-11.6	6.3	7.6	8.1	6.3
Exports of goods and services	..	8.3	4.2	8.6	5.9

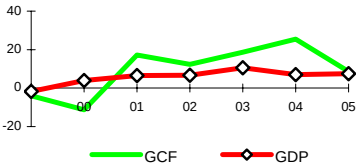
Economic ratios*



STRUCTURE of the ECONOMY

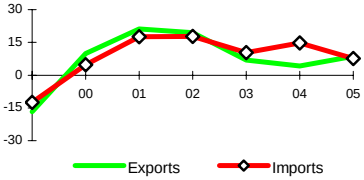
	1985	1995	2004	2005
(% of GDP)				
Agriculture	..	11.6	5.9	5.9
Industry	..	33.7	32.8	30.9
Manufacturing	..	20.6	20.8	19.2
Services	..	54.7	61.3	63.2
Household final consumption expenditure	..	66.8	65.1	62.0
General gov't final consumption expenditure	..	21.9	17.9	17.1
Imports of goods and services	..	61.0	59.4	57.5

Growth of capital and GDP (%)



	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	..	0.6	-0.7	4.0
Industry	..	6.3	8.8	7.0
Manufacturing	..	8.0	11.4	7.0
Services	..	5.9	6.8	5.6
Household final consumption expenditure	..	6.4	9.7	8.6
General gov't final consumption expenditure	..	1.9	7.5	-1.2
Gross capital formation	..	11.1	25.5	8.6
Imports of goods and services	..	9.6	14.8	7.6

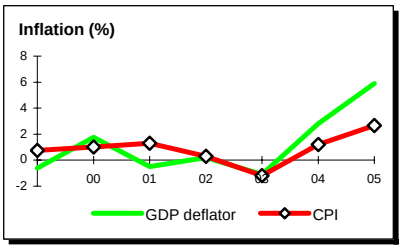
Growth of exports and imports (%)



* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

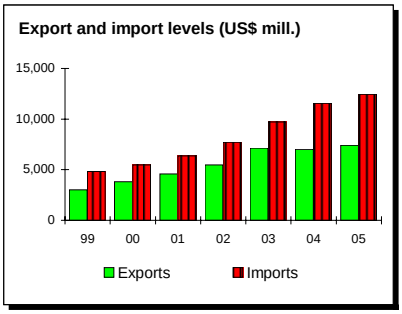
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	39.7	1.2	2.7
Implicit GDP deflator	..	46.4	2.8	5.9
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	28.2	29.3	28.3
Current budget balance	..	1.5	1.2	1.6
Overall surplus/deficit	..	-4.8	-2.2	-2.2



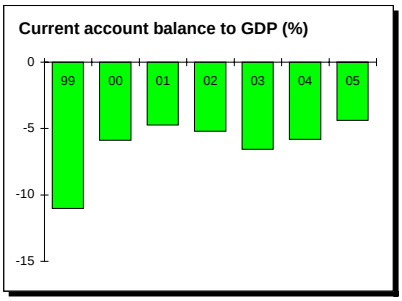
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	2,706	7,019	7,407
Mineral products	..	..	1,811	1,804
Agricultural products and food	..	..	1,024	1,243
Manufactures	..	..	2,504	2,284
Total imports (cif)	..	3,649	11,545	12,450
Food	..	..	578	616
Fuel and energy	..	..	769	581
Capital goods	..	491	2,765	3,365
Export price index *(2000=100)*	..	85	97	92
Import price index *(2000=100)*	..	100	97	97
Terms of trade *(2000=100)*	..	84	100	96



