

Transition report

October 1994



European Bank
for Reconstruction and Development



Economic transition
in eastern Europe and the
former Soviet Union

*Defining and measuring
transition*

*Institutional reform:
privatisation, finance and law*

Trade and foreign investment

*Macroeconomic
developments and prospects*

*Indicators for each country
in the region*

Guide to readers

Country grouping

The Report uses the following collective terms to refer to country groupings:

Eastern Europe	Albania, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic and Slovenia
Former Soviet Union	Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan
Baltic states	Estonia, Latvia and Lithuania
CIS	The countries of the former Soviet Union excluding the Baltic states
Countries of operations	The EBRD's member countries in eastern Europe and the former Soviet Union

Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development
CEFTA	Central European Free Trade Agreement
CEPR	Centre for Economic Policy Research
CIS	Commonwealth of Independent States (which includes as full or associate members all countries of the former Soviet Union, except the Baltic states)
CMEA	Council for Mutual Economic Assistance (former)
CSCE	Conference on Security and Cooperation in Europe
CSFR	Czech and Slovak Federal Republic
EA	Europe Agreement
EC	European Community
ECO	Economic Cooperation Organisation
ECU	European Currency Unit
ECSC	European Coal and Steel Community
EFTA	European Free Trade Area
EU	European Union
Euratom	European Atomic Energy Community
FDI	foreign direct investment
G-7	Group of 7 (Canada, France, Germany, Italy, Japan, UK and USA)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	Generalised system of preferences; exception to the Gatt's MFN principle; established to accord with lower tariff rates (than MFN) for industrial country imports from developing countries
IBRD	International Bank for Reconstruction and Development (World Bank)
IFI	International financial institution
IMF	International Monetary Fund
MFN	most-favoured nation: GATT principle; gives the country tariff treatment equal to the lowest rate generally offered to other countries
na	not available
NAFTA	North American Free Trade Agreement
NERA	National Economic Research Associates
NMP	net material product
NTBs	non-tariff barriers
OECD	Organisation for Economic Cooperation and Development
PCA	Partnership and Cooperation Agreement
PPP	purchasing power parity
SMEs	small and medium-sized enterprises
SRP	Special Restructuring Programme (of the EBRD)
STF	Systemic Transformation Facility (of the IMF)
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
UNESCO	United Nations Educational, Scientific and Cultural Organization
VAT	value added tax

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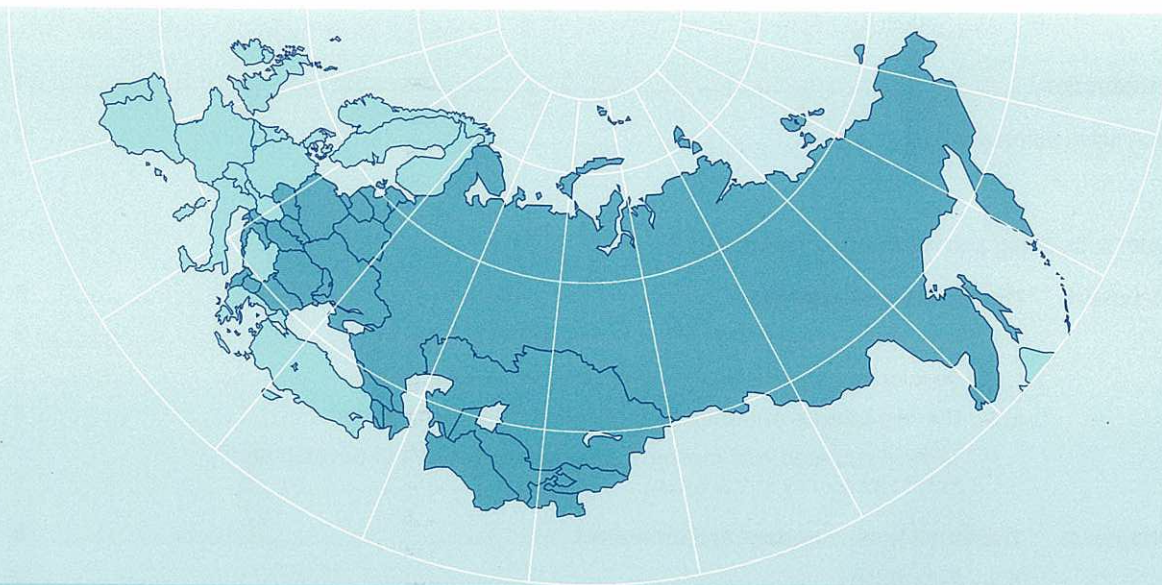
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**Economic transition in eastern Europe
and the former Soviet Union**

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Introduction

The first article of the Agreement Establishing the EBRD defines as its purpose “to foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative”. The transition is a complex and varied process which will take different forms in different countries. Effective involvement in that process requires analysis and measurement. One of the EBRD’s tasks is to promote and develop that analysis for the benefit of all participants in the process, be they from the private sector, governments or international institutions. This Report is a contribution to that task. It deals with the definition and measurement of transition (Part I), the institutional change which lies at the heart of transition (Part II), trade and foreign direct investment which will be among the key elements in the process (Part III), and macroeconomic developments and trends in the region (Part IV).

When the process of transition began at the end of the 1980s, the experience and theory to guide the course was very limited. Five years on much has been achieved and learned. Some of the early euphoria and simplistic messages have subsided. Most now understand that the process can be neither instantaneous nor painless. Among the 25 countries of operations of the EBRD, the transition is already far advanced in some countries and is under way in all countries. However, the problems and experience vary enormously and the strong differences in experience and performance constitute one of the central messages of this Report.

The design of policies for both public and private participants must be linked to the stage of the transition, whose documentation is therefore crucial to the transition process itself. The report examines some central aspects of the transition, particularly the financial sector, law and taxation. The institutional arrangements for these sectors constitute pillars of the “economic infrastructure” of a market economy and are thus basic to the transition. So too is the creation of the right environment for foreign direct investment. Though domestic investment will provide the main engine for growth in most countries, and is thus a prime concern of the EBRD, foreign direct investment can provide many benefits to the domestic economy in the development of skills, the understanding of the market system and the promotion of further investment opportunities. It is important, therefore, to understand the characteristics and determinants of foreign direct investment and those elements of the environment that will enhance its contribution to the domestic economy.

Both domestic and foreign investment will be greatly influenced by the future prospects for the economy. With statistical systems in an early stage it is not a straightforward matter to understand the recent past and likely future developments. The task of the last part of the Report is to contribute to this understanding.

This is the first *Transition Report* in what will be an annual series. The measurement of transition will remain a central theme, as will the analysis of institutional change and recent and future economic developments. Although many important issues of transition are addressed in this year’s Report, others have been left for deeper analysis in the years ahead. This Report is not a totally new departure in that it builds on earlier publications and work of the Bank, particularly the *Quarterly Economic Review* and the natural predecessor of this Report, last year’s *Annual Economic Outlook*. Pressure on resources precluded the continuation of the *Quarterly Economic Review* but, in addition to the *Transition Report*, the Bank will continue to report on recent economic developments in a number of forms, including the Statistical Appendix in the economics journal sponsored by the Bank, *The Economics of Transition*, and future statistical updates.

This *Transition Report* is the product of the Chief Economist's Office (CEO) of the EBRD working as a team. The editorial group was led by Kasper Bartholdy and John Flemming. Andrew Tyrie played a substantial editorial role in many chapters. The editorial work drew on extensive comments from Philippe Aghion, Willem Buiter and Ricardo Lago.

The Report is organised as follows: after the executive summary, John Flemming and I set out in Chapters 1 and 2 the definition and measurement of transition. The Appendix to Chapter 2 provides an overview, compiled by economists in the CEO, of each country's progress in transition; this work was organised by Mácé Mesters. In Chapter 3 John Flemming introduces the detailed treatment of institutional issues with a discussion of strategy. Aspects of institutional change are examined in Chapters 4-6: Steven Fries, assisted by Hubert Vogler, provides an analysis of privatisation, enterprise restructuring and the role played by financial institutions; Sophie Bourguignon discusses the framework of law; and Robin Burgess and Alexander Neuber, assisted by Toni Haniotis and Amrit Singh, consider issues of taxation. In Chapters 7-9, Hans Peter Lankes, drawing on inputs from Brian Hindley, Julie Lissaman, Patrick Messerlin, Alexander Neuber and Hiroko Yamane, presents an overview of policy issues related to trade and foreign direct investment in transition economies. The final two chapters focus on macroeconomic events and prospects. Recent economic developments are reviewed by Kasper Bartholdy and Andrew Tyrie in Chapter 10, which is supported by macroeconomic data series for each of the countries in eastern Europe and the former Soviet Union. The compilation of these tables was the work of all EBRD economists and was organised by Tanya Normak. In Chapter 11, Toni Haniotis analyses available macroeconomic forecasts for the region, emphasising the need to treat projections for transition economies with great caution. The latter analysis is backed by an Appendix, by Kasper Bartholdy, which discusses the large uncertainty that is associated with data on transition economies. While we have attempted to be as up-to-date as possible, the cut-off date for revisions to most of the draft chapters was early August 1994.

