odi

Overseas Development Institute

Briefing Paper

November 1992

AIDING EASTERN EUROPE AND THE FORMER SOVIET REPUBLICS

Since 1989 the republics of the former Soviet Union and Eastern Europe have opted to transform themselves into more decentralised Western-style market economies. This process of political and economic change has seen hyper-inflation, spectacular declines in production and trade, and, in some cases, armed conflict. It has been complicated by a fragmentation of the region from just eight to over twenty-five states, with additional partitions in prospect.

Various forms of external public resources are playing a positive role in the transformation process. Humanitarian aid is providing immediate relief to regions affected by civil war and economic turmoil. Short-term financial assistance, mostly on near-commercial terms, is providing balance of payments support to ease the external financing gap and finance critical imports, thus supporting the stabilisation and structural adjustment process. Official export credits are stimulating trade. Long term loans for investment projects in sectors such as energy are providing capital vital to the emergence of internationally competitive industries. Technical assistance is providing training and skills in support of the economic restructuring.

Despite some effusive claims, official development assistance (oda), that is grants and concessional loans for development purposes with at least a 25% grant element, has so far been limited. The bulk of external flows has been export credits. This Briefing Paper considers the new states' eligibility for different types of assistance, reviews assistance flows to the region and the leading suppliers, and examines the issue of diversion of resources from developing countries.

Economic and Social Indicators

	Population 1990 (m)	GDP per capita 1990 ($/index)	% change in GDP 1991 (%)	Infant Mortality Rate 1989 (per '000)
Albania	3.2	1,090	-21.1	25
Bulgaria	9.0	2,210	-25.0	14
Czechoslovakia	15.7	2,830	-16.4	11
Hungary	10.6	3,110	-7.5	16
Poland	38.4	1,660	-8.0	16
Romania	23.3	1,490	-12.0	27
Yugoslavia	23.8	3,460	-29.3	24
USSR	289.4	5,630[a] 1,960[b] 100[c]	-17.0	25
Russia	148.3	120[c]	-9.0	18
Ukraine	51.9	90[c]	-9.6	13
Belarus	10.3	110[c]	-3.1	12
Kazakhstan	16.7	77[c]	-10.0	26
Kirgizstan	4.4	54[c]	-2.0	32
Tadjikistan	5.3	38[c]	-8.7	43
Turkmenistan	3.7	56[c]	-0.6	55
Uzbekistan	20.5	50[c]	-0.9	38
Armenia	3.3	83[c]	-11.8	20
Azerbaidjan	7.1	59[c]	-0.7	26
Georgia	5.5	77[c]	-25.0	20
Moldova	4.4	82[c]	-11.9	20
Estonia	1.6	141[c]	-10.8	15
Latvia	2.7	128[c]	-7.9	11
Lithuania	3.7	102[c]	-13.0	11
Low income countries	3,007.0	324		70
Middle income countries	1,127.2	1,920		51
OECD	777.6	18,490		8

[a] official Gosbank exchange rate; [b] commercial exchange rate, introduced Oct.1990; [c] index, USSR=100

Sources: UNDP, *Human Development Report 1992*; IMF, World Bank, OECD and EBRD, *A Study of the Soviet Economy*, 1992; World Bank, *Statistical Handbook: States of the Former USSR*, 1992. IMF, *World Economic Outlook*, 1992.

Appropriate Assistance

Eastern Europe and the former Soviet republics (FSRs) can be divided into four broad, although slightly overlapping, categories in terms of the possible roles external assistance can play. These categories reflect pre-reform economic conditions, the extent and nature of reform and whether reform is accompanied by armed conflict. With the exception of the first criterion, these differ from conventional aid eligibility criteria as applied to developing countries such as levels of GDP per head and national food availability.

