

# CAPITAL FLOWS TO TRANSITION COUNTRIES UNDER FINANCIAL GLOBALIZATION

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## Abstract

During the 1990s, most transition economies undertook a series of market reforms, including opening their capital accounts and have become more integrated into global financial system. In this paper, we focused on the effects that the financial globalization and international private capital flows had on the development of transition countries as well as how they helped shape its financial markets. We concluded with some important developments regarding the desirable degree of openness of the capital accounts with regard to the growth in the long run.

**Keywords:** Financial globalization, transition countries.

## Introduction

In the last decades, many countries around the world have become more financially integrated, driven by the potential benefits of financial globalization. One of the main benefits of financial globalization is the development of the financial sector. Financial markets become deeper and more sophisticated when they integrate with world markets, increasing the financial alternatives for borrowers and investors. Financial markets operating in a global environment enable international risk diversification, and facilitate consumption smoothing. Although financial globalization has several potential benefits, it also poses new challenges. After the crises of the 1990s, countries become exposed to external shocks, and crises not only generated in their own country but also from contagion effects [20].

During the 1990s most transition economies have become more integrated into global financial system. The transition process for Central and Eastern Europe (CEE) is both a political and economic process. One of the most important political aspects concerns the reintegration of CEE into Europe, symbolised by many countries by prospective membership of the European Union. Economic integration, by contrast, is an extremely important aspect of economic transformation [4]. Financial development is important to provide a desirable economic integration for transition countries. In this regard, capital flows play a crucial role, in terms of fostering accelerated growth, technical innovation and enterprise restructuring.

Liberalization of capital flows is a general feature in almost all countries. This liberalization is creating many opportunities for transition economies, combined with deregulation and a more and more integrated international financial system. However, capital inflows can also have less desirable side-effects. In the context of incomplete structural reforms, international capital flows carry considerable risks and may magnify underlying macroeconomic and structural weaknesses.

Capital flows are influenced by many factors: liberalisation of international capital transactions; regulatory reforms of capital markets; improvements in the macroeconomic performance of countries; rapid progress in communication technologies, and privatisation and structural economic policies in countries. In the 1990s, capital account liberalization was an important part of the market reforms introduced by governments in the transition economies. Because of the capital account liberalization, these countries attracted large amounts of foreign capital – \$106 of the \$271 billion net private capital inflows to the emerging markets and developing countries in 2005, for example. Excluding Russia, the transition economies' net private capital inflows in 2005 were \$105 billion and a third of these flows were used to finance a current account deficit of \$34 billion [18].

In this paper, we focus on the effects that the financial globalization and international private capital flows had on the development of transition countries as well as how they help shape its financial markets. After reviewing the potential benefits and costs financial globalization, we explain the composition of capital flows in transition countries. The next section analyzes the effects of financial globalization on the development of transition countries from the point of view direct channels of growth. Last section provides conclusion.

## **1. Potential Benefits and Costs Financial Globalization**

Financial globalization involves obviously both benefits and risk to the countries in transition. There is general agreement among scholars and practitioners about the benefits and risks associated with financial globalization for economic development in general and for financial sector stability in particular.

The potential benefits of financial globalization will likely lead to a more financially interconnected world and a deeper degree of financial integration of developing countries with international financial markets. The main benefit of financial globalization for developing countries is the development of their financial system, which involves more complete, deeper, more stable, and better-regulated financial markets. A better functioning financial system with more credit is key because it fosters economic growth. There are two main channels through which financial globalization promotes financial development. First, financial globalization implies that a new type of capital and more capital is available to developing countries. Among other things, new and more capital allows countries to better smooth consumption, deepens financial markets, and increases the degree of market discipline. Second, financial globalization leads to a better financial

infrastructure, which mitigates information asymmetries and, as a consequence, reduces problems such as adverse selection and moral hazard [20].

Among the main benefits of financial integration with foreign markets are (a) the possibility over time of stabilizing the consumption profile of individuals at less cost than is involved in the case of a capital account with restrictions, complementing domestic saving efforts with foreign savings, and thereby accelerating investment and growth; (b) the possibility of diversifying risk by acquiring positions in assets and debt the risks of which differ from what is available on the domestic market, reducing the volatility of domestic revenue and consumption; (c) the possibility of supplementing residents' investments with foreign investment, using new technologies to exploit and manage resources; (d) facilitated access, via foreign investment, to new markets where the comparative advantages of productive sectors in transition countries can be taken advantage of; and (e) the possibility of delivering more efficient and complete financial services for domestic users by opening the field to competition by foreign players [16].

As for other developing economies, capital flows into the transition countries can make a significant contribution to growth. In most transition economies, domestic savings are low and financing costs high owing to underdeveloped financial systems. While the physical and human capital stock in these countries is generally abundant by the standards of comparable mostly middle-income countries, it is inefficiently employed and partially obsolete. The potential productivity of new capital is therefore likely to be higher than in more settled market environments. Investment for restructuring, combined with improved management and advanced technology, offers opportunities for raising the yield of some of the existing capital at relatively low cost. Foreign capital can help to realize this potential [21].

The potential benefits also include filling the saving–investment gap, allowing portfolio diversification directly and production diversification indirectly, lowering financing costs, setting or raising standards of business and corporate governance, raising the intensity of competition, and enhancing fiscal discipline through the restraining effect of the threat of capital flight. Foreign direct investment is also supportive of structural reforms, which pay off in terms of a higher productivity growth regardless of the host country's initial conditions [5].

Financial globalization can also carry some risks. These risks are more likely to appear in the short run, when countries open up. One well-known risk is that globalization can be related to financial crises. The crises in Asia and Russia in 1997–98, Brazil in 1999, Ecuador in 2000, Turkey in 2001, Argentina in 2001, and Uruguay in 2002 are some examples that captured worldwide interest [18]. The risks are highest in countries that have integrated themselves into the international capital markets but have so far failed to establish the foundations for macroeconomic and financial stability, and more generally the broader institutional foundations for a well functioning market economy. The main lesson to be learned is that building such foundations takes time, particularly in the less advanced transition countries [21].

There are various links between globalization and crises. If the right financial infrastructure is not in place or is not put in place during integration, liberalization

followed by capital inflows can debilitate the health of the local financial system. If market fundamentals deteriorate, speculative attacks will occur with capital outflows from both domestic and foreign investors. For successful integration, economic fundamentals need to be and remain strong, and local markets need to be properly regulated and supervised. The need for strong fundamentals is key since, other things being equal, financial globalization tends to intensify a country's sensitivities to foreign shocks. Moreover, international market imperfections, such as herding, panics, and boom-bust cycles, and the fluctuating nature of capital flows can lead to crises and contagion, even in countries with good economic fundamentals [18].

Capital flows can be higher risk in developing countries than developed countries. Besides economic and political instability, institutional investors can encounter some restrictions in developing and transition countries. The fluctuations in prices of equity capital and the monitoring of trade activities can be seen in new developing countries. Insufficient market capitalization and inefficiency financial system are the other factors which affect investors, negatively [1]. In addition, international capital flows carry considerable risks and may magnify underlying macroeconomic and structural weaknesses in the context of incomplete structural reforms. If capital inflows are in excess of the recipient economy's ability to absorb them productively, they can have a potentially negative impact on the financial sector and, ultimately, on the real economy. Large capital inflows have been associated with rapid credit expansion and riskier lending practices in many countries. Large inflows can also lead to real exchange rate appreciation, resulting in a loss of competitiveness and a deterioration in the debt servicing capacity of clients in the internationally exposed sectors and thus in the quality of banks' balance sheets [5].

During the 1990s, most transition economies undertook a series of market reforms, including opening their capital accounts. These reforms are costly and need to be financed. As domestic source for financing were limited, external financing was needed. Therefore the liberalization of capital flows are important part of the transition story [17].