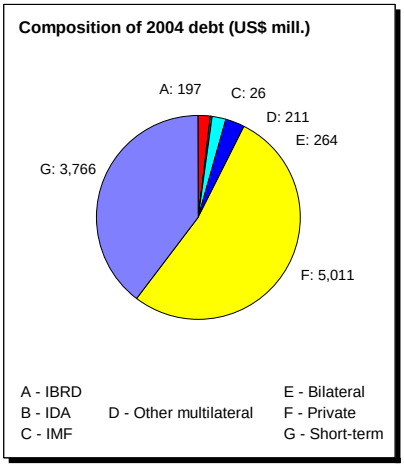
BALANCE of PAYMENTS

	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	..	3,191	10,994	11,643
Imports of goods and services	..	3,902	12,394	13,349
Resource balance	..	-711	-1,399	-1,705
Net income	..	-13	-234	-254
Net current transfers	..	109	330	835
Current account balance	..	-614	-1,303	-1,124
Financing items (net)	..	846	960	1,156
Changes in net reserves	..	-232	344	-31
Memo:				
Reserves including gold *(US$ millions)*	..	819	3,040	3,041
Conversion rate *(DEC, local/US$)*	..	3.4	2.8	2.8



EXTERNAL DEBT and RESOURCE FLOWS

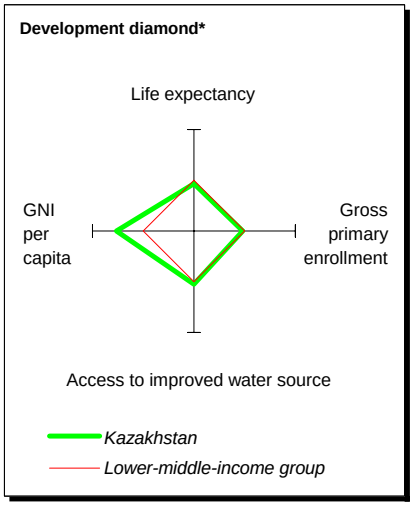
	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	..	770	9,475	..
IBRD	..	62	197	86
IDA	..	0	0	0
Total debt service	..	44	1,760	..
IBRD	..	4	129	126
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	18	237	..
Official creditors	..	89	-127	..
Private creditors	..	55	1,294	..
Foreign direct investment (net inflows)	..	73	773	..
Portfolio equity (net inflows)	..	6	8	..
World Bank program				
Commitments	..	58	0	..
Disbursements	..	12	22	14
Principal repayments	..	0	115	111
Net flows	..	12	-93	-97
Interest payments	..	4	14	15
Net transfers	..	9	-107	-113



Source: World Bank

Annex 4: Kazakhstan at a glance

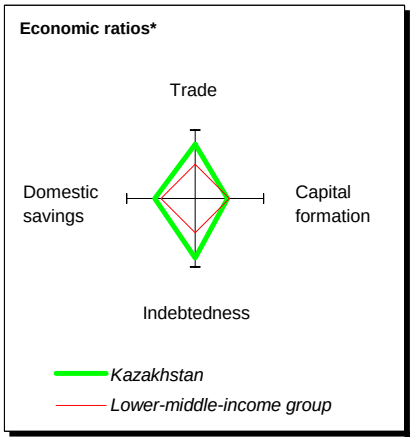
POVERTY and SOCIAL	Kazakhstan	Europe & Central Asia	Lower-middle-income
2005			
Population, mid-year *(millions)*	15.1	473	2,475
GNI per capita *(Atlas method, US$)*	2,930	4,113	1,918
GNI *(Atlas method, US$ billions)*	44.4	1,945	4,747
Average annual growth, 1999-05			
Population *(%)*	0.2	0.0	1.0
Labor force *(%)*	1.2	0.6	1.4
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	57	64	50
Life expectancy at birth *(years)*	65	69	70
Infant mortality *(per 1,000 live births)*	63	28	33
Child malnutrition *(% of children under 5)*	4	5	12
Access to an improved water source *(% of population)*	86	92	82
Literacy *(% of population age 15+)*	100	97	89
Gross primary enrollment *(% of school-age population)*	109	104	114
Male	110	105	115
Female	109	102	113