• First, some countries need highly concessional long-term aid – namely Albania and the four poorer Central Asian FSRs (Kirgizstan, Tadjikistan, Turkmenistan and Uzbekistan). However, there are continuing difficulties in determining eligibility for such aid, if conventionally based on per capita GNP. Pre-1989, socialist countries reported Net Material Product (NMP), a measure of physical output which excludes the services sectors except transport and distribution of products and so which is, by definition, lower than GNP. Since 1989, there have been large falls in output, compounding difficulties in determining eligibility. Furthermore, there are problems in converting national income from local currency into dollars as a range of volatile exchange rates exist (see Table).

• Second, there are countries where pre-reform economic and social welfare conditions were better, where absorptive capacity for loans exists, but where the effects of conflict are, or could be, so severe that there is an obvious role for emergency aid and concessional aid for reconstruction. This category includes Bosnia-Hercegovina and possibly FSRs such as Armenia, Georgia and Tadjikistan.

• Third, there is the rest of Eastern Europe, where reform is most advanced. There is a potential role here for bank lending and official assistance, at near-commercial rates, to support stabilisation and structural reform. This category includes the Czech and Slovak republics, Hungary and Poland (the so-called Visegrad Group), which are looking for early entry into the European Community; Bulgaria, Romania and the Baltic Republics (Estonia, Latvia and Lithuania), as the latter establish independent currencies, which are also likely to become more integrated into the EC-EFTA region; and some, although perhaps not all, of the other former Yugoslav republics (Croatia, Slovenia, Serbia-Montenegro and Macedonia).

• Lastly, there are the larger FSRs (Belarus, Kazakhstan, Ukraine and, particularly, Russia) which by virtue of their sheer size and highly integrated economies are special cases. Here a huge potential role is seen, perhaps rather optimistically, for short-term assistance to facilitate economic reconstruction, to stabilise or establish sound currencies, to meet financing gaps and to achieve the beginnings of restructured sustainable industrialised development.

• The former German Democratic Republic is not included in the above four categories as it is already absorbed into the Federal Republic and into the EC.

Overview of Assistance Flows

In 1990-91, \$49bn of assistance was committed to Eastern Europe; \$86bn was committed to the FSRs between October 1990 and June 1992, according to EC Commission estimates[1]. Credit guarantees at near commercial rates were especially prominent to the FSRs and accounted for about 50% of total commitments. Official loans at near commercial rates accounted for around 15% and grant aid for around 13%, of which almost half was debt relief and rescheduling, largely for Poland. Disbursement levels were much lower than levels of commitments, partly because many commitments are conditional on the adoption of approved economic adjustment programmes which are still being drawn up and because commitments are intended for disbursement over a number of years. Reporting procedures on disbursement are still being established and 20% of commitments reported to the EC are not even disaggregated by type of assistance. By mid-October, the OECD, which is responsible for collating data on aid disbursements, had received replies from only eight DAC donor countries on their 1991 programmes, some of which were incomplete.

The international financial institutions (IFIs) accounted for about half of total assistance committed to *Eastern Europe* in 1990-1. Germany, despite incurring substantial unification costs, and the USA have been important, accounting for over a quarter of assistance.

In contrast, by mid-1992 most commitments to the *FSRs* had been made by bilateral donors, with Germany alone accounting for over half of the total through its commitment of strategic assistance for the withdrawal of Soviet troops as well as substantial export credits.

The IFIs have accounted for relatively little of total commitments to the FSRs to date because the individual republics have only recently gained membership and because of problems in drawing up approved economic reform programmes, delaying commitment of assistance.

Nevertheless, the International Monetary Fund (IMF) has emerged as the most important external actor involved in the reform process to date throughout the region, through its role of advising on economic and financial issues and as one of few providers of quick-disbursing loans. Access to IMF facilities and most other economic assistance, such as from the World Bank and bilateral creditors, has been made conditional on the adoption of IMF approved economic reform programmes. In the longer term, the World Bank, the European Bank for Reconstruction and Development (EBRD) and, to a lesser extent, bilateral donors are expected to play a prominent role as economies stabilise and interests turn to the lengthy tasks of structural change and rehabilitation.