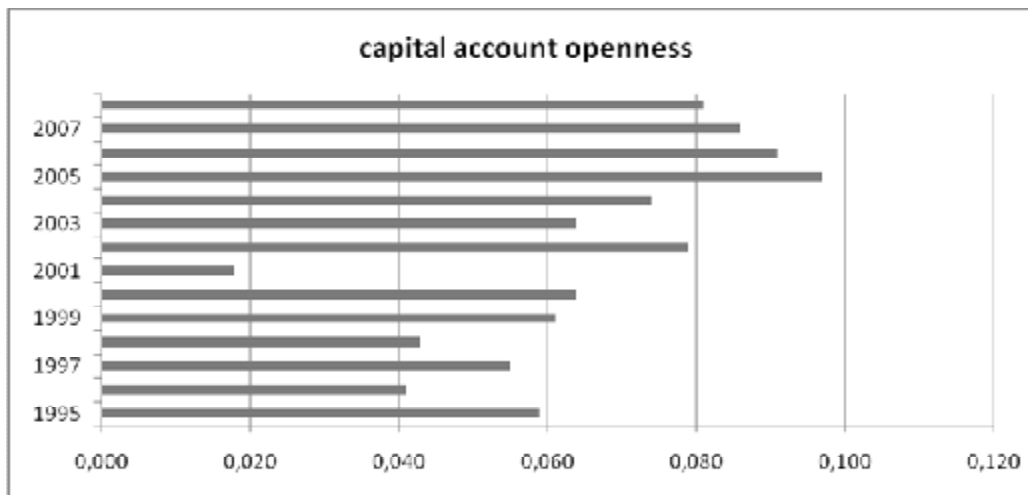
## **2. Capital Account Openness and the Composition of Capital Flows In Transition Countries**

Capital account liberalization is considered an important precursor to financial integration [14]. Economic theory suggests that the liberalization of capital flows can foster a more efficient allocation of resources, provide opportunities for risk diversification, and help promote financial development. In recognition of these potential benefits, governments of many countries have undertaken widespread capital account liberalization over the past quarter-century. Many attribute efficiency gains, increased diversification opportunities, and financial development in these countries to opening up capital markets [10].

Most transition economies undertook a series of market reforms and tried to adapted a policy of a high degree of capital account openness since the beginning of transition

process. As capital controls have been progressively eased in recent years, the capital account openness has increased significantly in CEE economies (Chart 1).

**Chart 1. Central and Eastern Europe, 1995-2008, (%)**



Source: World Economic Bank Data Base, 2007.

Note: CEE includes countries: Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Slovak Republic, Slovenia.

\*Capital account openness is measured by the net private capital inflows / GDP

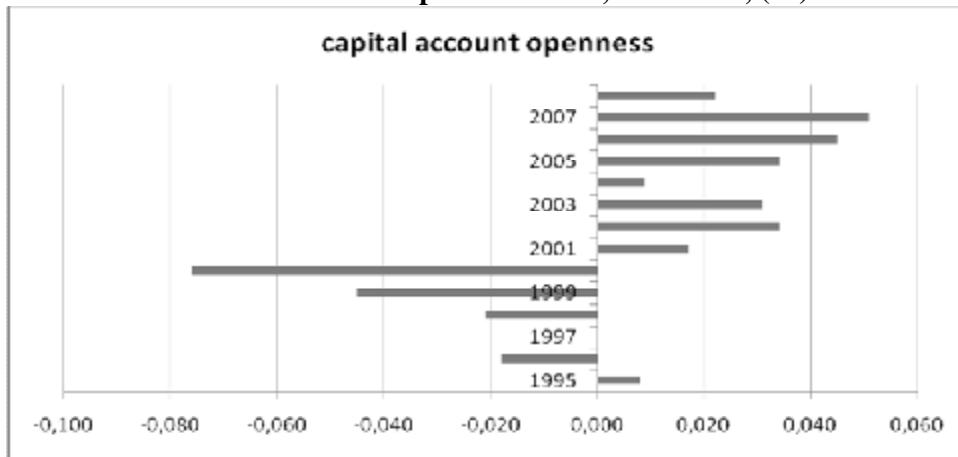
The CEE countries liberalized their capital accounts relatively quickly, and most transactions were already unrestricted by 1995, whereas Hungary, Poland, the Slovak Republic, and Slovenia took a more cautious attitude and opened up their capital accounts only gradually, achieving full liberalization in 2001-04. Different starting conditions played an important role in developing a country's liberalization strategy. For instance, because relatively high external debt in Hungary and Poland made these countries more vulnerable to external shocks, their authorities adopted a cautious attitude toward liberalizing capital flows [3].

Transition countries in European Union displayed some similar patterns as well. One important feature of the liberalization process in European Union countries was that the countries tended to liberalize inflows before outflows. This approach was mainly attributable to the initial uncertainty about the success of the transformation. In the first years of transition, the authorities feared that high inflation and depreciating currencies might trigger capital flight. The relatively fast macroeconomic stabilization in most of the countries dispelled this fear and from the second half of the 1990s onwards capital inflows caused more difficulties than potential outflows [3].

In Commonwealth of Independent States (CIS) economies, the capital account openness has been slower than CEE economies. The progress of capital account openness started in these economies after 2000. The liberalization of capital flows is still incomplete in most CIS economies (Chart 2). Although Azerbaijan, Kazakhstan and Tajikistan have higher

level than the other among CIS, the levels are not enough to growth for these economies [2].

**Chart 2. Commonwealth of Independent States, 1995-2008, (%)**



Source: World Economic Bank Data Base, 2007.

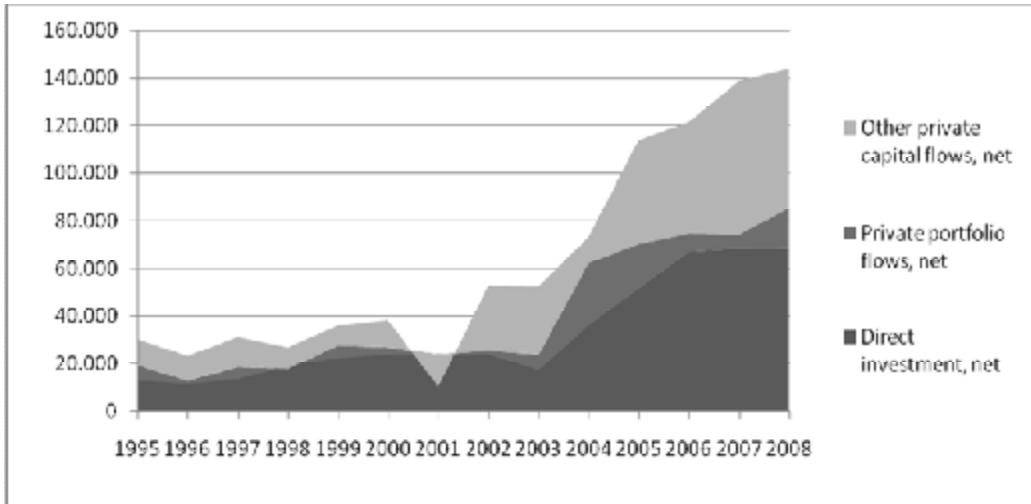
Note: CIS includes countries: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

\*Capital account openness is measured by the net private capital inflows / GDP

The transition process radically changed both the volume and composition of capital flows in many transition countries. The capital flows consists of direct and portfolio investment, and they are recorded in the financial account of a country. Direct investment covers all transactions between direct investors and direct investment enterprises, so it includes direct equity investment and reinvested profits. Portfolio investment implies transactions in equity securities and debt securities. Both international trade in financial assets in the various forms of cross-border portfolio holdings and the internationalization of production via foreign direct investment suggest an ever increasing international economic interdependence worldwide [22].

As in most developing countries, foreign direct investment is the most important type of capital flow in transition countries between 1995 and 2008. As the transition economies were affected by the financial crises of the late 1990's, the share of the portfolio flows decreased in this economies. Although there was a decline in the foreign direct investment in 2003, the share of the FDI started to increase (Chart 3). Hungary, Poland and Czech Republic are the CEE countries that attracted foreign direct investment.