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

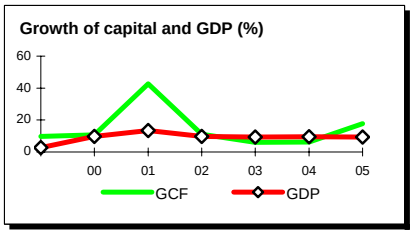
	1985	1995	2004	2005
GDP *(US$ billions)*	..	20.4	43.2	56.1
Gross capital formation/GDP	..	23.3	26.3	27.5
Exports of goods and services/GDP	..	39.0	52.2	54.5
Gross domestic savings/GDP	..	18.7	35.0	36.6
Gross national savings/GDP	..	18.2	27.5	26.6
Current account balance/GDP	..	-1.0	1.1	-0.9
Interest payments/GDP	..	0.5	1.9	..
Total debt/GDP	..	18.4	74.9	..
Total debt service/exports	..	3.9	38.0	..
Present value of debt/GDP	..	..	70.6	..
Present value of debt/exports	..	..	132.1	..

	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	-9.2	6.8	9.6	9.4	8.5
GDP per capita	-8.6	7.3	8.8	8.4	8.2
Exports of goods and services	-7.6	5.9	10.9	1.4	9.4

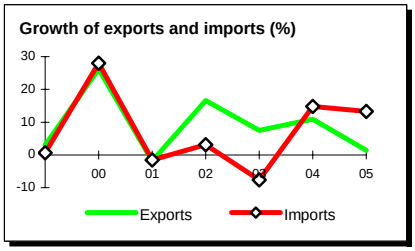


STRUCTURE of the ECONOMY

	1985	1995	2004	2005
(% of GDP)				
Agriculture	..	12.9	7.6	6.8
Industry	..	32.0	37.6	39.5
Manufacturing	..	15.3	14.2	14.6
Services	..	55.1	54.8	53.7
Household final consumption expenditure	..	67.7	53.3	52.0
General gov't final consumption expenditure	..	13.6	11.6	11.4
Imports of goods and services	..	43.5	43.5	45.4



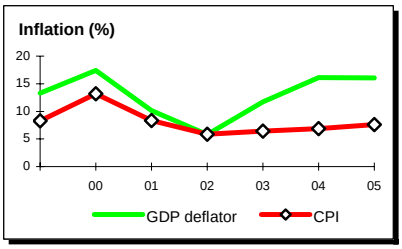
	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	-8.7	2.6	-0.1	7.3
Industry	..	8.6	11.2	10.3
Manufacturing	..	7.0	8.9	10.3
Services	..	6.5	10.8	10.4
Household final consumption expenditure	-13.0	5.0	9.2	11.7
General gov't final consumption expenditure	-6.4	3.2	10.6	11.8
Gross capital formation	-29.2	9.6	6.3	17.7
Imports of goods and services	-20.3	3.4	14.8	13.3



* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

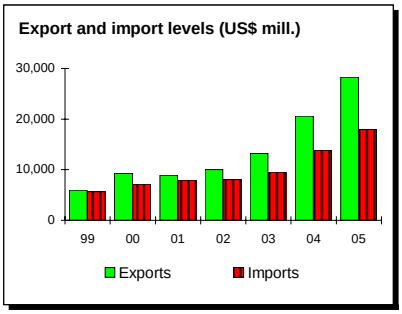
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	176.2	6.9	7.6
Implicit GDP deflator	..	160.9	16.1	16.1
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	17.9	23.4	27.7
Current budget balance	..	-7.4	7.2	11.4
Overall surplus/deficit	..	-6.7	1.7	5.4



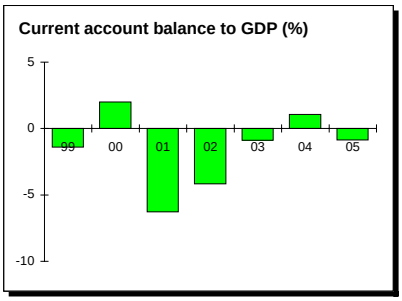
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	5,440	20,603	28,301
Fuel and oil products	..	1,306	12,902	19,525
Ferrous metals	..	1,062	2,187	2,325
Manufactures	..	1,235	1,983	2,644
Total imports (cif)	..	5,326	13,818	17,979
Food	..	309	666	910
Fuel and energy	..	938	1,693	2,062
Capital goods	..	1,094	5,481	7,609
Export price index *(2000=100)*	..	69	163	220
Import price index *(2000=100)*	..	80	180	207
Terms of trade *(2000=100)*	..	87	90	106