The Lending Agencies

International Monetary Fund

In 1989, only Hungary, Poland, Romania and Yugoslavia were members of the IMF, with Albania and Bulgaria joining and Czechoslovakia rejoining in 1991. Eastern European states have now become amongst the most active IMF members, accounting for 12% of current Stand-by arrangements and 19% of Extended arrangements. Hungary and Poland entered into the only fresh Extended Fund Facility arrangements made during FY1990/91 although the Polish facility was subsequently suspended in September 1991 after the government failed to meet the agreed targets on the size of its budget deficit. Albania, Bulgaria, Czechoslovakia and Romania currently have Stand-by arrangements. Before it broke up, the Czech and Slovak Federal Republic had become the IMF's fourth largest borrower worldwide.

Since April 1992, most FSRs have joined the IMF. By September, Stand-by arrangements had been concluded with Latvia and Estonia, enabling them to borrow up to \$120m, and were being negotiated with Lithuania, Kazakhstan, Kirgizstan and Belarus. A provisional \$4bn Stand-by arrangement for Russia was also agreed in April 1992 as part of a multi-donor \$24bn package of assistance. The first \$1bn tranche was made available in August, after considerable international pressure had been brought to bear on the IMF. However, approval of the remaining \$3bn is conditional on certain economic performance targets being achieved and a rouble zone being established and now will probably be delayed until 1993. The G10, in fact composed of eleven countries (the G7 plus Belgium, the Netherlands, Sweden and Switzerland), also intended to activate the General Arrangements to Borrow (GAB) facility for the first time since 1978 to finance a \$6bn stabilisation fund for Russia again as part of the \$24bn assistance package agreed in April. This facility now also seems unlikely to be activated for Russia before 1993, if at all, depending on when economic performance conditions are satisfied. Nevertheless, because the IMF anticipates a further \$25-\$30bn of loans to the FSRs over the next four years, as well as further loans to Eastern Europe, it may become necessary to activate the GAB.

In advising on the process of reform throughout the region, the IMF has made broadly similar policy prescriptions namely: restoration of financial stability; large scale liberalisation of prices; ownership reform; and substantial short-term tightening of fiscal and monetary policy. Drawing up prescriptions for the FSRs has been particularly difficult because of the currency situation in the 'rouble zone' and plans by some republics to establish separate currencies. The short-run stabilisation measures have entailed sometimes large reductions in real public sector expenditure, liberalisation of prices and privatisation measures, potentially giving rise to or exacerbating economic pressures on vulnerable social groups.

World Bank

Financial assistance is being provided through the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA) and the International Finance Corporation (IFC), the World Bank's private sector specialist institution.

New IBRD lending, which is at near commercial rates, to Eastern Europe increased from \$0.5bn in FY1989 to \$2.9bn in FY1991, falling to \$1.7bn in FY1992. Poland alone received some 38% of new loans to the region in 1990-2 while Eastern Europe accounted for 14% of new IBRD loans. Over a third of these loans were for structural adjustment programmes, with a further fifth for the energy sector. IBRD loans to the region also have a relatively greater technical assistance component than those to developing countries.

The volume of IBRD loans to the region is expected to grow substantially during FY1993 and 1994, following the entry of the FSRs into the Bank in April and May 1992. The first loans to Russia were announced in August, totalling \$600m and a further \$1.1bn of loans to Russia are under preparation. IBRD loans to the FSRs could rise to \$4-5bn per annum in future years.

Albania, the only country in the region so far to have acquired IDA soft credit status, had a \$41m credit approved to help finance critical imports. The eligibility of the poorer Central Asian republics for IDA status is currently being assessed.

European Bank for Reconstruction and Development

This was founded in 1990, with capital of Ecu 10bn (\$13bn), specifically to provide loans, equity and technical assistance to Eastern Europe and the former Soviet Union. All Eastern European countries and FSRs, except Armenia are now members.