**Chart 3. Total Net Capital Flows to Central and Eastern Europe, Billions US dollars, By Type, 1995-2008**

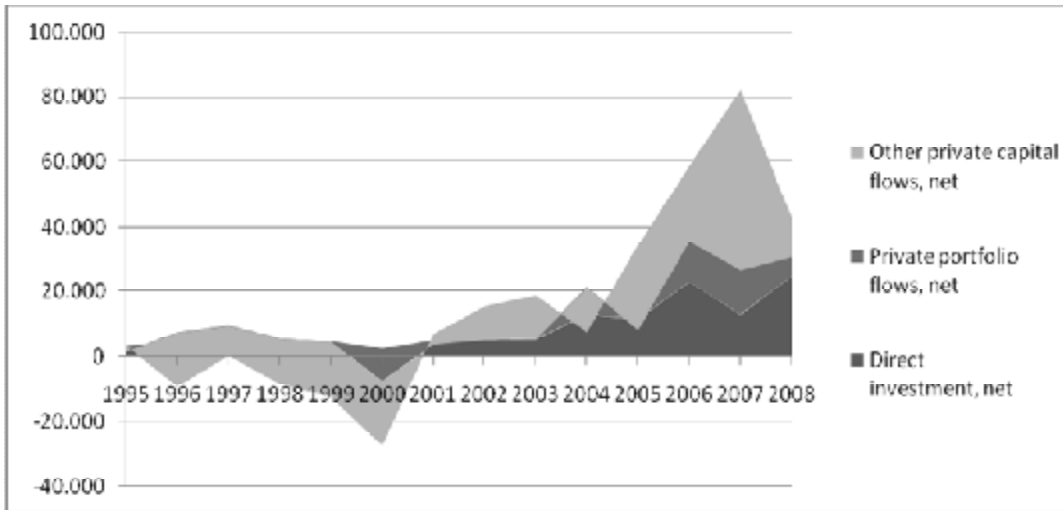


Source: World Bank Economic Outlook Database, 2007

Total net capital flows to Commonwealth of Independent States have followed a fluctuation situation between 1995 and 2008. The share of investments have accounted for a substantial part of net capital flows in CIS countries. Especially, after 2000, the share of foreign direct investment has started to increase. Portfolio flows in CIS economies have appeared to have recovered since 2000 (Chart 4). Foreign direct investment are mostly concentrated in Azerbaijan, Kazakhstan and Russia. The rest of the region is not successful to attract foreign direct investment.

**Chart 4 : Total Net Capital Flows to Commonwealth of Independent States, Billions US dollars,**

**By Type, 1995-2008**



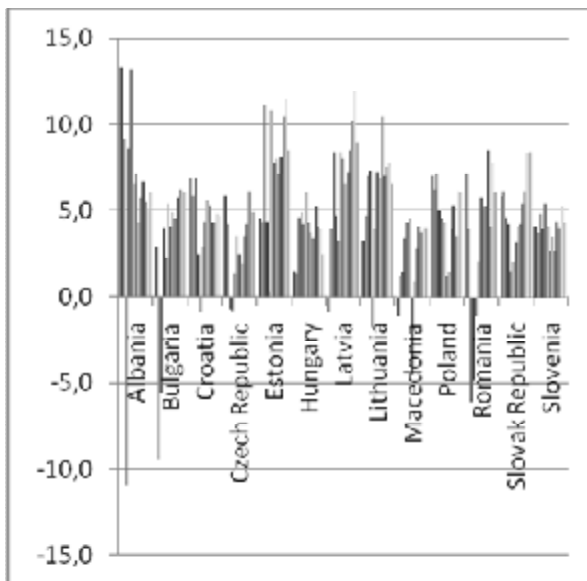
Source: World Bank Economic Outlook Database, 2007

### 3. Developments In Transition Countries

The history of world witnessed significant events in the 20<sup>th</sup> century. The process of globalization have begun to increase since the second part of that century and financial regulations in many countries have let to the opening of the developing countries into global economy. The emergence of the European Union provided to increase the importance of economic and monetary unions. International organizations have facilitated the movements of goods and services and have accelerated to join the national economies into global economies. Another significant event of that century was the break up of the USSR and new independent states come out. Transition economies try to adapt to the conditions of world trade with the movements of trade and financial and try to solve their domestic problems with foreign supports. After breaking up of the USSR, in the first phase of transition process many economies faced to a decline in their productions and serious macroeconomic instabilities including in important decreases in exchange rates [2].

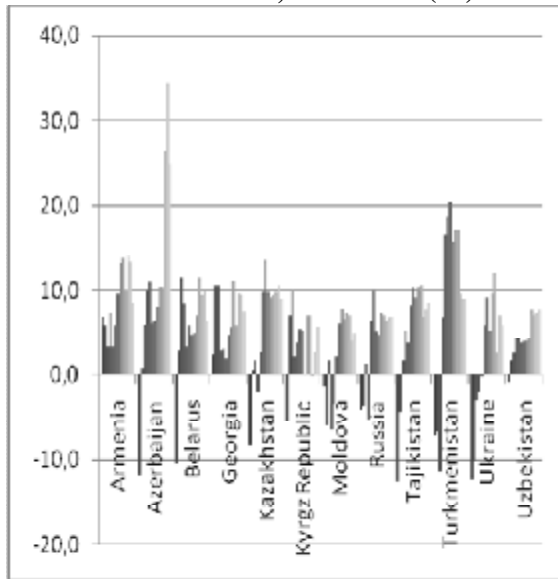
Since the collapse of the communist system in 1989, the countries in Central and Eastern Europe and Commonwealth of Independent States experienced drastic macroeconomic changes. Chart 5 and Chart 6 illustrate the growth rates of real GDP for individual country groups from 1995 until 2006. At the beginning of transition, all economies underwent a decline in their growth rates that was pronounced but different in intensity. CEE recovered more quickly than the other transition countries, while it took Russia and the other economies in the Commonwealth of Independent States longer to achieve positive growth again. After a renewed decline in 1997/98, all country groups seem to have embarked on a positive course that even seems to point to a convergence of growth rates.

**Chart 5 : GDP in CEE, 1995-2006 (%)**





**Chart 6 : GDP in CIS, 1995-2006 (%)**



Source : EBRD, Transition Report Update 2007.

Theoretical models have identified a number of channels through which international financial integration can help to promote economic growth in the developing world. Researchers explained a number of direct and indirect channels through which embracing financial globalization can help enhance growth in developing countries. Direct channels are related in development of financial sector, lower cost of capital due to better risk allocation, augmentation of domestic savings and transfer of technology while indirect channels are related in promotion of specialization, inducement for better policies, enhancement of capital inflows by signaling better policies. In this study, we focus direct channels to analyze the development of transition countries [14].

### **3.1 Financial Development**

The financial sector appears to have special importance in two ways. First, the financial sector has the function to canalize savings into investment. Second, it is possible to interpret the degree to which the financial sector is developed as a measure of broad macroeconomic efficiency. Thus, financial development influences total factor productivity and the long-run growth rate [19].

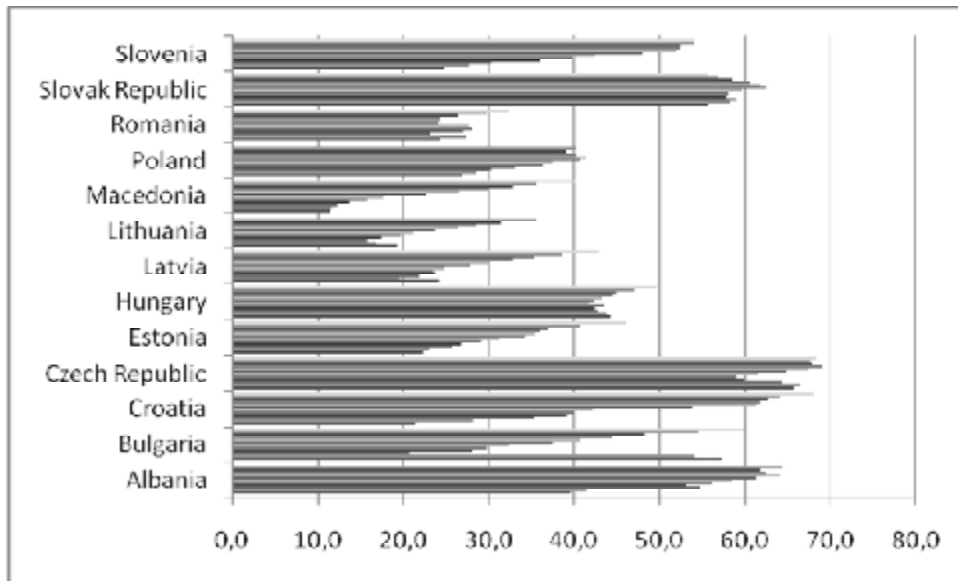
The degree of financial development can be measured in terms of different components, namely the size, the structure and the efficiency of the financial sector [13]. Indicators that measure the size of the financial sector basically include information about the

"depth" of financial intermediation, facilitating economic activity and reducing transaction costs. Structural indicators give information about the allocation of resources and the relevance of different financial institutions, e.g. the impact of private and state-owned banks. Using efficiency indicators the level of transaction cost, the importance information asymmetries and in particular the competition environment can be recorded [19].