The CEO would like to thank EBRD staff from other departments who contributed to the Report: Bart le Blanc, Miklos Nemeth, Philippe Richard and Guy de Selliers for valuable comments, and members of the Office of the General Counsel (OGC) for their guidance on a number of legal issues related to Chapters 5 and 9, although it must be emphasised that the OGC does not necessarily endorse the statements made here. Sandy Donaldson (copy editing), Simon De Nicola (design) and Steven Still (design) have provided invaluable assistance. The support work in the CEO has been organised by Linda Hine. We are very grateful to all those who have contributed in their different ways.

The assessments, statements and views expressed in this *Transition Report* are not necessarily those of the EBRD and responsibility for them, and any errors, is taken by myself on behalf of the Chief Economist's Office.



Nicholas Stern
Chief Economist

26 September 1994

Executive summary

Chapter 1

The meaning of transition

This Report focuses on the progress made by 25 countries in effecting their transition from central planning towards open market-oriented economies. It therefore emphasises the role of private enterprise. This first chapter considers the meaning and essential content of economic transition. The context of different countries' transition programmes varies with their stage of development, and implementation is affected by the degree of macroeconomic stability. The differences between the linked concepts of development, transition and stabilisation are set out; indices of development for the transition economies are presented in a table. The transition economies span the World Bank's "middle-income" category but inherited more equal income distribution and better health and schooling indicators than is typical of that group.

Chapter 2

Transition: measurement and indicators

A summary table presents measures of the stage of transition for each country in the region. The table includes figures on the share of the private sector in GDP, as well as indicators of progress on large-scale privatisation, small-scale privatisation, enterprise restructuring, price liberalisation, the trade system and financial sector reform. An appendix elaborates further on advancement by individual countries in these areas. Most countries have liberalised trade and prices, and privatised most small-scale units. Much less has been achieved in large-scale privatisation, enterprise restructuring and financial sector reform. In these areas of transition the Czech Republic, Estonia, Hungary, Poland and the Slovak Republic are the most advanced. Russia and Kyrgyzstan, of the CIS countries, have gone furthest in institutional reforms. The private sector share of GDP lies in the 40-55 per cent range for most countries in eastern Europe and the Baltic states, as well as for Russia where large-scale privatisation has been rapid; in other parts of the CIS it remains around or below 30 per cent.

Chapter 3

Transition strategies

This chapter discusses strategies of transition with particular emphasis on the pace and sequence of steps leading to the hardening of budget constraints and to the privatisation of enterprises and banks. Countries undertaking more radical stabilisation and reform strategies have typically been rewarded with better performance. It does not follow, however, that faster would always be better. Measures may be required to mitigate the impact of stabilisation and structural reform on output, employment and social factors. Institutional reform is bound to be lengthy and associated with revisions, which may militate against the general preference of enterprises for regulatory and macroeconomic stability. A coherent reform programme, which includes a clearly defined timetable for institutional change, can, if it is regarded as politically credible, make it easier for enterprises and individuals to form expectations and to adjust their economic decision-making in a rational manner.

Chapter 4

Restructuring, privatisation and financial deepening

Restructuring and privatising former state enterprises is crucial to the transition. Some countries have privatised quickly, typically through mass voucher privatisation, leaving restructuring to the new owners. The adequacy of this approach depends on the corporate governance arrangements implicit in the new ownership structure. Under an alternative approach, a government agency may attempt to ensure the restructuring prior to privatisation. This effort may, however, delay the privatisation process. Both approaches require the problems of inherited bad debts to be tackled. Care has to be taken in devising any form of debt restructuring to ensure that it does not undermine the attempt to establish financial discipline with its ultimate sanction of bankruptcy. Internally generated funds will be an important source of finance for investment, and will demonstrate confidence and commitment by managers. Privatised enterprises will, however, need access to additional investible funds through the development of the domestic financial sector, which itself requires financial restructuring. This process can be assisted by, among others, international financial institutions.

Chapter 5

The framework of law in transition

Certain economic freedoms are required to underpin a market economy. All of the countries in transition have embarked on the reconstruction of, or are constructing from scratch, legal frameworks associated with these freedoms. This chapter, together with an accompanying table, summarises the position in 25 countries. Six major areas for legal reform are briefly examined; property, contract, security, bankruptcy, competition and company legislation. For each area of law a short summary of the purpose of that law in a market economy is provided, followed by an explanation of the legal treatment under socialism. Each section concludes with a description of legal reform to date, drawing on the information in the table. While adding to the statute book may be a step forward, legislation without effective implementation and enforcement may be of limited effect. Progress has, not surprisingly, been slower on implementation and enforcement than on legislation. This reflects, among other things, the need for institutional reform in such areas as the courts and legal education.

Chapter 6

Taxation and transition

Taxation is fundamental to transition. In a market economy the government has to finance the purchase of resources, whereas under the old regime it could command them. This chapter focuses, from a tax perspective, on the radical transformation of the relationship between the government and enterprises, as market reforms lead to an increase in the number of companies and to a weakening of their compliance with tax laws. Meanwhile, because of the changing role of government responsibilities and the economic disruption associated with transition, revenue requirements do not fall greatly despite the phasing-out of subsidies and the shedding of some responsibilities by the state. In response to these pressures, the tax structures of transition economies, which initially shared industrial economies' reliance on direct and domestic indirect taxes, have shifted somewhat, probably temporarily, towards a greater reliance on trade taxes. In the medium term the transition economies will need to reconstruct both a direct and an indirect tax base. Raising adequate revenue is essential if inflation is to be contained in economies whose capital markets do not yet allow adequately for non-monetary financing of government deficits. Some principles for this task are set out, focusing on economic efficiency and administrative effectiveness. In its treatment of direct taxation, the chapter concentrates on the reform of enterprise taxation.

Chapter 7

Openness to trade and foreign investment in transition

World trade has grown faster than output in the post-war period as global economic integration has intensified under more liberal arrangements for international trade and finance. The integration of the reforming economies involves them in substantial adjustments in the direction and composition of trade. Their new openness also allows them to import relative price structures from world markets, and international competition can be brought to bear on monopolistic indigenous industries. Trade can boost both effective aggregate demand and supply with benefits to efficiency and resource utilisation. Openness to foreign investment permits the transfer of technology, design and marketing skills and increases the range of bidders for privatised enterprises. Policies should allow these benefits to be reaped in a non-discriminatory way, without attempts to single out individual sectors or enterprises for privileged treatment. Governments are unlikely to do the job of attracting the "right" kind of trade and investment better than markets.

Chapter 8

Trade policy reform

While CMEA trade collapsed in the early 1990s, the fast-reforming countries of central Europe and the Baltic states achieved a rapid reorientation of trade towards Western markets. This was facilitated by a network of trade agreements. Restrictions on trade were rapidly dismantled. Tariffs were in several cases initially reduced to very low levels; this was subsequently partially reversed in Poland and Russia, for example, while Hungary resorted to non-tariff measures. Real exchange rates have risen since the initial liberalisation, increasing demands from producer groups for protection which is of doubtful general benefit. The chapter includes a table which describes the trading regime in each of 25 countries in eastern Europe and the former Soviet Union. Trade Agreements between east European countries on the one side and EU and EFTA on the other have left Western countries free to invoke contingent protection - which they have done, although the frequency of such restrictive action may be lessening. Trade is also impeded by internal difficulties including inadequate international financial experience and institutional infrastructure.

Chapter 9

Foreign direct investment

Flows of foreign direct investment (FDI) into eastern Europe and the former Soviet Union remain disproportionately concentrated on a few relatively small economies, although most countries in the region have adopted fairly open FDI regimes. The chapter includes a table which describes these regimes country-by-country. Survey evidence suggests that, among the determinants of FDI, gaining access to local product markets is more important than using cheap and skilled local labour to process goods for export. The tax system, particularly its predictability, and capital controls can be important to foreign investors. Countries succeeding in attracting FDI have tended to cut back special privileges previously offered to foreigners and have concentrated more on national treatment for all investors. Governments have been particularly prone to provide the automotive industry with protection, tailor-made to induce particular foreign investments. Industry-specific protection may, however, be difficult to justify from the perspective of the economy as a whole.

Chapter 10

Recent macroeconomic developments

The macroeconomic performance of the countries of eastern Europe and the CIS diverged in 1993, with stabilisation and growth in most of eastern Europe and the Baltic states but high inflation and continuing declines in output in the CIS. Unemployment has stabilised in the mid-teens in eastern Europe, with the exception of the Czech Republic where it is much lower. Recorded unemployment remains very low in the CIS despite falling output; many individuals, who are effectively unemployed, formally retain their jobs in order to qualify for social benefits. An appendix to this chapter presents data on each country's performance.