---

1. The EC has been entrusted with a lead monitoring and coordinating role (see p.3).

Food as Economic Aid and Relief

Food aid, often the immediate, highly visible response to a perceived situation of distress and hunger, has constituted a large proportion of total grant assistance received so far by Eastern Europe and the FSRs. Between January 1989 and June 1992, the region received 4.4 million tonnes, representing 11% of total world food aid receipts of over that period. Much of this food is being supplied by the EC and the USA. In 1989, Poland was the only recipient. Coverage was extended to Romania in 1990 and Albania, Bulgaria and the USSR in 1991. In 1992 there have been further food aid actions, for Russia and the three Baltic states. Albania is now dependent on food aid to feed its population, owing to major disruptions to agricultural production and difficulties with land reform. Food aid to the region has been supplied either as programme aid, for sale to the public, or emergency aid, in some cases through international NGOs.

However, although food aid has represented a large proportion of oda so far to the region, its overall economic significance should not be exaggerated. For example, the FSRs imported 38 million tonnes in 1991/92, largely funded under export credit programmes. Only 3% of the total was grant aid.

Some aid has been controversial. In particular, the arrival of a large consignment of food aid just before the 1990 Polish harvest combined with the simultaneous unloading by farmers of hoarded foodstuffs disrupted agricultural markets.

Albania will require continued high levels of food aid in the remainder of 1992 and 1993. A massive food aid operation has also been drawn up for Bosnia, with almost 300,000 tonnes of food aid to be distributed to some 3 million people between November 1992 and March 1993 under a joint WFP-UNHCR programme. This operation involves logistical operations comparable to those in Southern Sudan and Afghanistan. Some drought-hit Eastern European countries (not Hungary) are likely to import cereals in 1992/3 but large scale food aid is unlikely.

Several FSRs could also experience possibly localised food shortages and so require food aid. This is due to the breakup of the previously highly concentrated structure of the Soviet agricultural and food processing sectors, which had met the needs of food deficit states, and to hard currency shortages, constraining commercial or even semi-concessional food imports. Indeed, some food aid may be supplied in the absence of national or regional food shortages to address the needs of vulnerable groups, possibly as cash handouts of counterpart funds generated from food aid sales.

The EBRD made its first loans in mid-1991. Initially the Bank faced problems in finding sufficient private sector projects. Its mandate is to direct at least 60% of funding to private sector enterprises. Nevertheless, by mid-September 1992 it had committed some $1.4bn in loans and equity, covering 42 projects. Almost half of approved loans have been in the telecommunications sector, where rapid upgrading is considered an urgent priority. Romania, Poland and Hungary received four-fifths of total loans approved. However, the geographical distribution of loans should change in future years, following a decision in February 1992 to earmark 40% of the Bank's loans for FSRs excluding the Baltic states. The Bank intends to authorise lending of Ecu2bn ($2.5bn) in 1993.

Other United Nations agencies

Although normally a significant source of grant aid, other UN agencies have had relatively little involvement in supplying credit to Eastern Europe and the FSRs to date. Many Western governments have chosen to work within a framework involving only the IFIs. Emergency assistance has shown a revealed preference for bilateral action involving Western NGOs and the Red Cross rather than the UN specialised agencies. However there has been one notable exception, Bosnia, where UNHCR and, since November 1992, WFP have been active (see Box).

The UNDP, the largest provider of technical assistance within the UN, has been one of the more active UN agencies in the region overall. The FSRs are now seeking UNDP status as well. UNIDO and the UN Economic Commission for Europe, UN agencies with a long tradition of significant Eastern European involvement, are also playing an enhanced role. The ILO, UNFPA, UNICEF and the WHO are now becoming more actively involved in Eastern Europe and the FSRs.

European Community

Assistance to Eastern Europe and the Baltic States have been provided under the EC's PHARE programme while assistance to the 11 CIS states and Georgia has been provided under TACIS, a technical assistance programme. TACIS was initiated in 1991 with an annual budget of Ecu 400m ($496m), increased to Ecu 450m in both 1992 and 1993. Further assistance has been provided under other EC programmes such as TEMPUS, a higher education programme, whilst loans have been provided through a number of EC affiliates.