### *Size of Financial Sector*

The size of the financial sector gives an idea about the "depth" of financial intermediation. The amount of M2 as a percentage of GDP, acts as an indicator of the "depth" of the financial sector. This monetary aggregate has increased significantly in CEE countries since the beginning of transition. The Albania, Croatia and Czech Republic have recorded a significant increase in their degree of monetarisation, which exceeded to 60% in 2005. In addition, the Slovak Republic (55.7%) and Slovenia (54.1%) increased M2 relative to GDP. However, the amount of M2 as a percentage of GDP has increased slower in Lithuania and Romania (Chart 7).

**Chart 7. The Depth of the Financial Sector in CEE, 1995-2006**

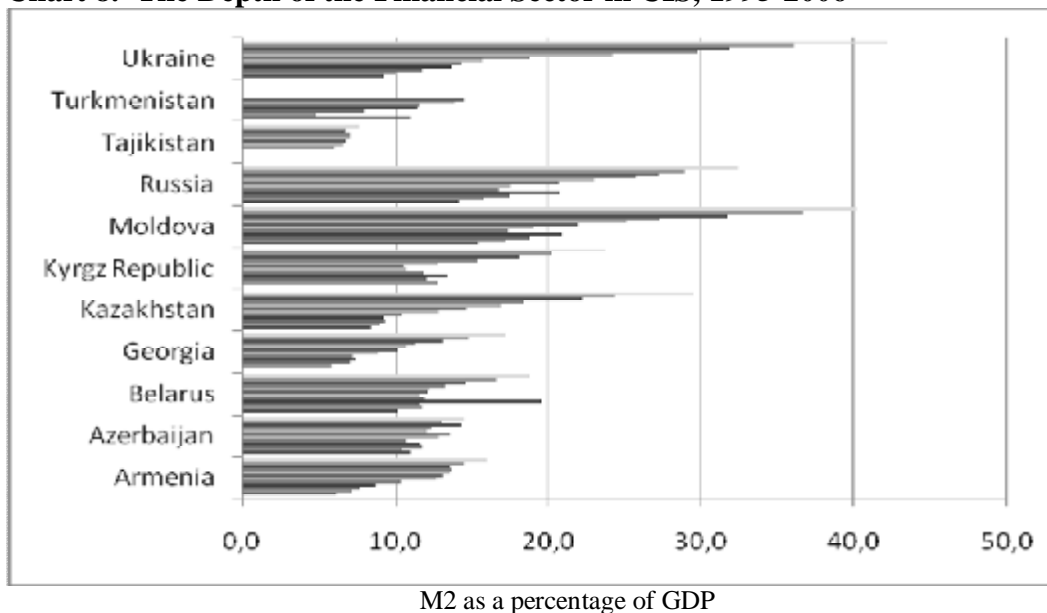


M2 as a percentage of GDP

**Source:** World Bank, World Development Indicator, 2007

The increase in the money has been slower in CIS countries. The CIS countries experienced a lower increase in their degree of monetarisation. Some countries in CIS have a more favourable position than the others. Moldova, Ukraine and Russia have recorded more increase than the other countries (Chart 8).

**Chart 8. The Depth of the Financial Sector in CIS, 1995-2006**



Source: World Bank, World Development Indicator, 2007

### ***Structure of Financial Sector***

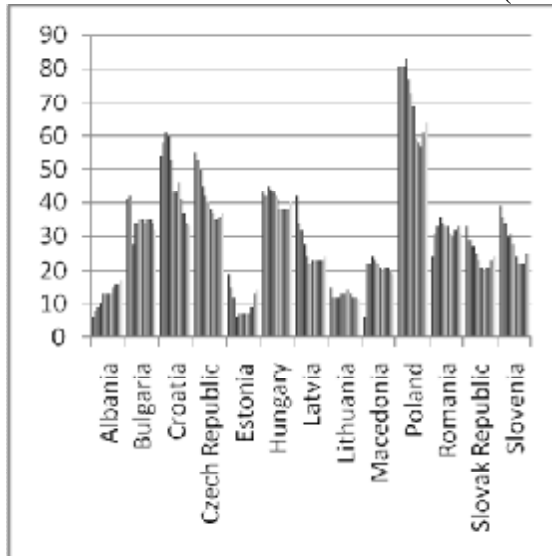
Market-oriented financial sector is of fundamental importance to the post-communist transition. Banks in a market economy play a key role in the monetary payments mechanism, in the mobilisation intermediation and allocation capital. An efficient and prudent banking system facilitates the process of saving and investment and thus promotes long-term growth.

### **The number of banks**

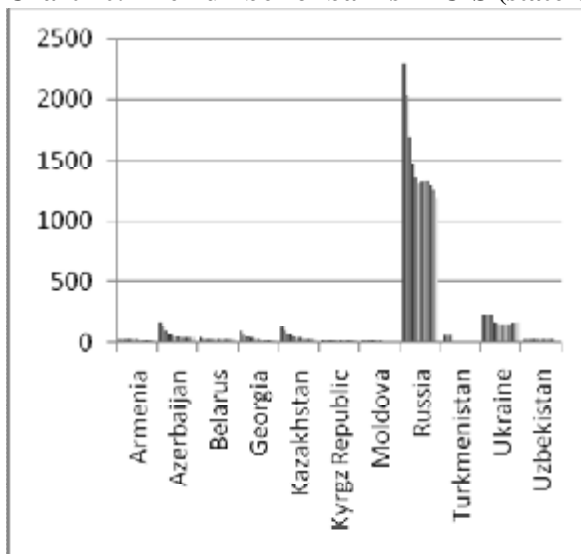
Nearly all CEE economies have experienced a decline in the number of domestic banks last ten years. For example, the number of banks in Croatia has decreased from 54 in 1995 to 33 in 2006. In Latvia, this decline is from 42 to 24 (Chart 9). This development is a result of regulations for banking supervision as well as of numerous bank crises [19]. There are also some economies that experienced a rise in their bank number, e.g. Albania from 6 bank in 1995 to 17 banks in 2006. CIS countries have also recorded a decline in the number of domestic banks. The number of banks in Azerbaijan, for example, has decreased from 184 in 1995 to 44 in 2006. Surely, Russia has experienced a significant decline in the number of domestic banks. In Russia, the number of banks has decreased

from 2297 in 1995 to 1189 in 2006 (Chart 10 ).The share of foreign banks rise significantly in all transition countries (Chart 11 and Chart 12).

**Chart 9. The number of banks in CEE (state-owned)**

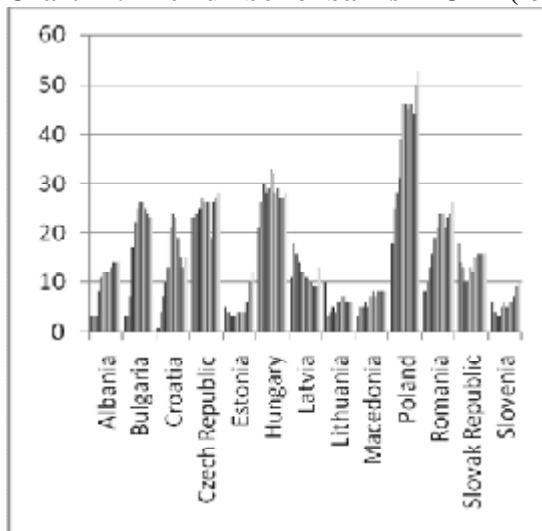


**Chart 10. The number of banks in CIS (state-owned)**



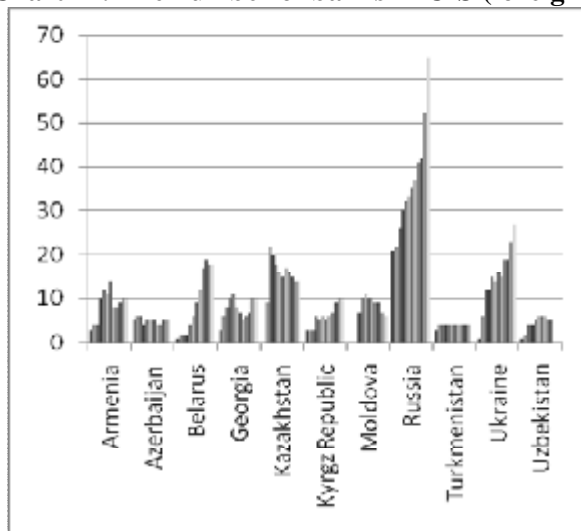
Source: EBRD, Structural Indicators, 2007.