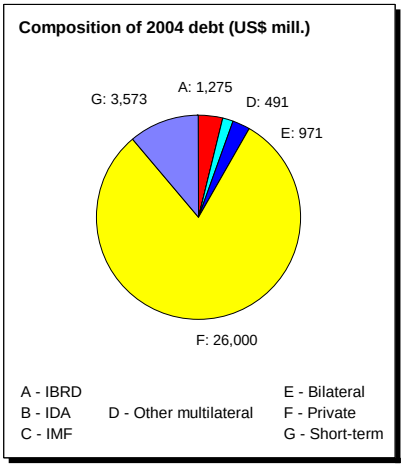
BALANCE of PAYMENTS

	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	..	5,975	22,602	30,552
Imports of goods and services	..	6,102	18,844	25,445
Resource balance	..	-127	3,758	5,106
Net income	..	-146	-2,815	-5,180
Net current transfers	..	59	-488	-412
Current account balance	..	-213	455	-486
Financing items (net)	..	370	3,544	-1,459
Changes in net reserves	..	-157	-3,999	1,945
Memo:				
Reserves including gold *(US$ millions)*	..	1,653	9,277	7,070
Conversion rate *(DEC, local/US$)*	..	49.8	136.0	132.9



EXTERNAL DEBT and RESOURCE FLOWS

	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	..	3,750	32,310	..
IBRD	..	295	1,275	599
IDA	..	0	0	0
Total debt service	..	235	8,774	..
IBRD	..	14	131	712
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	11	24	..
Official creditors	..	395	56	..
Private creditors	..	240	8,177	..
Foreign direct investment (net inflows)	..	964	4,104	..
Portfolio equity (net inflows)	..	0	-14	..
World Bank program				
Commitments	..	283	0	..
Disbursements	..	107	60	37
Principal repayments	..	0	87	658
Net flows	..	107	-27	-621
Interest payments	..	14	44	54
Net transfers	..	93	-72	-675

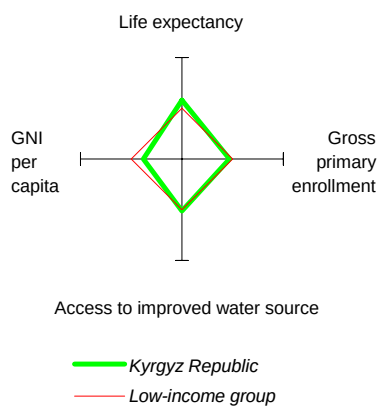


Source: World Bank

Annex 5: Kyrgyz Republic at a glance

POVERTY and SOCIAL	Kyrgyz Republic	Europe & Central Asia	Low-income
2005			
Population, mid-year *(millions)*	5.2	473	2,353
GNI per capita *(Atlas method, US$)*	440	4,113	580
GNI *(Atlas method, US$ billions)*	2.3	1,945	1,364
Average annual growth, 1999-05			
Population *(%)*	1.0	0.0	1.9
Labor force *(%)*	1.8	0.6	2.3
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	48	..	..
Urban population *(% of total population)*	36	64	31
Life expectancy at birth *(years)*	68	69	59
Infant mortality *(per 1,000 live births)*	58	28	80
Child malnutrition *(% of children under 5)*	7	5	39
Access to an improved water source *(% of population)*	77	92	75
Literacy *(% of population age 15+)*	99	97	62
Gross primary enrollment *(% of school-age population)*	98	104	104
Male	98	105	110
Female	98	102	99