Chapter 11

Macroeconomic forecasting in transition

The forecasters' predictions for 1993 were typically too pessimistic for the countries of eastern Europe and too optimistic for the CIS countries. The chapter includes the remarkable statistic that growth forecasts for individual countries prepared in 1993 for the same year were on average about four percentage points off target. Judging by the range of forecasts offered for each country, precision is not increasing. The forecasters foresee positive growth for most of eastern Europe in 1994-95 and expect the contraction in the CIS to slow. They also expect an increase in the rate of unemployment and a reduction of inflation in most countries.

An appendix to this chapter discusses the implication of discrepancies between statistics on output and those relating to its uses in consumption, investment and (net) exports. Statistical inconsistencies of this nature are not unique to transition economies but occur there in an acute form. A solution in statistical methodology has been known for 50 years but has rarely been applied. A rough application to Hungary suggests that recorded output figures for this country may not, as many would have expected, understate growth. For the Czech Republic, where statistical matters seem to have received relatively little attention, there are much stronger reasons to believe that growth has been underestimated by a substantial margin.



Defining and measuring transition

Chapter 1 The meaning of transition

1.1 Transition: the purpose of the EBRD
and of the Report

1.2 Development, transition
and stabilisation distinguished

1.3 The ingredients of transition
and some measurement issues

Table: Estimated real incomes
and other indicators of development
for each country in transition

Chapter 2 Transition: measurement and indicators

2.1 Summary

Table: Progress in transition in eastern Europe
and the former Soviet Union

2.2 Commentary on transition indicators

Appendix 2.1: Transition indicators

1. The meaning of transition

1.1 Transition: the purpose of the EBRD and of the Report

The Agreement Establishing the European Bank for Reconstruction and Development was signed in Paris on 29 May 1990. The objectives of the Bank are defined in Article 1 as follows: “In contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative in the central and eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics”. The purpose of the *Transition Report* is to examine the transition in the Bank’s countries of operations and to measure, interpret and understand its progress.

As an investor the EBRD promotes the transition through its projects. This Report does not describe the Bank’s investments in detail nor does it try to identify their impact on transition. Rather it tries, in measuring and interpreting the transition, to help in the understanding of the process it is attempting to promote. This in turn provides the context in which the Bank can direct and assess its investment activities, help other investors in the region in understanding economic prospects, and contribute to any assessment by the shareholders of the Bank of progress by the countries towards the basic objectives which were set in 1990. However, it will be the countries themselves, and not an external agent such as the EBRD, which will be the prime movers of economic change, and the EBRD is only one, although a significant one, among many investors in the region. It is, of course, much more than an investor, being specially concerned with the demonstration effects of its projects and with the whole context for private sector development.

In this Report the concepts of development, transition and stabilisation are firmly distinguished. While the concepts are very different, the relationships between them are strong. Some principles behind both the concepts and their relationships are discussed briefly in the second section of this chapter. The third section of this chapter discusses the essential ingredients of an open market economy, and thereby points to the choice of indicators of progress towards that goal: indicators of transition.

1.2 Development, transition and stabilisation distinguished

Development is a summary term which includes as its basic element the advancement, in a number of key dimensions, of the standard of living of individuals. Among these dimensions, education, health and command over

resources are central. There are many possible indicators along these dimensions: literacy, years of schooling, and skill levels are common for education; infant mortality rates, life expectancy and various morbidity measures are common for health; wealth, income and consumption are common for command over resources. The environment in which the individual lives and works is clearly an important aspect or determinant of his or her standard of living. The focus on individuals and their standard of living makes poverty and income distribution crucial issues for development. Data on the development status of 22 of the Bank’s countries of operations are presented in Box 1.1.

Transition is not only an intermediate goal contributing to economic development. It may also be regarded as an ultimate objective in itself. The market economy, in contrast to central planning, gives, in principle, the individual the right to basic choices over aspects of his or her life: occupation and place of work, where to live, what to consume, what risks to take or avoid, and so on. The right to these choices may be seen as a basic liberty and as a fundamental aspect of standard of living. Of course, the notion of liberty goes far beyond the elements of choice described but these choices may be regarded as basic to it. Thus the transition is also an end in itself.

Whether or not the open competitive market economy contributes to development is an analytical and empirical issue, on which the founders of the Bank expressed a very strong and positive view. Such a view had become increasingly widespread during the 1970s and had become dominant by the late 1980s. But it must be recognised that it was not so at the time of the founding of the Bretton Woods institutions, nor indeed for the first two or three decades after the Second World War. In summary, the argument is that individuals freely pursuing their interests and interacting in the market place together provide a more efficient, dynamic and creative economy than one based on centralised commands. The centralised command economy may suffer more severely from political manipulation, corruption, the arbitrary exercise of power, poor information, cumbersome systems and perverse incentives. While it is recognised that there are many respects in which markets may fail, and that there are circumstances (such as war or natural disaster) where command systems may be required, the dominant view now is that, on balance, a market-based system has overwhelming advantages over central planning.

The transition from a command to a market economy is the movement towards a new system for the generation

and allocation of resources. It involves changing and creating institutions, particularly private enterprises. The role of the state in a market economy remains important, although very different from that in a command economy. This changed role requires fundamentally different governmental institutions. The meaning and measurement of transition is examined in the next section of this chapter.

Stabilisation concerns basic macroeconomic variables including inflation, balance of payments, debt, unemployment and output shocks. Progress in achieving macroeconomic stability will be an important determinant of achievements in the transition, but it is very different from the transition itself. For example, an unstable macroeconomic position will discourage private investment, hindering both transition and development. One would also expect setbacks in other aspects of economic development, as the provision of medical and educational services may be disrupted by the shocks facing large enterprises that supplied many of these services in the old regime, or as fiscal shocks may disrupt public sector payments for the services. Such disruption would, of course, be additional to the economic problems for individuals caused by the dislocation of employment.

The notions of development, transition and stabilisation, although strongly inter-related, are therefore distinct.

1.3 The ingredients of transition and some measurement issues

In general terms, transition is the progression from a command economy to an open market-oriented economy. The transition concerns institutional change. It is the institutional arrangements for the allocation and generation of goods and resources, and the ownership incentive and reward structures that institutions embody, that characterise the differences between a market and a command economy; these arrangements are the subject of Part II (which comprises Chapters 3-6) below.

Before indicators of this progression can be selected, the key ingredients of the open market-oriented economy must be examined more closely, enabling the identification of the important dimensions of the progression which the indicators are intended to capture. In identifying the “key ingredients” it must be remembered that there are many varieties of market economy which may be viewed as the “end point” or “target” of the transition. The contrasts between the economies of Japan, Germany and the USA illustrate that the possibilities are very broad. Given that there were also many, and large, differences in the starting points for the Bank’s countries of operations and, further, that there could be many routes between any given starting point and any given end point, it is important to remember

that the transition is not a simple, linear, one-dimensional progression to a “standard” market economy.

While there are no doubt important basic choices to make over the long term, it must also be recognised that the countries of the region are faced with existing systems and international arrangements in which they wish to participate. These include, for example, the European Union, the GATT, the EBRD, the IMF, the World Bank and the OECD. The member countries and the systems themselves will provide both models and constraints for the EBRD’s countries of operations. Also there is in part a joining, or re-joining, of a historical development of market economies from which they were previously excluded.

What then are the key ingredients of a market economy? There are many ways they may be categorised. The characterisations chosen in this Report are intended to capture the essential properties from the point of view of economic analysis, and in a form which provides some possibility of empirical measurement or assessment. The categories selected provide the basic structure for the main table on transition indicators presented and discussed in Chapter 2. Basic elements of the market economy are:

- *enterprises and households*, which are responsible for decisions concerning production and consumption. These decisions are taken in response to incentive structures embodied in the workings of the markets in which they operate;
- *markets*, which are the means by which goods and resources are exchanged between enterprises and households;
- *financial institutions*, which are crucial players in the integration of transactions over time; in particular the channelling of savings and investments, the organisation of payments, and the enforcement of individual (household or enterprise) financial discipline.

The state plays a major role in the market economy, across many dimensions, which is very different from that of the command economy. Basic elements include: (a) legal and regulatory structures and governmental responsibilities concerning the behaviour of enterprises and financial institutions, property rights, transactions and contracts, and the functioning of markets; (b) the provision of parts of education, public health and medical care; (c) the provision and protection of certain public goods or services including defence, law and order, the environment, and elements of the infrastructure; (d) the provision of protection against important aspects of poverty; (e) a system of taxation that can support the provision of the above services.