**Chart 11. The number of banks in CEE (foreign owned)**



Source: EBRD, Structural Indicators, 2007.

**Chart 12. The number of banks in CIS (foreign owned)**



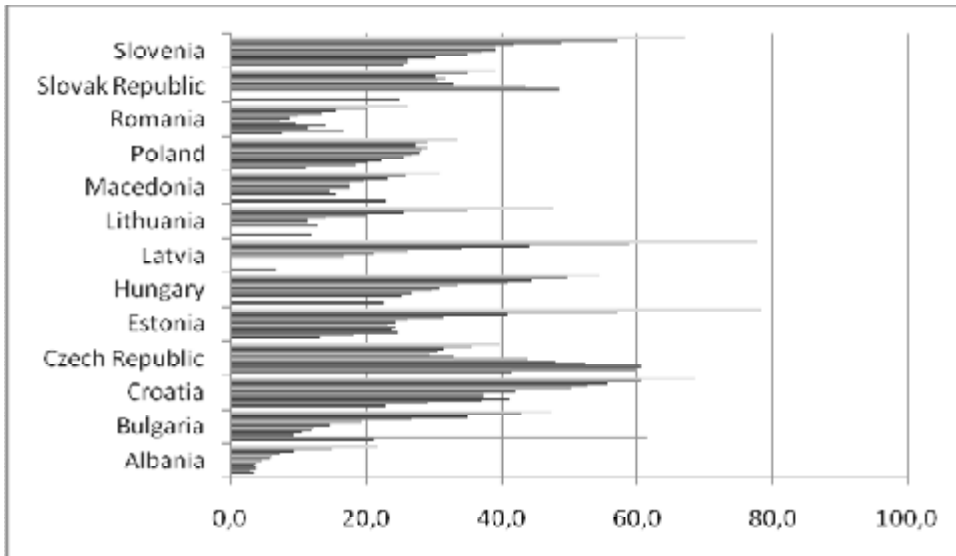
Source : EBRD, Structural Indicators, 2007.

The level of bank intermediation

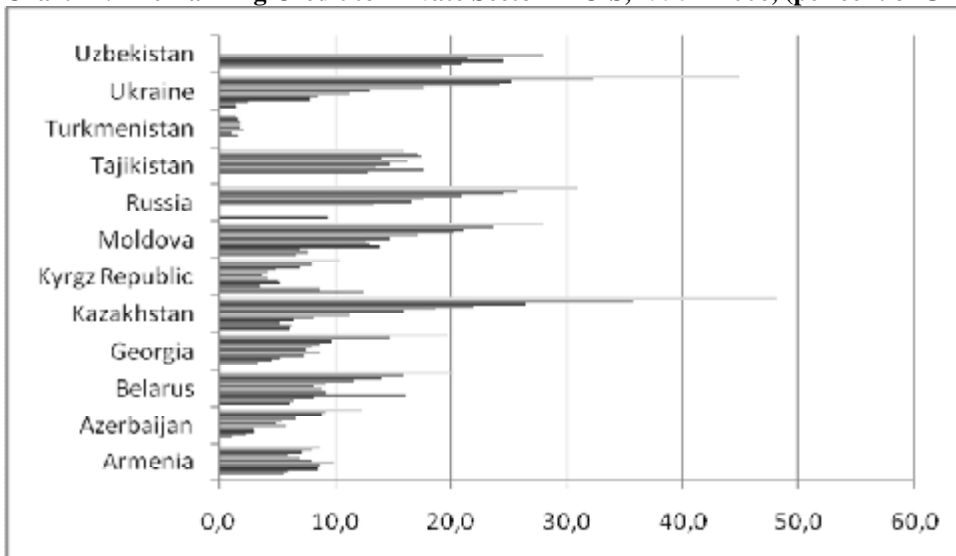
The level of bank intermediation, measured by the ratio of domestic credit to GDP, increased between 1995 and 2006 in many CEE economies. Banking credit to private

sector in per cent of GDP has exceeded 60 percent of GDP in Estonia, Latvia and Slovenia between 1995 and 2006 (Chart 13). In transition countries factors that affected banking sector intermediation include macroeconomic and fiscal performance, as well as bank-specific characteristics such as ownership, market power and capitalisation [5]. In CIS economies, the degree of bank intermediation is lower than CEE economies. Kazakhstan and Ukraine have higher percent of GDP than the other CIS economies (Chart 14).

**Chart 13. The Banking Credit to Private Sector in CEE, 1995 – 2006, (per cent of GDP)**



**Chart 14. The Banking Credit to Private Sector in CIS, 1995 – 2006, (per cent of GDP)**



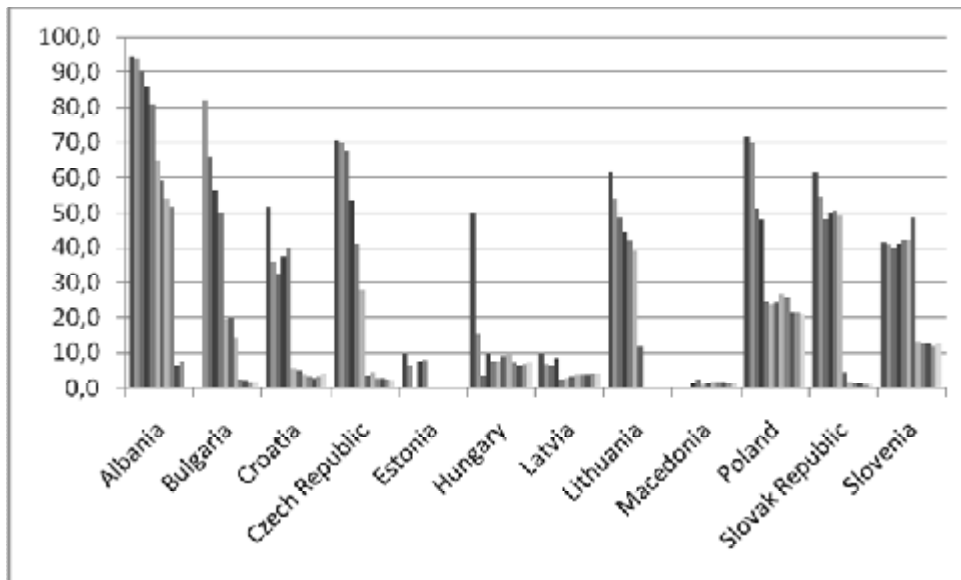
Source :EBRD, Structural Indicators, 2007.

## The process of bank privatisation

In transition countries chose different strategies for the method and speed of privatisation of state-owned enterprises, including banks. These strategies were different among transition countries. For example, while Hungary went for a quick sale of its banks to foreign direct investors, Poland combined public offering with management buyouts and some placements with foreign strategic investors [5].

The process of bank privatisation has been grown in the CEE countries (Chart 15). Many of them has made very good progress in bank privatisation, except Lithuania, Poland and Slovenia. However, the process of bank privatisation has been slower in the CIS countries (Chart 16). In the CIS countries, the state still maintains a high degree control over the banking sector, with the exception of Armenia, Kazakhstan, Kyrgyz Republic, Tajikistan and Ukraine.