Development diamond*

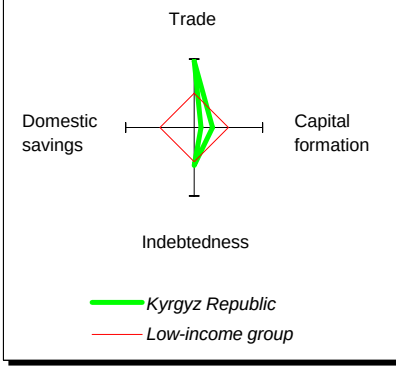


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1985	1995	2004	2005
GDP *(US$ billions)*	..	1.7	2.2	2.4
Gross capital formation/GDP	..	18.3	14.5	14.4
Exports of goods and services/GDP	..	29.5	42.6	39.0
Gross domestic savings/GDP	..	5.4	5.8	-4.7
Gross national savings/GDP	..	8.6	11.1	5.5
Current account balance/GDP	..	-14.1	-3.4	-8.3
Interest payments/GDP	..	1.2	1.3	..
Total debt/GDP	..	36.7	94.9	..
Total debt service/exports	..	13.2	14.0	..
Present value of debt/GDP	..	..	68.5	..
Present value of debt/exports	..	..	131.7	..

	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	-5.3	4.6	7.0	-0.6	5.2
GDP per capita	-6.6	3.4	5.9	-1.8	4.1
Exports of goods and services	..	2.6	12.8	-6.8	..

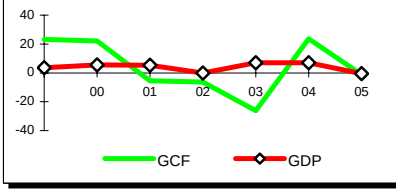
Economic ratios*



STRUCTURE of the ECONOMY

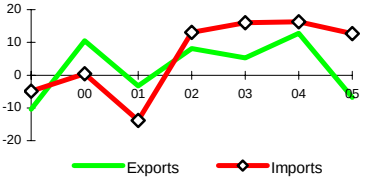
	1985	1995	2004	2005
(% of GDP)				
Agriculture	..	43.9	33.3	34.1
Industry	..	19.5	24.1	20.9
Manufacturing	..	9.3	17.1	14.1
Services	..	36.6	42.6	45.0
Household final consumption expenditure	..	75.0	76.0	85.9
General gov't final consumption expenditure	..	19.5	18.2	18.9
Imports of goods and services	..	42.4	51.3	58.2

Growth of capital and GDP (%)



	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	-2.9	5.2	4.1	-4.2
Industry	-14.3	2.7	3.0	-10.9
Manufacturing	-24.3	5.7	2.2	-15.6
Services	-2.7	4.8	11.9	8.1
Household final consumption expenditure	-13.9	5.1	7.5	12.0
General gov't final consumption expenditure	-19.3	2.0	4.6	-0.8
Gross capital formation	-17.1	-1.4	23.6	-1.1
Imports of goods and services	..	1.0	16.3	12.7

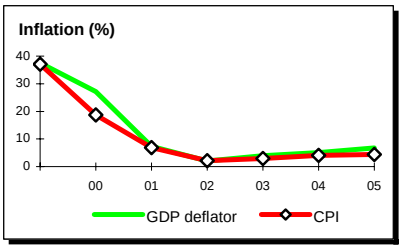
Growth of exports and imports (%)



* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

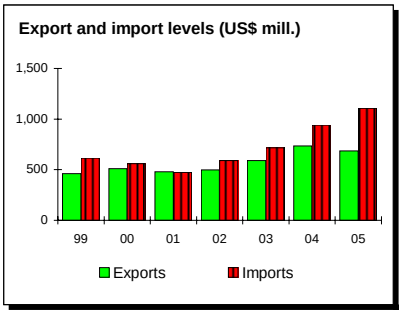
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	..	4.1	4.4
Implicit GDP deflator	..	42.0	5.1	6.8
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	21.6	22.8	24.2
Current budget balance	..	-8.6	-0.2	-0.2
Overall surplus/deficit	..	-16.5	-4.0	-3.9