In describing the key elements of the market economy the Report lays emphasis on those aspects affecting most strongly the functioning of enterprises, since the Bank's main tools are investments in enterprises. This chapter comments briefly on the five elements above, focusing on the aspects that avail themselves to some measurement or assessment as presented in Table 2.1 and Appendix 2.1.

The *privately owned enterprise* is the basic element of the market economy. Ownership has many dimensions, including rights of control, access, sale and so on, but central here is the right to the surplus income after costs and taxes have been met, i.e. the net profits. Owners of private enterprises, therefore, wish to maximise profits. It is this seeking after profit which provides the driving force in the market economy. The extent to which output derives from private enterprises is the first, and arguably the most important, indicator of progress towards a market economy: the transition. This can be measured in a number of ways, including total output and total employment. It is the adaptation, creation and growth of private enterprise which is at the heart of the process.

It is important not to have a narrow view of what constitutes private ownership. There can be long-term leases with unlimited rights to and control of output, but very limited rights of resale of the leased assets. There may be onerous obligations to maintain or provide certain services. Prices, profits and investment can be strongly regulated, as for example in many privatised utilities. There are often, or usually, rules governing the relationships between different participants in the firm including stockholders, managers and employees. These can vary greatly in different environments. All these differences will result in different behaviours and outcomes, and are therefore important to understanding the nature of the economy and how it functions. Many of the aspects described are summarised under the headings "property rights" and "governance", and some are measured or assessed in the table in Chapter 2. These differences remind us that we should not have a single model of what is meant by a private firm.

The relationships between the individual private firms and the state will be crucial elements in the functioning of the economy. It is the state which should ultimately enforce honesty and transparency in the firms' transactions, including observance of contracts and proper accounting. It is ultimately the state which should ensure that enterprises and households operate within their own resources, although wider cultural and social patterns conditioning attitudes towards tax evasion, compliance with contracts, bribery and corruption are of great importance as well.

For all these reasons, emphasis is placed on legal structures in describing enterprises. It is important, however, to recognise that resort to the law to settle or enforce rules of behaviour varies greatly across societies. Reputation and social convention on accepted behaviour are generally very powerful sanctions in most societies. It would therefore be a mistake to look only, or even in some cases first, to legal structures in the understanding of property rights and governance. Indeed in many countries capitalism developed a long way with weak enforcement of rules, little transparency, and no competition and bankruptcy law.

The *market* is the key arena in which enterprises and households interact. A well-functioning set of markets has the following features: trade possible in a very broad range of goods and services covering the crucial inputs and outputs; good information about quality and prices; flexible prices; and above all competition. It is competition which provides the incentive for creativity, innovation and efficiency. Without competition the economic system is unlikely to deliver the virtuous outcomes claimed for the market economy. The most important factor in competition is freedom of entry into a market. It is important constantly to be aware of, and attempt to embody in measures and analysis, the extent to which markets are competitive, and are open to entry of new companies.

A force of special relevance is competition in international trade. If producers have to compete in export markets or with importers then their production activities are subject to the rigours of a much fiercer market, embodying broader knowledge and techniques. Performance is likely then to be much superior to an economy that is not subject to this discipline. This analytical observation receives strong support in the empirical evidence concerning the performance of economies that have attempted to shield their producers for long periods from international competition. Hence the emphasis on openness to international trade in this Report's measures of market development. Part III (which comprises Chapters 7-9) is also devoted to international issues.

Financial institutions are at the heart of a market economy. They play fundamental roles as links for the allocation of resources over time (channelling savings and investment), for the allocation and assessment of risks, for payments mechanisms, and for the enforcement of financial discipline. Most importantly their knowledge of, and ability to monitor, enterprises makes it possible for investments to take place and thus to make productive use of investible funds. They are therefore crucial intermediaries for the investment process and, in particular, for the EBRD. Accordingly, a section of the indicators is devoted entirely to measuring and assessing the emergence and role of financial institutions.

The relationship between firms and financial institutions is basic to the development of each. In the old regime the banks played a fairly passive role and had to respond to government directives where loans were demanded of them. This lack of choice, and the absence of any incentive for financial discipline in enterprises, in the command economy meant that budget constraints were “soft” and many of the loans were “bad”. Thus the softness of the budget constraint facing enterprises in the old regime and the poor state of the balance sheet of many banks (with many “non-performing” loans) are intimately connected. Correspondingly, the independence of financial institutions from government directions to lend to certain enterprises and the ability to harden the budget constraint (and ultimately to enforce bankruptcy) are crucial parts of the establishment of an effective market economy.

It is fundamental to an understanding of the market economy to recognise that the role of the state is not eliminated in the transition but is transformed. Instead of directing output and resources, the role of the state is to set, supervise and enforce “the rules of the game”; provide certain goods or services, the markets for which may have inherent problems or failures; ensure certain rights, for example to aspects of education and health services; offer protection from certain catastrophes, including safety nets; and so on. While the fulfilling of these responsibilities does not necessarily imply public ownership, participation by the state in these activities will mean that production of goods and services in the market economy will usually be far from 100 per cent in the private sector. Thus the “distance” from the market economy cannot be measured in terms, for example, of the difference between 100 per cent and the proportion of output arising in the private sector. One hundred per cent private output is not the goal of transition.

These are responsibilities which, if not accepted by the state, could lead to poor functioning of the market economy and potentially disastrous consequences for individuals and households. How and to what extent these responsibilities are discharged is a challenge for analysis, decision and implementation. The issue of the role of the state is rendered still more complex in the context of transition since it is the state itself which is responsible for directing its changing form. Detailed discussion of all these elements goes far beyond the scope of this Report. Some of them will be discussed in more detail in future *Transition Reports*. This Report focuses on some aspects of special relevance for the emergence of private enterprise. The changing of institutions, towards those described as being key elements of the market economy, defines the transition. This Report is devoted to the analysis and measurement of this institutional change.

Box 1.1.

Indicators of development

What is meant by “degree of development” relates to a whole complex of characteristics. Special attention is usually given to GDP per head. That is not easily measured when patterns of relative prices vary widely and exchange rates are liable to distortion. Moreover, an oil-rich island whose dictator is accumulating financial assets in off-shore countries while the populace struggles to survive on subsistence incomes without education, clean water or health services is not highly developed, even if per capita GDP is high. The standard of living is a concept that goes far beyond purchasing power. Indicators of development should include, as well as average income, income distribution, nutrition, education, morbidity, and mortality or life expectancy.

In Table 1.1 below, a number of indicators are set out, where available, for 22 of the 25 countries under review, together with comparable data on five other groups of countries. These are the World Bank’s groups of low-, middle- and high-income countries; the G7 (Canada, France, Germany, Japan, Italy, United Kingdom, and the United States) as a subset of high income countries, a major force in the International Financial Institutions and also the leading bilateral donors; and seven South American countries some of which are also undertaking market reforms and most of which have similar per capita income to that of the east European economies. The first column in Table 1.1 relates to GNP per head in “international dollars” adjusted for differences between purchasing-power parity (PPP) and market exchange rates. The countries are listed in ascending order of this indicator. The difference between PPP and market exchange rates can be very large, especially for the EBRD’s countries of operation. It should be noted that, although the source used in Table 1.1 for data on GNP per capita in international dollars is a publication of the World Bank, this is not the income concept on the basis of which the World Bank itself classifies countries as low-, middle- or high-income economies (as set out in greater detail in the footnotes to Table 1.1).

From Table 1.1, it can be seen that the Bank’s countries of operations fit squarely in the middle-income range, with Tajikistan on the fringe of the low-income group on the basis of per capita income and Albania on the fringe on the basis of the proportion of population in agriculture. Of the rest, perhaps two thirds fall into the World Bank’s lower-middle category and one third, including Russia with its large population, in the upper-middle class.