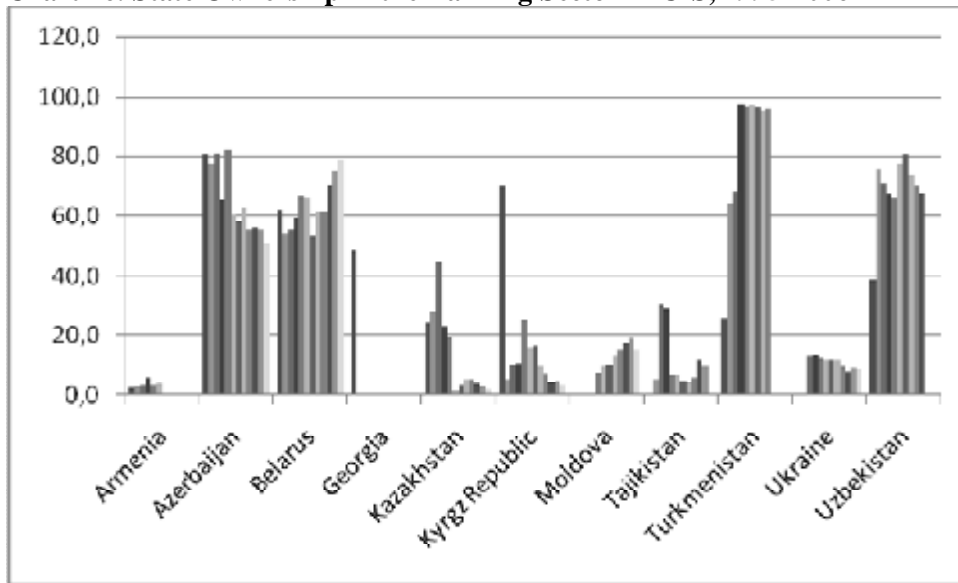
**Chart 15. State Ownership in the Banking Sector in CEE, 1995-2006**



Asset share of state-owned banks (in per cent)

Source: EBRD, Structural Indicators, 2007.

**Chart 16. State Ownership in the Banking Sector in CIS, 1995-2006**



Asset share of state-owned banks (in per cent)

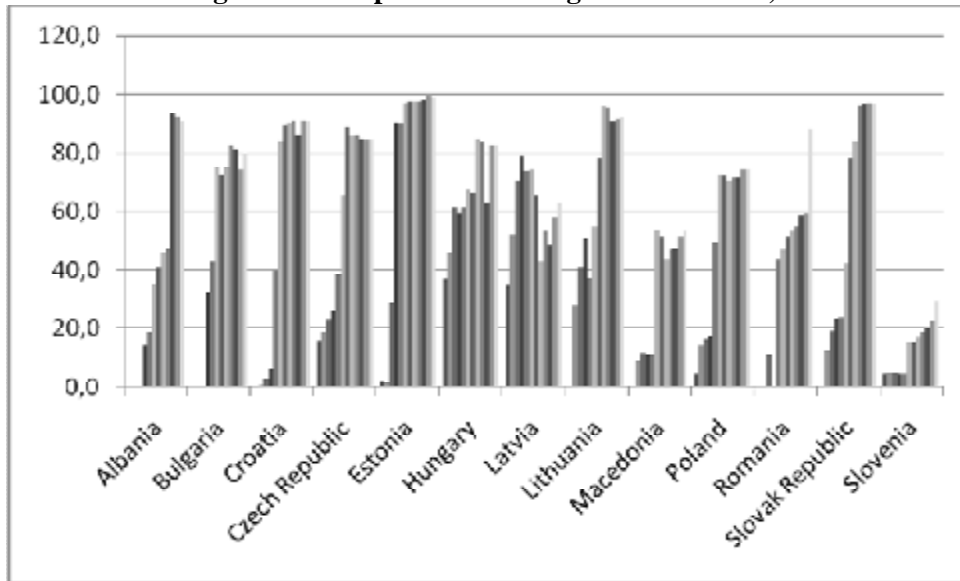
Source: EBRD, Structural Indicators, 2007.

The entry of foreign banks has been an important factor that has raised the level of development in the banking sector. Foreign banks motivate competition and innovation, often bring stronger corporate governance and management, and render the sector more efficient by introducing new skills, products and technology [5].

The process of foreign banks in transition countries has helped reform in the banking sector. In CEE countries, foreigners control most of the assets of the banking sector in CEE, except Slovenia (Chart 17.) Hungary was the first country to open its banking sector to foreign participation. The Czech Republic resisted foreign ownership of its larger banks until the failure of several of these banks in the period 1996-1998 prompted the sale of all large banks to foreign strategic investors (Buiters and Taci, 2003). In CIS, the process of foreign banks has been slower (Chart 18). Foreigners control less of the assets of the banking sector in CIS countries, except Armenia, Georgia, Kazakhstan and Kyrgyz Republic.



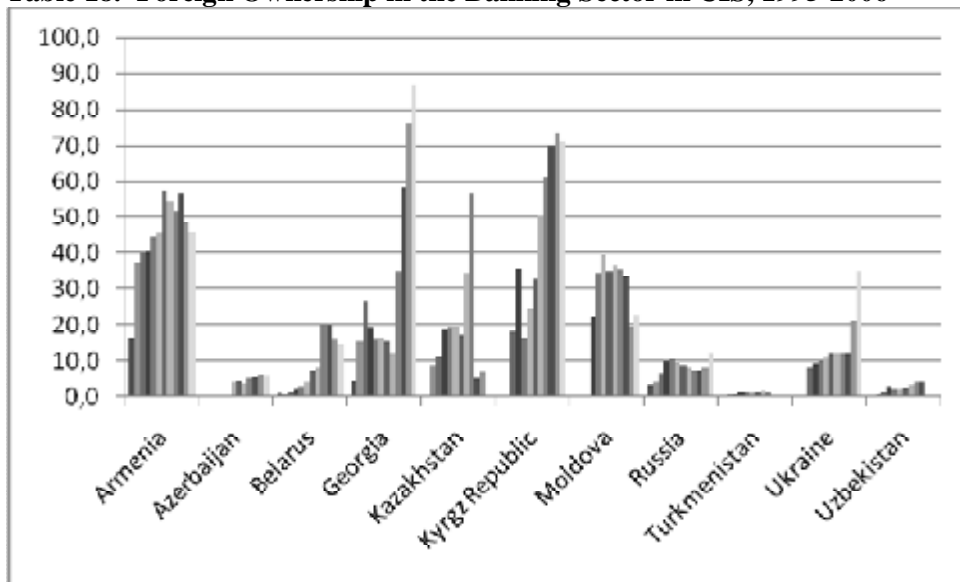
**Chart 17. Foreign Ownership in the Banking Sector in CEE, 1995-2006**



Asset share of foreign-owned banks (in per cent)

Source: EBRD, Structural Indicators, 2007.

**Table 18. Foreign Ownership in the Banking Sector in CIS, 1995-2006**



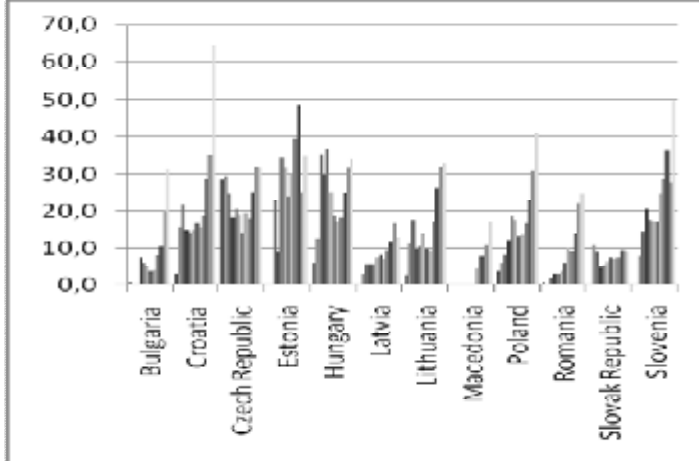
Asset share of foreign-owned banks (in per cent)

Source: EBRD, Structural Indicators, 2007.