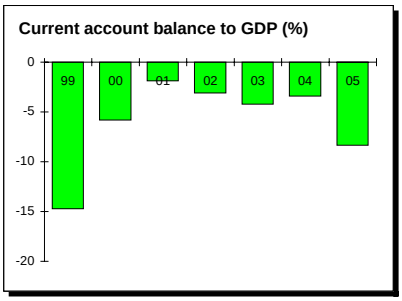
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	409	733	687
Electricity	..	41	22	20
Gold	..	0	287	231
Manufactures	..	165	208	226
Total imports (cif)	..	595	941	1,106
Food	..	77	112	140
Fuel and energy	..	188	256	314
Capital goods	..	84	163	191
Export price index *(2000=100)*	..	93	116	116
Import price index *(2000=100)*	..	82	99	89
Terms of trade *(2000=100)*	..	113	116	130



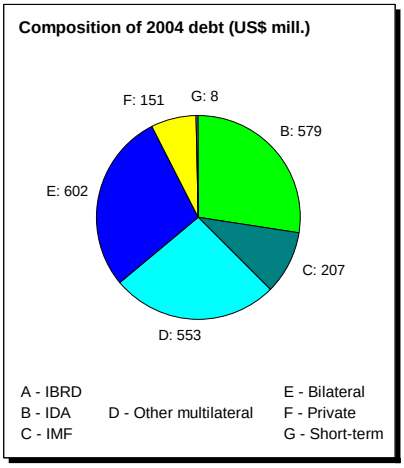
BALANCE of PAYMENTS

	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	..	448	942	942
Imports of goods and services	..	726	1,135	1,397
Resource balance	..	-278	-193	-455
Net income	..	-35	-90	-81
Net current transfers	..	79	209	332
Current account balance	..	-235	-75	-204
Financing items (net)	..	187	237	297
Changes in net reserves	..	48	-162	-93
Memo:				
Reserves including gold *(US$ millions)*	..	114	565	612
Conversion rate *(DEC, local/US$)*	..	9.7	42.7	41.0



EXTERNAL DEBT and RESOURCE FLOWS

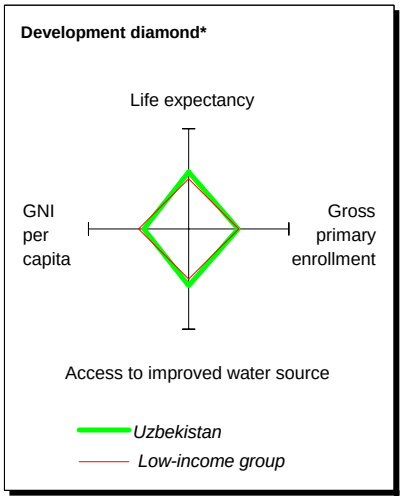
	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	..	610	2,100	..
IBRD	..	0	0	0
IDA	..	141	579	565
Total debt service	..	60	161	..
IBRD	..	0	0	0
IDA	..	1	7	9
Composition of net resource flows				
Official grants	..	54	51	..
Official creditors	..	119	80	..
Private creditors	..	0	-54	..
Foreign direct investment (net inflows)	..	96	77	..
Portfolio equity (net inflows)	..	0	0	..
World Bank program				
Commitments	..	60	9	..
Disbursements	..	81	25	34
Principal repayments	..	0	3	4
Net flows	..	81	23	29
Interest payments	..	1	5	5
Net transfers	..	81	18	25