Table 1.1
Estimated real incomes and other indicators of development for each country in transition

	PPP-based GNP per capita (in "international dollars" ¹)	Share of agriculture in GDP (in per cent) ²	Share of urban population in total population (in per cent)	Infant mortality (per 1,000 live births)	Life expectancy at birth (years)	Total fertility rate ³	People per doctor	People per hospital bed (latest available observation)	Secondary school enrolment ⁴	Energy use (oil equivalent) per capita (kg)
	1992	1992	1991	1992	1992	1992	1990	1987-92	1991	1992
Albania	na	56	36 ⁵	32	73	2.9	na	246	79	421
Tajikistan	2,000	33	32	49	69	5.1	350	96	na	na
Georgia	2,470	48	56	19	72	2.2	170	90	na	na
Armenia	2,500	41	68	21	70	2.8	260	120	na	1,092
Uzbekistan	2,600	39	41	42	69	4.1	290	83	na	na
Azerbaijan	2,650	29	54	31	71	2.7	250	101	na	na
Romania	2,750	20	55 ⁵	23	70	1.5	560	113	80	1,958
Kyrgyzstan	2,820	28	38	37	66	3.7	280	85	na	1,148
Lithuania	3,710	28	68	16	71	2.0	220	79	na	na
Moldova	3,870	33	47	23	68	2.3	250	77	na	1,600
Turkmenistan	3,950	48	na	54	66	4.2	290	92	na	na
Latvia	4,690	24	71	17	69	1.8	200	72	na	na
Kazakhstan	4,780	38	57	31	68	2.7	250	75	na	4,722
Poland	4,880	8	63 ⁵	15	70	1.9	490	153	83	2,407
Ukraine	5,010	23	67	18	70	1.8	230	na	na	3,885
Bulgaria	5,130	16	68	16	71	1.5	320	100	71	2,422
Estonia	5,250	13	72	13	70	1.8	210	82	na	na
Slovak Republic	5,620	6	na	13	71	2.0	280	na	97	3,202
Hungary	5,740	7	66 ⁵	15	69	1.8	340	99	81	2,392
Russia	6,220	13	74	20	69	1.7	210	73	na	5,665
Belarus	6,840	24	66	15	71	1.9	250	na	na	4,154
Czech Republic	7,160	6	na	10	72	1.9	na	na	na	3,873
Low-income ^{6,7}	1,300	30	27	73	62	3.4	6,000	1,050	40	335
Middle-income ^{6,7}	4,000	10	67	42	69	3.0	2,100	450	55	1,750
High-income ^{6,7}	17,800	3	78	7	77	1.7	420	144	93	5,100
G-7 countries ⁶	19,600	2.5	78	7	77	1.7	402	120	na	4,864
South America ⁶	5,500	12.3	73	39	68	3.3	1,186	540	na	780

Sources: *World Development Report* 1994, World Bank; *Social Indicators of Development* 1994, World Bank; UNESCO *Statistical Yearbook* 1993.

- ¹ PPP stands for purchasing power parity. The estimates quoted here stem from the World Bank's *World Development Report* 1994. In the computation of these estimates each country's nominal GNP per capita was divided by the "purchasing power parity", defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one US dollar would buy in the United States.
- ² The numbers in this column are drawn partly from the World Bank's *World Development Report* and partly from the data presented in Appendix 10.1 to this Report. For Belarus, Georgia, the Russian Federation, Slovak Republic, Turkmenistan and Ukraine the figures refer to the share of agriculture in Net Material Product.
- ³ The "total fertility rate" represents the number of children that would be born to a woman if she were to live to the end of her childbearing years and bear children at each age in accordance with prevailing age-specific fertility rates.
- ⁴ Defined as the ratio of children of all ages enrolled in secondary school to the country's population of 12-17 year-olds. Note that the exact definition of secondary school may vary across countries and that late entry of more mature students as well as "bunching" in final grades can influence these ratios. A different, and possibly more interpretable statistic, is the ratio of 20-24 year-olds that have at some point in their lives entered secondary or higher levels of education. On this measure some selected ratios were: CSFR 81% (1980), Estonia 89% (1989), Hungary 75% (1990), Kazakhstan 91% (1989), Poland 83% (1988), and the Soviet Union 99% (1989).
- ⁵ Data refer to 1992.
- ⁶ The figures shown in these rows are unweighted averages (exceptions are listed below) of available observations for, respectively, low-income countries (see the definition of low, middle and high income in footnote 7), middle-income countries, high-income countries, G-7 countries, and South American countries (in the latter group we have included Bolivia, Brazil, Chile, Columbia, Peru and Venezuela). For the rows covering low, middle and high-income countries, columns 2 to 10 contain weighted averages.
- ⁷ These categories refer to the World Bank's classification of low-, middle- and high-income countries. The key for this classification is nominal GDP per capita (as opposed to PPP-based per capita GNP which is defined in footnote 1). For the purpose of this classification the World Bank converts national GDP data into common currency using the so-called Atlas method which applies the average exchange rate for three years, adjusted for differences in inflation between the individual country under analysis and the United States. The countries are placed by the World Bank in the three income categories based on the following ranges for the Atlas estimates of per capita GDP: low: US\$ 675 or less; middle: US\$ 676-8,355; high: US\$ 8,356 or higher.

The health indicators, such as infant mortality and medical provision (on the listed indicators) were all better than the typical middle income country around 1990 and than our South American sample but a number of these indicators have since deteriorated. Secondary school enrolment was also high by the standards of middle-income countries.

While the Central Asian countries have a particularly young population and a high birthrate, eastern Europe and the remainder of the former Soviet Union have west-European demographic structures and trends but substantially lower per capita income levels. This may lead to heavy pressure for reform of social security systems in the years ahead.

With the exception of Albania, energy consumption ran ahead of income status, with that of Russia, Belarus and Kazakhstan high, even by OECD standards. It is well known, however, that much of this energy was wasted and that the pattern of usage did not conform in any way to that of high income countries. It has been suggested that half to two-thirds of the former Soviet Union's energy consumption was wasted. Making allowance for rather less inefficiency elsewhere suggests that only Albania conformed to the low income pattern of energy scarcity while none of the formerly centrally planned European economies used energy as a high income country would. Albania's per capita energy consumption was little more than half that of our South American sample.

Table 1.2
Percentage share of income or consumption

	Lowest 20%	Second 20%	Third 20%	Fourth 20%	Highest 20%	Highest 10%
Poland (1989)	9.2	13.8	17.9	23.0	36.0	21.6
Hungary (1989)	10.9	14.8	18.0	22.0	34.4	20.8
Yugoslavia (1989)	5.3	10.7	16.2	23.7	44.2	27.4
Bulgaria (1992)	10.4	13.9	17.3	22.2	36.2	21.9
Low-income ¹	2.9	6-13	10-16	19-22	40-60	25-45
Middle-income ¹	2.7	7-12	11-16	19-22	45-60	25-45
High-income ¹	4.8	10-13	16-18	22-25	40-45	20-30
G-7 countries (various years) ²	6.2	11.7	17.2	24.0	41.1	25.0
South America (various years) ²	4.1	8.0	12.4	19.7	55.9	40.1

Source: World Bank, *World Development Report* 1994.

¹ See the definitions of these categories in footnote 7 to Table 1.1 above.

² The estimates in these rows are unweighted averages of the latest available observations for, respectively, the G-7 countries and a selection of South American countries (Bolivia, Brazil, Chile, Columbia, Peru and Venezuela).

2. Transition: measurement and indicators

2.1 Summary

The previous chapter distinguished between development (on which Box 1.1 provides data), stabilisation (the subject of Chapters 10 and 11 below) and transition itself which is the subject of this chapter and the focus of the Report.

The discussion in the first section of this chapter is organised around Table 2.1, which summarises in tabular form the position of the 25 countries of the Bank's operations in their transition from their centrally planned and state-owned past to their private enterprise and free market future. It is a summary table which draws on material set out in greater detail and precision in the transition indicators in Appendix 2.1. The latter are discussed more extensively in Section 2 of this chapter.

The structure of Table 2.1 builds on the discussion of the preceding chapter. The lead indicator, and the only one in this table that is quantitative rather than qualitative, is the measure of private sector activity. The next block of indicators concerns the basic unit of production, the enterprise. This is followed by measures relating to markets, where enterprises interact. The final block pertains to financial institutions, which represent a crucial element in the foundations underpinning a market economy.

Considerable caution is needed in using Table 2.1. The indicators are by no means comprehensive, nor is the classification system for each individual indicator, provided with the table, able fully to encapsulate the countries' different efforts and progress in reform in each field. Central to transition is the role of the state in the economy, whether as owner, regulator or director of market signals. The transition indicators provide a guide to the extent to which the state has withdrawn from ownership and regulation, but zero ownership and zero regulation are clearly not ideals. None the less, progress on both fronts from the levels inherited from socialist regimes remain crucial indicators of transition.

Despite the extensive caveats above, Table 2.1 serves to illustrate a number of clear trends, some taking place throughout the region (as reflected in variations across columns of the table), others serving to delineate certain "transition groups" of countries (represented in the table by rows with similar patterns). While transition has many dimensions, its essence lies in the expansion of private sector activity. This is also a dimension which allows

quantitative, albeit rough, measurement. Accordingly we have chosen this as the first of the indicators on which we focus. We have, drawing on official statistics as well as on subjective judgement, produced an estimate of the private sector's share of GDP for each of the countries under analysis (see Box 2.1 for a discussion of the great conceptual and practical difficulties associated with these data). The estimates indicate that the private sector, including informal activity, accounts for more than half of GDP in 9 of the 25 countries.

Each of the other columns in Table 2.1 is concerned with a particular area of market-oriented reform. The table shows that almost all the countries of the region have initiated reform in all the listed areas. Most of them have already completed widespread liberalisation of prices and foreign trade. At least two-thirds of the countries in the region have embarked upon, and in many cases completed, comprehensive small-scale privatisation.