## Stock market capitalization

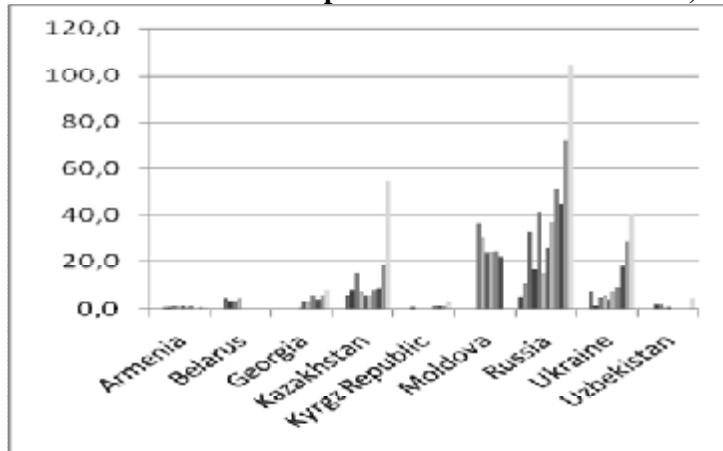
In terms of their stock market capitalization, CEE is in a better position. Particularly, Croatia, Estonia, Hungary, Poland, Lithuania and Slovenia show a clear upward trend between 1995 and 2006 (Chart 19 and Chart 20). Nevertheless, the stock market capitalization still remain considerably below the relevant quotients of developed economies. Because the stock market is of relevance in financing enterprises, further efforts especially to attract foreign investors can be very important [19]. This holds true even more for the CIS, where the limited data shows to less developed stock markets.

**Chart 19. Stock Market Capitalization in CEE 1995-2006, in percent of GDP**



Source: EBRD, Structural Indicators, 2007.

**Chart 20. Stock Market Capitalization in CIS 1995-2006, in percent of GDP**



Source: EBRD, Structural Indicators, 2007.

## *Efficiency of the Financial Sector*

Efficiency of the financial sector can be measured the difference between the lending rate and the deposit rate [13]. The high interest rates for loans at the beginning of transition and the low deposit interest rates characterize a situation of insufficient competition in the banking sector. This implies a poor efficiency of the financial markets [19]. The following table shows the spread between lending and borrowing rates as a measure of financial efficiency. According to Table 1, the spreads in many transition economies have decreased since 2002. The decline in interest rate spreads as transformation is improving, driven by privatisation and cross-border capital flows. This means that there is a competition in domestic banking sector. However, some economies, for example Romania, Tajikistan, Kyrgyz Republic and Georgia, still have high spreads. These economies still have a high degree of state control of their banking sector and a low intensity of competition.

**Table 1. The spread between lending and borrowing rates in Transition Countries, 2002-2006**

CEE	2002	2003	2004	2005	2006	CIS	2002	2003	2004	2005	2006
Albania	6.6	6.3	6.5	9	7	Armenia	9.2	13.8	13.3	11.5	-
Bulgaria	6.6	5.9	5.8	4.9	-	Azerbaijan	8.7	6	6.5	na	-
Croatia	9.3	9.8	9.6	8.3	6.1	Belarus	10	6.6	4.2	2.2	1.1
Czech Republic	7.1	6.9	6.6	6.0	-	Georgia	22	23	24	14	-
Estonia	2.9	2.7	4.1	6.9	4.1	Kazakhstan	3.1	4	4.4	3.9	-
Hungary	2.3	2.5	1.9	2.2	1.8	Kyrgyz Republic	18.9	16.7	22.6	20.8	22.5
Latvia	4.3	2.4	4.2	3.1	3.6	Moldova	8.7	6.5	5.8	5.9	6.3
Lithuania	5.8	4.9	5.4	5.3	5.2	Russia	10.7	8	6.2	7.5	6.4
Macedonia	8.5	7.8	5.5	6.9	5.0	Tajikistan	0	1	12.7	11.4	15.3
Poland	7.4	6.7	6.6	5.9	5.3	Turkmenistan	4.1	5	6	8.7	-
Romania	18.3	15.4	14.5	13	9.1	Ukraine	17.5	10.9	9.6	7.7	-
Slovak Republic	5.3	4.7	4.4	4.5	-	Uzbekistan	7.4	3.6	5.1	4.4	-
Slovenia	4.1	4.4	4.8	4.5	4.1						

Source: EBRD, Transition Report Update 2007.

### **3.2 Credit Ratings**

The better credit ratings reflect improvements in macroeconomic fundamentals and policies, progress in economic reform, and stronger financial positions. Fitch, Moody's and Standard & Poor's have upgraded the international credit ratings of ten transition economies since the beginning of 2000 (Table 2). As of February 2002, eight countries - the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia - had received investment grade ratings. Bulgaria and Romania are rated sub-investment risks. Azerbaijan, Kazakhstan, and Russia received upgrades in 2001 but they remained in the sub-investment grade category. Since 2000, Russia has been moved up three notches

because of improved fiscal and liquidity positions. Only Hungary had been rated prior to the transition[23].

**Table 2. Credit Ratings for the Transition Economies and Changes in 2000-2002**

<b>Fitch, S&amp;P/Moody's</b>	<b>Country</b>	<b>Date</b>	<b>Outlook</b>
<b>Investment grade</b>			
A/A2	Slovenia	Dec. 1999	Stable
A-/A3	Hungary	Nov. 2000	Stable
	Estonia	Aug. 2001	Stable
BBB+/Baa1	Czech Republic	Nov. 1997	Stable
	Poland	Nov. 1998	Stable
	Estonia	Sep. 2000	
BBB/Baa2	Latvia	Jun. 1998	Positive
BBB-/Baa3	Croatia	Jun. 2001	Stable
	Lithuania	May 2001	Stable
	Slovakia	Oct. 2001	Stable
<b>Sub-investment grade</b>			
BB+/Ba1	Slovakia	Dec. 1998	Positive
BB/Ba2	Kazakhstan	Jul. 2001	Stable
BB-/Ba3	Bulgaria	Jan 2002	Stable
	Azerbaijan	Jul. 2000	
B+/B1	Russia	Oct. 2001	Stable
	Azerbaijan	Jun. 2000	
B/B2	Romania	Nov. 2000	Positive
	Russia	Aug. 2000	
B-/B3	Ukraine	Jun. 2001	Stable
	Russia		
<b>Downgrades</b>			
CCC+/Caa1	Republic of Moldova	May 2001	
CCC-/Caa3	Turkmenistan	May 2001	N/A
CC/Ca2	Republic of Moldova	Jun. 2001	Negative

**Source:** Fitch, Mood's and Standard and Poor's rating services. In UNECE (2002).

### 3.3 Investments

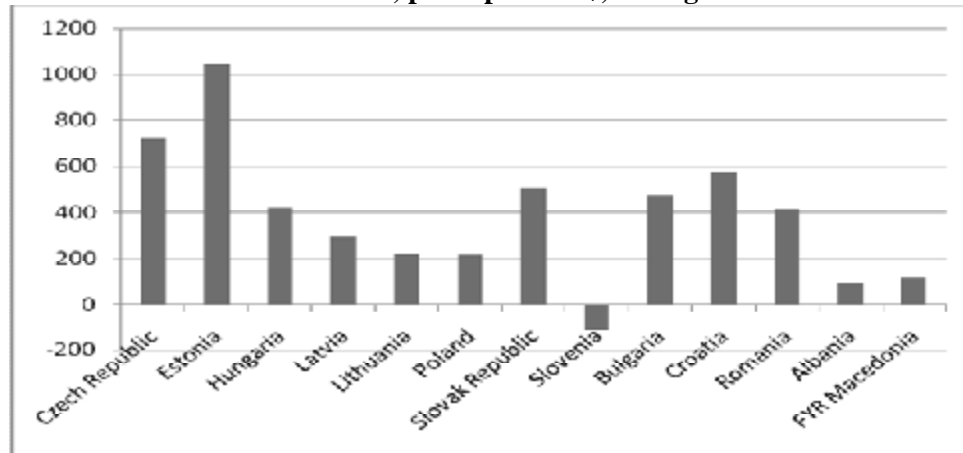
Capital flows can affect domestic investment in several ways. First, foreign direct investment contributes directly to new plant and equipment. Second, FDI may produce investment spillovers beyond the direct increase in capital stock through linkages among firms. For example, multinational corporations may purchase inputs from domestic suppliers thereby encouraging new investment by local firms. Foreign direct investment for mergers and acquisitions does not contribute to capital formation directly unless the new foreign owners modernize or expand their acquisitions by investing in new technology. Foreign direct investment may also "crowd out" domestic investment, if multinational corporations raise productivity and force local competitors out of the

market. This is usually the case when multinational corporations use imported inputs or enter sectors previously dominated by state-owned firms. Finally, foreign direct investment foreign loans and portfolio investment may reduce interest rates or increase credit available to finance new domestic investment [18].