The PHARE initiative, begun in 1989 to support projects in Poland and Hungary, was extended to include Czechoslovakia, Romania and Yugoslavia in 1990 and Albania and the Baltic States in 1991. Its budget has increased from Ecu 500m ($637m) in FY1990 to Ecu 1bn ($1.2bn) in FY1992. In its first full year of operation, 1990, a diverse range of projects were supported by the programme. However, to ensure greater coherence, since 1991 the programme has concentrated on a number of 'core activities', including restructuring of public enterprises, modernisation of financial services, promotion of the private sector and the development of the labour market and the social sector.

Bilateral Assistance

Well over half of bilateral assistance commitments have been in the form of export credits, particularly from Germany and with Russia as by far the largest recipient, partly under the multi-donor $24bn package of assistance agreed in April 1992. A large proportion of hard currency trade prior to reform was also covered by credits. However, the more recent credits which entail a fuller coverage of guarantees to private exporters, with higher risk of deferred payment, implicitly involve higher *de facto* cost to the guarantor state. Many governments have subsequently frozen their credit lines with Russia because of arrears exceeding $4bn on debts excluded from the deferral of principal payments on medium term debt.

Official development assistance commitments have formed a more modest proportion of total bilateral assistance. The OECD estimates that Eastern Europe was committed some $1.7bn of bilateral oda from OECD/DAC members in 1990, some two-thirds of which was from the EC, Germany and the USA. This included some food aid (see Box), and a $1bn Polish zloty stabilisation fund which was never drawn upon. (Donors are now considering rechanneling this aid into other projects.) With the gradual extension of support to the rest of Eastern Europe and the FSRs, official development assistance was higher in 1991 and 1992, but still a small matter in comparison with export credits.

The UK and some other bilateral donors have established new arrangements to handle assistance to the region. The UK established a Know-How Fund in 1989 for Poland, which was subsequently extended to include other Eastern European countries and had some £30m ($52m) of funds in 1991. A separate Fund of £50m ($87m) allocated over a two year period was established for the former USSR in 1990. The Know-How Funds continue to be carried, but separately identified, on the Aid Vote. Including the UK share of EC expenditure, this is now the fastest-growing part of the aid programme. On 12 November 1992, HMG announced the planned expenditure levels for assistance to the FSRs/Eastern Europe as £188m in the current FY and £232m in 1993/94, rising to £331m in 1995/96. This is a planned 76% cash increase, whereas aid for developing countries is planned to stick at £1.9bn in cash terms.

Japan, globally the largest bilateral provider of oda loans, has so far committed, and fully distributed, 7.5 billion yen ($61m) for food aid and medicine to the FSRs as grant assistance. $2.5bn of loan and guarantee assistance has already been committed to Russia, mostly been in the form of export credits, but Japan may be unwilling to provide greater assistance until its continuing dispute over sovereignty of the Kurile islands has been resolved.

Coordination of Assistance

A striking feature of the coordination of assistance to both the FSRs and Eastern Europe has been the lack of UN involvement outside the Bretton Woods institutions. The EC was appointed by the G24 (the 24 OECD members) as coordinator of bilateral assistance to Poland and Hungary at the 1989 Paris Summit; and this role was later extended to include other Eastern European countries. In this capacity, the EC organises regular sectoral working meetings attended by the G24, the relevant IFIs and Eastern European government officials; organises short-term grant assistance; puts together groups of donors to draw up packages of balance of payments assistance; and collates data on assistance flows. In the special case of Bosnia, the EC and the UN are operating alongside each other.

No single coordinator has been appointed to cover assistance to the FSRs. Instead, coordination has been organised through a series of three ministerial conferences held in Washington (January 1992), Lisbon (May 1992) and Tokyo (October 1992), attended by members of the OECD, some developing countries, UN agencies and the IFIs. At the Washington Conference, five sectoral working groups were established to facilitate additional meetings and, in some cases, dispatch assessment missions. However, at the Tokyo conference it was decided to replace these with World Bank-led consultative groups, most of which are expected to be convened by mid-1993. These groups will combine interested donors, appropriate international organisations and the country concerned to foster greater donor cooperation.