Banking reform, enterprise restructuring and large-scale privatisation are the areas where progress in the transition has been slowest. This is not surprising as fundamental change in large-scale institutions, if it is to be rational and effective, must take time. Markets can be created and reformed and small enterprises privatised much more quickly.

Those countries that have made most progress are the Czech Republic, Hungary, Poland, the Slovak Republic, the Baltic states, and several countries of former Yugoslavia. Most of these countries have also started to tackle the much more thorny problem of large-scale privatisation and the related issue of financial sector reform. None the less, even the most advanced countries are finding the latter particularly difficult.

An intermediate group includes the other east European countries, Kyrgyzstan and Russia. The latter two countries, especially Russia, have made spectacular progress on privatisation over the past year, but are less advanced than the countries listed above in the areas of financial sector reform and enterprise restructuring.

The remainder of the CIS states have made less advancement with transition. They have found it particularly difficult to liberalise their trade regimes, embark upon enterprise restructuring and even, in some cases, achieve small-scale privatisation.

Box 2.1**Concepts of private output**

If an enterprise is state-owned and state-run the convention is to classify all its net output as state production. Consider, however, a case in which a state-owned factory is leased to a private enterprise. In this case, all the net output is generally classified as private. *A fortiori*, a private enterprise in which the pension fund of a state enterprise holds a minority stake does not thereby experience any diminution of its privateness. How would one treat the contribution of a private sub-contractor buying from and selling to state-owned enterprises? In principle, again, its contribution is as private as that of a manufacturer of pencils which uses timber from state forests and sells its products entirely to government ministries.

The measure quoted in the first column of Table 2.1 relates to the whole value added of privately controlled enterprises even if they buy inputs, including the services of leased

equipment, from the state and sell their product to it and even if the state, or state-owned organs, are (non-controlling) minority shareholders. The figures in the column build on official estimates, where available.

It is obviously difficult to apply these criteria precisely and to identify the net output of the qualifying enterprises. Their employment is likely to be more easily identified and, if output per person does not vary systematically with the sectoral control of their employer, the private share of employment may be suggestive of the private share of GDP. Unfortunately, however, many people in transition economies have several employments or work in groups that effectively become private enterprises once their state quotas are fulfilled. Thus, it is difficult to apply even this indicator with any precision.

Table 2.1 Progress in transition in eastern Europe and the former Soviet Union¹

(see classification system for transition indicators opposite)

Countries	Private sector share of GDP Mid-94 in % (rough EBRD estimate)	Enterprises			Markets and trade		Financial institutions
		Large-scale privatisation	Small-scale privatisation	Enterprise restructuring	Price liberalisation and competition	Trade and foreign exchange system	Banking reform
Albania	50	1	3	2	3	4	2
Armenia	40	1	3	1	3	2	1
Azerbaijan	20	1	1	1	3	1	1
Belarus	15	2	2	2	2	1	1
Bulgaria	40	2	2	2	3	4	2
Croatia	40	3	4	2	3	4	3
Czech Republic	65	4	4	3	3	4	3
Estonia	55	3	4	3	3	4	3
FYR Macedonia	35	2	4	2	3	4	2
Georgia	20	1	2	1	2	1	1
Hungary	55	3	4	3	3	4	3
Kazakhstan	20	2	2	1	2	2	1
Kyrgyzstan	30	3	4	2	3	3	2
Latvia	55	2	3	2	3	4	3
Lithuania	50	3	4	2	3	4	2
Moldova	20	2	2	2	3	2	2
Poland	55	3	4	3	3	4	3
Romania	35	2	3	2	3	4	2
Russian Federation	50	3	3	2	3	3	2
Slovak Republic	55	3	4	3	3	4	3
Slovenia	30	2	4	3	3	4	3
Tajikistan	15	2	2	1	3	1	1
Turkmenistan	15	1	1	1	2	1	1
Ukraine	30	1	2	1	2	1	1
Uzbekistan	20	2	3	1	3	2	1

¹ Many west European countries would for almost all transition elements qualify under category 4. What is being assessed in Table 2.1 is the status rather than the pace of change. Thus, for instance, the placement of Slovenia's small-scale privatisation in category 4, despite the absence of a comprehensive small-scale privatisation programme in that country, reflects the fact that small-scale activity in Slovenia was largely private before a comprehensive transition process was initiated.

Classification system for transition indicators²

Transition element	Category	Description of the category
Large-scale privatisation	4	More than 50 per cent of state-owned enterprise assets privatised in a scheme that reflects support for corporate governance
	3	More than 25 per cent of large-scale state-owned enterprise assets privatised or in the process of being sold but with major unresolved issues regarding corporate governance
	2	Advanced comprehensive scheme almost ready to be implemented; some sales completed
	1	Little done
Small-scale privatisation	4	Comprehensive and well designed programme implemented
	3	Nearly comprehensive programme implemented, but design or lack of central supervision leaves important issues unresolved
	2	Substantial share privatised
	1	Little done
Enterprise restructuring	4	Restructuring programme which substantially improves corporate governance in operation; strong financial discipline at the enterprise level; large conglomerates broken up
	3	Structures created (for example through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation) to promote corporate governance; or strong action taken to break up conglomerates
	2	Moderately tight credit and subsidy policy; weak enforcement of bankruptcy legislation; little action to break up large conglomerates
	1	Lax credit and subsidy policies weakening financial discipline at the enterprise level; few other reforms to promote corporate governance
Price liberalisation and competition	4	Comprehensive price liberalisation and price competition; anti-trust legislation in place
	3	Comprehensive price liberalisation and price competition
	2	Price controls remain for several important product categories
	1	Most prices remain formally controlled by the government
Trade and foreign exchange system	4	Few import or export quotas; insignificant direct involvement in exports and imports by ministries and state-owned former trading monopolies; almost full current account convertibility at unified exchange rate; no major non-uniformity of customs duties
	3	Few import quotas; almost full current account convertibility at unified exchange rate
	2	Few import quotas; almost full current account convertibility in principle but with a foreign exchange regime which is not fully transparent (possibly with multiple exchange rates)
	1	Widespread import controls or very limited legitimate access to foreign exchange
Banking reform	4	Well functioning banking competition and prudential supervision
	3	Substantial progress on bank recapitalisation, bank auditing, and establishment of a functioning prudential supervisory system; significant presence of private banks; full interest rate liberalisation with little preferential access to cheap refinancing
	2	Interest rates significantly influencing the allocation of credit
	1	Little progress beyond establishment of a two-tier system

² The classification system established here is crude and builds on the judgement of EBRD economists. More detailed and less subjective descriptions of country specific progress in transition is provided in descriptive form in Appendix 2.1. The classification system used in Table 2.1 may be revised and refined in future editions of the *Transition Report*.

While the starting point is important in a number of respects, it is noteworthy that progress with transition is not necessarily rigidly associated with any single opportunity (or handicap) inherited after the collapse of communism. Countries with a similar inheritance from the former Soviet Union have varied enormously in their degrees of progress. The countries that inherited a higher GDP per capita have by no means uniformly done better in reform than the poor. Even regional or internal conflict has not necessarily acted as a bar to reform.

While this Report focuses on assessing and analysing transition itself, it is important to bear in mind that progress with transition influences the type of assistance that IFIs can provide. This issue is taken up in greater detail in Box 2.2.

2.2 Commentary on transition indicators

This commentary draws on the detailed transition indicators in Appendix 2.1.

The private sector's share in GDP

In 1993, the private share of output rose in the countries of eastern Europe by 10-40 percentage points. There were very large gains, from a low base, in Albania, the Czech Republic and the Slovak Republic, with the Czech Republic moving past Poland into first place. Smaller gains were posted by Poland (which was already close to 50 per cent) and Romania (which, along with Bulgaria, Croatia and FYR Macedonia, is still close to 35-40 per cent - well ahead of the majority of CIS countries).

Nevertheless, Russia and Armenia now have private shares in employment and output similar to those of countries of central Europe. In Russia's case, this involves more than a doubling from below 25 per cent a year ago to around 50 per cent now. In the rest of the CIS, the private sector's share of GDP is put in the 15-30 per cent range. This range reflects not only variation across countries, but also considerable uncertainty in each particular case, arising not only from the conceptual problems, but also from additional difficulties relating to cooperatives and other entities in which property rights are not well defined, as well as the so-called "shadow economy" which includes many operations by employees of state enterprises using facilities of these enterprises for their own purposes. Such activity is now widespread in many countries. Uncertainty in this respect not only obscures the measurement of private sector activity but also raises important questions about the level and path of total output itself, questions which are taken up later in this Report (see Chapters 10 and 11).

Box 2.2

The role of IFIs at different stages of transition

The individual governments and countries will remain the key players in transition. None the less, international financial institutions (IFIs) can provide valuable assistance in advancing reform.