Source: World Bank

Annex 6: Uzbekistan at a glance

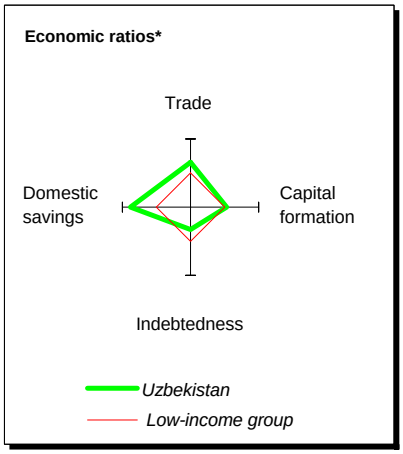
POVERTY and SOCIAL	Uzbekistan	Europe & Central Asia	Low-income
2005			
Population, mid-year *(millions)*	26.2	473	2,353
GNI per capita *(Atlas method, US$)*	520	4,113	580
GNI *(Atlas method, US$ billions)*	13.5	1,945	1,364
Average annual growth, 1999-05			
Population *(%)*	1.2	0.0	1.9
Labor force *(%)*	3.0	0.6	2.3
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	26	..	..
Urban population *(% of total population)*	37	64	30
Life expectancy at birth *(years)*	67	69	59
Infant mortality *(per 1,000 live births)*	55	28	80
Child malnutrition *(% of children under 5)*	..	5	39
Access to an improved water source *(% of population)*	85	92	75
Literacy *(% of population age 15+)*	99	97	62
Gross primary enrollment *(% of school-age population)*	103	104	104
Male	103	105	110
Female	102	102	99



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

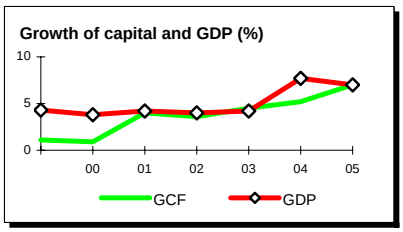
	1985	1995	2004	2005
GDP *(US$ billions)*	..	13.4	12.0	13.7
Gross domestic investment/GDP	..	27.3	24.5	25.1
Exports of goods and services/GDP	..	36.7	40.2	39.6
Gross domestic savings/GDP	..	27.1	31.9	32.7
Gross national savings/GDP	..	27.1	34.5	35.7
Current account balance/GDP	..	-0.2	9.9	10.6
Interest payments/GDP	..	0.6	1.3	1.1
Total debt/GDP	..	14.7	39.4	33.0
Total debt service/exports	..	17.1	17.5	14.4
Present value of debt/GDP	..	..	37.3	31.2
Present value of debt/exports	..	..	90.7	77.6

	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	-1.9	4.5	7.7	7.0	3.5
GDP per capita	-4.1	3.1	6.5	5.8	2.4
Exports of goods and services	..	2.2	28.1	11.8	2.3

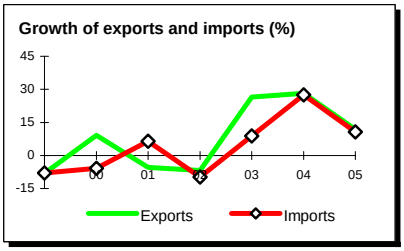


STRUCTURE of the ECONOMY

	1985	1995	2004	2005
(% of GDP)				
Agriculture	..	32.3	30.8	28.1
Industry	..	27.8	26.0	28.7
Manufacturing	..	11.9	10.2	11.3
Services	..	39.9	43.3	43.2
Household final consumption expenditure	..	50.6	51.9	50.9
General gov't final consumption expenditure	..	22.3	16.2	16.4
Imports of goods and services	..	36.8	32.8	32.0



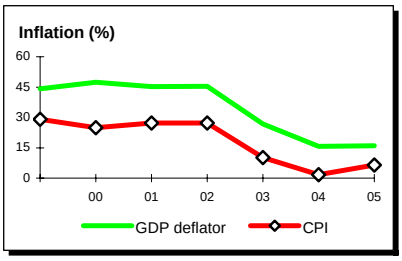
	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	0.3	4.9	10.1	6.2
Industry	-4.3	2.9	5.0	5.0
Manufacturing	..	1.3	2.0	2.0
Services	-3.8	5.0	7.5	8.0
Household final consumption expenditure	..	..	..	..
General gov't final consumption expenditure	..	..	..	..
Gross capital formation	-13.5	4.6	5.2	7.0
Imports of goods and services	..	-1.3	27.6	10.7