Implications for resource flows to developing countries

Vanishing Aid and Trade Preferences

The reforms in Eastern Europe and the FSRs potentially affect developing countries directly through changes in the economic relationships with the region, and indirectly through an eventual diversion of resource flows and trade preferences of advanced industrial economies from developing countries to Eastern Europe and the former Soviet republics. Some countries, such as Cuba, Mongolia and Vietnam, have already been adversely affected by the gradual elimination, from some $5bn in 1987, of the former USSR and Eastern European aid programmes. Both these and other developing countries such as India, have also experienced a massive decline in bilateral trade as a result of the virtual cessation of barter trade following the dissolution of the CMEA at the end of 1990. The conversion of Eastern Europe and the FSRs from trade-preference givers to trade preference receivers has also reduced the value of existing preferences to ldcs.

Aid Diversion

To date there has been little evidence of diversion of bilateral oda as measured by the overt switching of assistance from developing countries. Many bilateral donors have sought publicly to make aid to the region additional to their existing aid programmes to developing countries. This concern to demonstrate additionality has been formally reflected in the creation of new programmes, such as PHARE, TACIS and the British Know-How Funds, specifically for assistance to Eastern Europe and the FSRs. However, if any future aid programme cuts are accompanied by increased oda efforts in Eastern Europe and the FSRs, even from separate budget lines, diversion will have occurred.

So far, the region has not directly 'competed' with LDCs for highly concessional assistance, such as IDA credits. But to funding constraints faced by the 10th replenishment of IDA, even to reach the minimum $18bn level necessary to maintain the volume of lending to the poorest countries, could be added crowding-out effects, particularly if several FSRs and new countries such as Vietnam, in addition to Albania, are granted IDA status.

Official Lending

IFIs providing loans at near-commercial rates have been more active in the region but, so far, without reducing absolute lending to developing countries. However, by the mid-1990s, the World Bank anticipates lending equivalent to 40% of its current IBRD loan approvals to Eastern Europe and the FSRs. Borrowing by the region from the IMF is likely to represent a similar proportion of the Fund's current activities. Potentially, these levels of borrowing could strain the IMF's liquidity and the IBRD's capital base and so affect lending to developing countries.

Substantial export credits have been committed to the region. These are not a new phenomenon. However, more recent credits have entailed increased government underwriting and, given creditworthiness limits, could curtail future export credits to developing countries.

Indirectly, any additional demand for external savings by Eastern Europe and the FSRs, whether from public or private sources, puts upward pressure on world interest rates, as already has the reunification of Germany, thus increasing the cost of borrowing by developing countries.

Debt

Western governments may also favour Eastern Europe and the FSRs for debt relief. Already, in April 1991, the Paris Club agreed to an unprecedented debt forgiveness package cancelling up to 50% of the $33bn Polish debt. Russia is also pressing the West for a massive debt rescheduling and deferral agreement on the $70-80bn former Soviet debt, for which, excluding the relatively large Ukrainian share, Russia has offered to assume sole responsibility if other republics renounce claims on former Soviet assets.

Technical and Political Cooperation

Technical assistance efforts in support of Eastern Europe and the FSRs are attracting scarce management and professional expertise, potentially weakening the pace of institutional reforms elsewhere. The IMF has just established the Joint Vienna Institute to retrain former socialist officials and managers. This shift in political focus also weakens the voice of developing countries in global affairs. Yet the attention which Eastern Europe and the FSRs are receiving is probably inevitable, because of the major implications for global stability of developments in the region. Voiced concerns about the diversion of resources from developing countries tend to be faint in comparison with the deafening alarm over the consequences of an eventual failure of Western supported reform.

This Briefing Paper draws on a recent ODI Special Report by Charlotte Benson and Edward Clay, *Eastern Europe and the Former Soviet Union: Economic Change, Social Welfare and Aid*, ODI 1992.