A country's stage of transition will determine, to a significant extent, the type of investment or assistance that can and should be provided. In countries that are at the early stages of transition, including many smaller countries of the CIS, private sector opportunities for investment may be limited, especially where modest progress on structural reform is combined with great macroeconomic imbalances. In these countries, project-financing IFIs will tend to channel more of their efforts through the public sector, including for work on infrastructure. Greater emphasis on state projects is a corollary of the comparatively modest size of the private sector, greater country risk, difficulty in analysing enterprise accounts, and a less developed legal framework. Technical assistance in projects and in promotion of a market-friendly environment will be important, as will encouragement of the development of financial intermediaries.

As transition progresses, the scope for targeting IFI assistance more directly to the private sector increases, as seen in the Baltics, Russia, south-eastern Europe, and to some extent Kyrgyzstan. Local financial institutions may be available to act as intermediaries for IFI funding in local projects; the opportunities for participation in both joint ventures with foreign companies and early-stage equity funds will increase.

At more advanced stages of transition and macroeconomic stabilisation, for example that achieved in the Czech Republic, Hungary, Poland and the Slovak Republic, it becomes possible for IFIs in general, and the EBRD in particular, to place greater emphasis on direct investment in the local private sector. Meanwhile there is a decline in demand for IFI funding for the strongest segment of private investment projects as joint ventures and fully domestically owned companies gain access to private foreign sources of finance. Although the state sector, at this stage of transition/stabilisation, typically enjoys access to international capital markets, infrastructure projects may continue to have IFI involvement, especially projects that contain a private sector promoting (or privatising) element, such as certain types of investment in the telecommunications sector. Moreover, even in advanced stages of transition, the problems of bank and financial sector restructuring remain areas with potential for beneficial IFI involvement.

Large-scale privatisation

The large increases in private sector activity in the Czech Republic, Russia and the Slovak Republic were achieved by transferring existing assets into private hands through various forms of privatisation of large-scale enterprises. One very significant development in 1993 was Russia's privatisation, with its heavy reliance on transfers to workers and managers individually rather than collectively. This model is likely to prove influential in other parts of the CIS.

Voluntary share-ownership by individual employees, for instance in Russia, may be motivated by a desire on the part of these employees for some control of their own futures, and may not encourage restructuring schemes. It may, however, given some employee solidarity, help in resolving some of the governance issues highlighted in the EBRD's *Annual Economic Outlook 1993* (Chapter 2) and in Chapter 4 below.

Small-scale privatisation

In most of eastern Europe, privatisation of small-scale enterprises had already gone a long way in 1992. However, Bulgaria has continued to make only slow progress. The Baltic countries, Kyrgyzstan and Russia have made substantial advances on small-scale privatisation over the past 1 1/2 years.

The growth of small-scale enterprises (SMEs) already privatised and that of new businesses (typically concentrated in the previously underdeveloped service sector) is a second, but less well documented, source of additional private activity. Ninety-three per cent of trading activity in Poland is now in private hands. Many small and new enterprises may not be registered or have well-reported activity. About 10,000 new enterprises were created in Estonia in 1993 but, as elsewhere, between a third and half are inactive. The number of non-agricultural firms rose in 1993 by 65 per cent in Romania and by 40 per cent in Slovenia. In Poland's larger and older private sector, the number of private domestic companies grew by only 15 per cent, while those with foreign participation increased by 50 per cent to account for about 20 per cent of the total. Many registered enterprises are known to be inactive; in Bulgaria, for instance, only about half of the nearly half a million new businesses registered are believed to be functioning. In Croatia, the number of both active and inactive enterprises probably roughly doubled last year. About a third of registered enterprises file reports, but these may understate their activity rate.

Growth in the size and number of SMEs and their problems is less fully documented for the CIS than for eastern Europe and the Baltics. Russia now has 700,000 registered enterprises and, on some estimates, about four unregistered ones for each that is registered. Non-registration is attractive as it enables enterprises to escape the notice of the revenue authorities. Turkmenistan saw

substantial spontaneous small-scale private sector growth in 1993, with one-third of registered SMEs in private hands in mid-1993. At that point about 20 per cent of such non-agricultural businesses were private in Belarus. In Ukraine about 30 per cent of smaller enterprises have been leased to private entities. Heavy taxation there has boosted the informal sector despite attempts to reimpose regulation.

Though rapid, the growth of the private sector in both eastern Europe and the former Soviet Union is still constrained by the obstacles encountered by individual enterprises, obstacles which may also account for the low activity rate. Outright legal and regulatory barriers have been removed progressively in many countries but inadequate financial and utility infrastructure is widely cited, as is macroeconomic, policy, tax and regulatory instability. Small enterprises obtain 10 per cent or less of new credits in several countries. The level of settlement and advisory services are as important as access to credit itself; and for medium-sized growing enterprises the under-developed non-bank capital market is also a problem.

In much of the CIS, the obstacles encountered by private business are greater than in eastern Europe, with war-damaged infrastructure in Armenia, Azerbaijan, Georgia and Tajikistan, and difficulty in obtaining access to accommodation and labour in some still heavily regulated economies.

Enterprise restructuring

Much restructuring of large enterprises has taken place, mostly in response to privatisation, a cut in many countries of state subsidies and a tightening of policies guiding provision of bank credits to companies. Rarely has the rationalisation in the enterprise sector reflected vigorously implemented and carefully targeted government restructuring programmes. Hard budget constraints in disequilibrium economies, such as those emerging from decades of central planning, would be expected to lead to a high incidence of bankruptcy. In practice, this has not materialised (there were nine bankruptcies in the Ukraine and 13 in Lithuania in 1993) although nearly all the countries have made some legislative provision for bankruptcy. Typically, such laws are stronger on the consequences of bankruptcy than on ensuring that it is declared where enterprises are, indeed, insolvent. Enforcement is weak.

Even Poland and the Czech Republic have been cautious in implementing bankruptcy. Only Hungary has gone very far, and there too administrative constraints have given many enterprises a stay of execution. One reason for this may be that in many cases bankruptcy and subsequent liquidation would not be the best outcome: it could reduce output more than consumption and add to unemployment. This last argument is more plausible in those countries (such as all but the Czech Republic in eastern Europe)

where unemployment exceeds the 10 per cent now typical of western Europe, than in those of the CIS where recorded unemployment remains well below 5 per cent.

Competition and liberalisation of prices, wages and interest rates

The benefits associated with the use of markets depend strongly on competition. As mentioned above, price and import liberalisation is well advanced in most of eastern Europe and the former Soviet Union. However, freed markets in economies dominated by very large enterprises - which characterise the former centrally planned economies - are unlikely to be competitive without major enterprise reform, even though import liberalisation helps generate competitive pressure.

Few of the reforming economies have taken radical steps to break up state-owned enterprises, partly because of their physical integration within very large plants. Rather than follow Western models of anti-trust and competition policy, they have tended to resort to the model of regulated monopolies confined in the West largely to natural monopolies in the public utility field. While some regulations on the activities of monopolies may be desirable, the current regime for these extensive monopolies' prices or margins remains a major limitation on price liberalisation in parts of the CIS such as Belarus, Moldova and Uzbekistan. Such regulation is often exercised by local governments, as in Russia. In Ukraine, controls were tightened in 1993 but are circumvented in the shadow economy. Bulgaria has also recently imposed temporary controls following the introduction of value added tax. The regulation of utility prices, rents, basic foodstuffs and medicines remains widespread. Of course, some of these regulations would also be present in mature market economies and some may be desirable.

Labour markets seem to have been generally liberalised. However, taxes on "excessive" wage increases have been applied in a number of countries including the Czech Republic and Poland. In the CIS countries, it is common to tax enterprises on the excess of their payroll over a specified multiple of the number of employees and the minimum wage. Average wages in excess of 10 times the statutory minimum may be taxed as profits. This has several effects. It encourages the retention, or even hiring, of employees who are paid only the minimum and may not be asked to work. This may be a partial substitute for a free-standing unemployment compensation system which ensures that redundant individuals continue to have access to those goods and services distributed by or through enterprises. It may be less beneficent if such "unemployed" people are not effectively available for hire by new start-up businesses - in which case they are probably also rather ineffective in restraining nominal wage increases.

Since wages and profits in an enterprise together amount to its value added, a tax on both (less a per-employee allowance) is equivalent, at the margin, to an additional value added tax. In much of the CIS, the two rates taken together, if rigorously applied, would become a very stiff VAT indeed. Neither the effects of the excess wage tax, nor those of the minimum wage, represents a wage control mechanism that differs substantially from that ruling in the West, but direct controls apply to the state sectors of most east European economies. Controls on state sectors do not represent major infringements of market precepts if they can be interpreted as the exercise of a managerial prerogative by the state in relation to its own employees. Labour market structures, trades unions, and the size and attitude of employers differ markedly - as do labour market institutions such as collective agreements, labour exchanges and the legal status of strikes.