In addition, foreign capital can have indirect impact on domestic investment. To attract foreign investors governments of developing countries have to implement sound macroeconomic policies, develop their institutions and improve governance. Loans and portfolio flows also contribute to the deepening and broadening of financial markets. Moreover, FDI usually results in the transfer of managerial skills and new technology and, consequently, improves productivity [14].

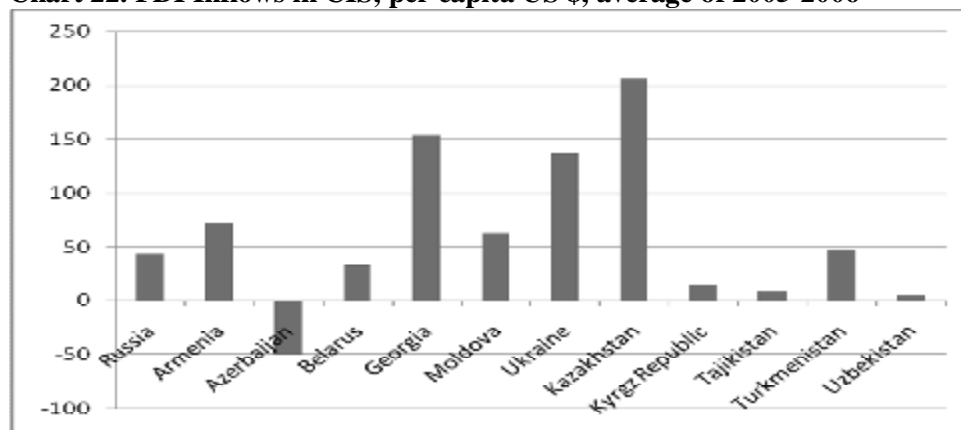
In the transition economies, foreign direct investment proved resilient in the wake of the Asian and Russian financial crises (1997-1998) and again during the global slowdown in 2001. In general, FDI flows in the transition economies remain influenced by governments' privatisation decisions [23]. In CEE economies, especially, Czech Republic, Estonia, Slovak Republic, Bulgaria, Croatia and Romania, the foreign direct investment inflow per capita has exceed \$ 400. While Estonia has the highest FDI per capita, Albania has the smallest FDI per capita (Chart 21). CIS countries received relatively small amounts of FDI per capita. Among CIS economies, Kazakhstan, Georgia and Ukraine have more the amount of FDI per capita than the rest of the region (Chart 22).

**Chart 21. FDI Inflows in CEE, per capita US \$, average of 2005-2006**



Source: EBRD, Transition Report Update 2007.

**Chart 22. FDI Inflows in CIS, per capita US \$, average of 2005-2006**



Source: EBRD, Transition Report Update 2007.

In addition, a study found that foreign direct investment inflows are significantly influenced by risk, unit labour costs, host market size in transition countries. Moreover, the study identified that private sector development, industrial development, the government balance, gross reserves, and corruption are significant determinants of perceived country risk [4]. According to another study investigated the relationship between capital inflows and domestic investment in transition countries. The results show that FDI flows may produce small investment spillovers in host economies which have either completed the transition process or are in its final stages [18].

### 3.4 Savings

Almost all of the transition economies in Eastern Europe and the former Soviet Union experienced a severe decline in their national saving rates. The saving collapse could be explained by the elimination of involuntary saving, a feature of central planning, or by a change in equilibrium saving reflecting the new economic-circumstances following the end of socialism [7]. Table 3 shows the savings in CEE and CIS economies. Savings in these economies still have lower rate as a percentage of GDP. After liberalization of capital flows, savings continue to stay same rates.

**Table 3. Savings, percent of GDP**

	2001	2002	2003	2004	2005	2006	2007	2008
<b>Central and Eastern Europe</b>	19.2	19.0	18.4	18.7	18.7	18.2	18.7	19.5
<b>CIS</b>	29.8	26.6	27.5	29.6	29.6	28.6	27.0	25.5

Source: IMF, World Economic Outlook, Statistical Annex, 2007.

In addition, there is a study which supports the table. The study analyses the effects of the gross foreign capital inflows on the national savings and domestic investments. The

foreign capital inflows into transition countries increase the levels of national investments but not the national savings levels. Foreign capital inflows into transition countries have had a positive “crowding-in effect” on the national investment. Portfolio investment inflows have no significant influence on national investments [15]. Same result found another study. This study shows that greater liberalization is association with lower saving with a one a year lag [7].

### 3.5 Transfer of Technology

Financially integrated economies attract a large share of FDI inflows, which have the potential to generate technology spillovers and to serve as a conduit for passing on better management practices. These spillovers can raise aggregate productivity and, in turn, boost economic growth. To estimate the level of technology is hard in transition countries because of lack of data. So the internet users were used in this study as an indicator of the level of technology. The following table indicates the internet users in CEE and CIS economies since the beginning of 2000. Both CEE and CIS economies have an increase at the internet users. The internet users in CEE economies are more than CIS economies. Even though CIS economies have a smaller increase, it is important to see an increase after financial liberalization (Table 4).

**Table 4. Internet Users, 2002-2006 (per 100 inhabitants)**

CEE	2002	2003	2004	2005	2006	CIS	2002	2003	2004	2005	2006
Albania	0,4	1,0	2,4	6,0	15,0	Armenia	2,0	4,6	5,0	5,3	5,8
Bulgaria	8,0	12,0	15,9	20,6	24,4	Azerbaijan	3,6	4,2	4,9	8,1	9,8
Croatia	18,0	23,2	31,1	32,4	34,6	Belarus	9,0	16,3	25,1	34,8	56,5
Czech Republic	25,5	23,5	25,2	27,0	34,7	Georgia	1,6	2,6	3,9	6,1	7,5
Estonia	32,8	44,4	50,2	51,9	57,4	Kazakhstan	1,7	2,0	2,7	4,1	8,4
Hungary	15,8	23,7	26,7	29,7	34,8	Kyrgyz Republic	3,0	4,0	5,2	5,3	5,6
Latvia	13,3	24,2	35,4	44,7	46,7	Moldova	3,5	6,8	9,5	13,1	17,4
Lithuania	14,4	20,1	22,3	25,8	31,7	Russia	4,1	8,3	12,9	15,2	18,0
Macedonia	5,0	6,2	7,8	7,9	13,2	Tajikistan	0,1	0,1	0,1	0,3	0,3
Poland	23,0	23,2	23,4	26,0	28,6	Turkmenistan	0,3	0,4	0,7	1,0	1,3
Romania	10,1	18,5	20,8	22,1	32,4	Ukraine	1,9	5,3	8,0	9,8	12,1
Slovak Republic	16,0	25,6	30,7	35,3	41,8	Uzbekistan	1,1	1,9	2,6	3,3	6,3
Slovenia	37,6	40,1	48,0	55,4	63,6						

Source: EBRD, Structural Indicators, 2007.

In addition, a research examined a large set of more than 8,000 firms for ten advanced transition countries in order to uncover the importance of different channels of technology transfer through FDI and its impact on productivity growth of local firms. The study found that direct FDI effects were found to provide by far the most important productivity effect for local firms in transition countries [6]. This is an important evidence in term of the effect of capital flows on the development of transition countries.

## 5. Conclusion

Capital flows support the transition in many ways. The region's economic opportunities and potential as a location for production and as a growing market remain large. Foreign investment -FDI as well as bank lending, bond finance and portfolio equity flows- is helping to develop these opportunities in many transition economies. During the 1990s most transition economies undertook a series of market reforms, including opening their capital accounts and have become more integrated into global financial system. In this paper, we focused on the effects that the financial globalization and international private capital flows had on the development of transition countries as well as how they helped shape its financial markets. We used direct channels to analyze the development of transition countries and concluded with some important developments regarding the desirable degree of openness of the capital accounts with regard to the growth in the long run. The effect of financial globalization is positive on transition countries in terms of financial development, investments, savings and transfer of technology. Especially, the improvements on the size, structure and efficiency of financial sector in transition countries are remarkable under financial globalization.

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