The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

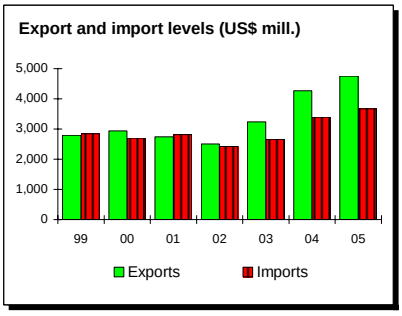
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	305.0	1.7	6.5
Implicit GDP deflator	..	370.9	15.7	15.9
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	34.6	32.2	31.0
Current budget balance	..	3.2	5.8	4.3
Overall surplus/deficit	..	-3.8	0.4	-0.7



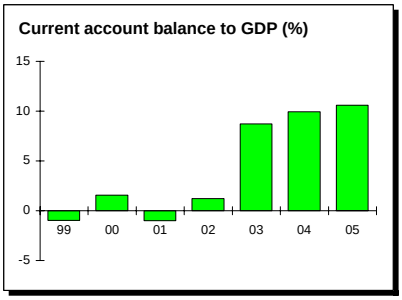
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	3,475	4,263	4,749
Cotton	..	1,584	876	1,033
Gold	..	611	1,242	1,292
Manufactures	..	200	588	738
Total imports (cif)	..	2,748	3,392	3,667
Food	..	526	261	287
Fuel and energy	..	54	81	104
Capital goods	..	1,386	1,753	1,770
Export price index *(2000=100)*	..	124	120	122
Import price index *(2000=100)*	..	118	110	117
Terms of trade *(2000=100)*	..	106	109	104



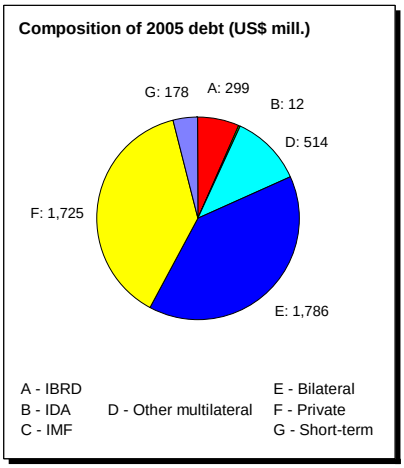
BALANCE of PAYMENTS

	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	..	3,731	4,837	5,409
Imports of goods and services	..	3,745	3,949	4,370
Resource balance	..	-14	888	1,039
Net income	..	-26	-49	-61
Net current transfers	..	19	356	470
Current account balance	..	-21	1,195	1,448
Financing items (net)	..	452	-682	-700
Changes in net reserves	..	-431	-513	-748
Memo:				
Reserves including gold *(US$ millions)*	..	1,867	2,147	2,895
Average official exchange rate *(local/US$)*	..	22.7	1,019.2	1,112.9



EXTERNAL DEBT and RESOURCE FLOWS

	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	..	1,958	4,745	4,514
IBRD	..	163	312	299
IDA	..	0	5	12
Total debt service	..	647	863	792
IBRD	..	0	30	32
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	13	94	56
Official creditors	..	365	108	95
Private creditors	..	145	-148	-309
Foreign direct investment (net inflows)	..	-24	187	211
Portfolio equity (net inflows)	..	0	0	0
World Bank program				
Commitments	..	226	40	0
Disbursements	..	163	28	30
Principal repayments	..	0	19	21
Net flows	..	163	9	9
Interest payments	..	0	11	12
Net transfers	..	163	-2	-3



Source: World Bank

Erklärung

Hiermit erkläre ich, dass ich die vorliegende Dissertation selbständing und ohne Benutzung anderer als der angegebenen Hillsmittel verfasst habe. Des weiteren versichere ich, dass diese Dissertation noch keiner anderen Fakultät oder Universität zur Prüfung vorgelegen hat.

Oldenburg, den 10. Oktober 2007.

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Lebenslauf

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Sprachkenntnisse	Kirgisisch, Russisch, Englisch, Deutsch

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