Government monetary policy is bound to be reflected in market interest rates. While these were high in real terms in the economies (such as Poland's) undergoing early radical reform, they remained negative in most of the CIS, as interest rates failed to catch up with the inflationary consequences of accommodating money and credit policies until very recently. Real rates are now positive in Kyrgyzstan, Russia and Ukraine, among others, but there are some doubts about the sustainability of the tight policies they reflect.

Throughout the period, there have been directed credits at below-market rates, targeted on preferred sectors and distressed enterprises, particularly, but not exclusively, in the CIS. Even where a market interest rate is apparently charged, the quality of the credit may reflect the borrower's access to political, and ultimately state-directed, support rather than its ability to generate a cash surplus.

Trade and the foreign exchange system

Only the Baltic states have yet committed themselves to full convertibility of their currencies for both current and capital account purposes, whereas the issue of convertibility has only just presented itself to the 10 members of the CIS that have introduced national currencies only in the past two years.

The norm - in eastern Europe now as in western Europe between 1950 and 1980 - is free convertibility for current account purposes only. This means that a prospective importer can freely buy the currency needed to effect his purchases. He cannot, however, hold it as an asset in itself, or convert it into overseas assets, or keep it against some vague intention to purchase imports at some future date. This last restriction implies that an exporter must convert the hard currency proceeds of his sales into local currency promptly. This is sometimes referred to as an obligation to "surrender" the hard currency. That terminology is

somewhat harsh if the rate at which the conversion takes place is a free market rate - subject of course to a ban on residents' capital account transactions. In several countries, however, such as Ukraine, the mandatory conversion is at an unfavourable official exchange rate - in which case the arrangement is equivalent to an export tax.

In a number of countries, again particularly in the CIS, exporters are not required to convert all their proceeds into domestic currency (whether at market or at penal official rates). Such partial surrender conditions amount to an element of capital account convertibility in as much as the exporter is allowed to hold foreign currency for a period without immediate plans to spend it on imports. The exporter is legally free to use it only for imports in the end; in the meantime, the choice, whether to hold foreign currency or convert it into local currency, will be determined by a comparison of nominal interest rates with expected exchange rate changes.

This mechanism thus brings capital account considerations into the determination of interest and exchange rates, which is what capital controls were largely designed to avoid. They are also designed to avoid the flight of domestic capital, but they have been singularly ineffective in several CIS countries, such as Russia and Ukraine.

Capital inflows are generally more welcome and require that foreign investors can convert and remit their profits (a current account transaction) and, at least at the end of the day, can extricate their investment (unwinding the original capital account transaction). Rules along these lines are in force everywhere except in Georgia, Latvia and Lithuania (which are more liberal) and parts of the CIS that have not yet progressed so far. A number of countries, including Hungary, that welcome foreign capital and workers impose restrictions on the remittance of salaries, as they could be used both to reduce taxable profits and to syphon off capital.

The previous paragraphs have made several references to importers and exporters whose activities were controlled directly in the old regime, under which most people and enterprises were formally debarred from international trade, as well as indirectly obstructed through the inconvertibility of the currency. Trade liberalisation is almost complete in eastern Europe and the Baltics, with rather more qualifications in Bulgaria, Latvia and Romania than elsewhere. The picture is very different in the CIS, where most inter-state trade is still intergovernmental and based on state orders. Progress there has varied, with Kyrgyzstan and Russia relatively advanced.

Russia's liberalisation has been accompanied by more extensive use of trade taxes. In general, such taxes raise revenues and are compatible with free markets, although

they are inefficient from the point of view of production (see Chapter 6). In the limiting case a tax can reach a prohibitive level, at which point it does not differ from a ban. Moreover, taxes are quite often waived in particular cases or classes of cases. A structure of highly varied and selectively waived tariffs has similarities with a system of controls and licensing. In this respect, Russia's progress has perhaps been more modest than revolutionary.

Banking reform

The establishment of a well functioning banking sector and prudential supervision has proven to be an extremely difficult task. Following the massive structural shifts caused by reforms in all the areas covered above, virtually all large state-owned banks in eastern Europe and the former Soviet Union have seen a sharp decline in the real value of their asset base as companies that have been rendered uncompetitive have become unable to repay their obligations. One task of financial sector reform is to establish incentives for banks to allocate their lending to those enterprises and individuals that can be expected to earn the highest return on their placements. A number of east European countries, including the Czech Republic, Hungary, Poland and Slovenia, are in the process of creating these incentives through a combination of state-financed recapitalisation of the large banks, tightening of prudential requirements and supervision, and privatisation (see Chapter 4). However, this process has not come close to completion in any country in the region.

The challenges ahead

The purpose of this chapter has been to provide an analytic description of the stage of transition, rather than a prescription. However, the differences in economic circumstances and the stage of transition across countries do indicate different sets of priorities for policy. For the countries where transition is most advanced, and generally where progress has been made on macroeconomic stabilisation, the priority is for enterprise restructuring and the development and reform of financial institutions, while maintaining and advancing stabilisation achievements. Progress on these fronts may require substantial attention to the social consequences of restructuring.

The intermediate group share the problems of the advanced group but face, in many cases, larger macroeconomic imbalances. In this group, privatisation and issues of corporate governance tend to remain high on the agenda.

For countries at an earlier stage of transition, the liberalisation of markets and privatisation remain the priority within the field of structural reform. These are generally also the countries where macroeconomic instability remains a severe and urgent problem.

Appendix 2.1. Transition indicators

Introductory remarks

Enterprises

Albania

The reform process was initiated in 1991, and a comprehensive programme was adopted in 1992.

Size of the private sector

Fifty per cent of total employment is estimated to be in the private sector.

Large-scale privatisation

Privatisation of large companies has been insignificant. At the end of 1992, 300 enterprises were categorised as "large-scale", which excluded them from the more active small-scale privatisation programme (discussed below). However, many of the then-large-scale companies have now cut staff levels sufficiently to fall into the category of "small and medium-sized enterprises" (which at present includes all companies with less than 300 staff).

Small-scale privatisation

The Privatisation Law (1991) and subsequent amendments regulate the privatisation of small-scale entities (defined as those with less than 15 staff). Privatisation of these units progressed rapidly in 1991-92 as many entities were taken over by employees. Privatisation of retail shops is virtually complete. Since mid-1993, responsibility for the small-scale privatisation programme has rested with the National Agency for Privatisation, and the programme has been expanded to include entities with less than 300 employees or a book value of less than US\$ 1/2 million. During the second half of 1993, the Agency sold about 500 units (with a total book value of lek 659 million).

The Law on the Main Constitutional Provisions (1991) and the Law on Land (1991) prohibit the sale and purchase of land. Foreign individuals or companies cannot own land, but are permitted to enter a land-lease contract for up to 99 years.

By the end of 1993, 92 per cent of agricultural land had been privatised; most of this happened

in 1991-92 as farmers spontaneously took over the land of former cooperatives. The sale of state-owned housing is regulated by the Law on the Privatisation of State Housing (1992) and by subsequent by-laws. By the end of 1993, 80 per cent of state buildings had been privatised.

Property restitution

According to two laws passed in 1993, former owners and their heirs can claim compensation or restitution of non-agricultural land. In the case of property that has already been privatised, the law prescribes co-ownership between the new and former owners.

Growth of private enterprise

The number of individuals employed in the non-agricultural private sector rose from about 50,000 at end-1992 to 130,000 at end-1993.

Enterprise restructuring

The main "restructuring tool" has been a sharp tightening of enterprise access to bank credits and government subsidies. A rapid accumulation of inter-enterprise arrears in 1991-92 was halted in early 1993 by the nationwide move to a settlement system relying on payment before delivery. Inter-enterprise arrears were netted out and a strictly limited set of financially viable firms were granted the financial means to write off their claims on non-viable companies. Despite the adoption by parliament of a bankruptcy law in 1992, no bankruptcies have yet taken place. An agency was established in 1993 to restructure or terminate the operations of 31 large companies.

Armenia

The reform process was initiated in 1987 as part of perestroika.

A comprehensive reform package was adopted in January 1992. Significant progress has been made on price liberalisation, privatisation, tax reform, and the liberalisation of the exchange and trade system.

Size of the private sector

About 40 per cent of GDP is thought to be generated in the private sector, which employs about 35 per cent of the labour force.

Large-scale privatisation

The Law on Privatisation and Denationalisation of State-owned Enterprises and Unfinished Construction Sites was adopted on 27 August 1992 and amended in November 1993. At least five large-scale enterprises have been privatised. The government intends through its newly introduced privatisation programme to distribute freely to the population 20 per cent of the shares in 70 per cent of the country's large- and medium-scale industrial enterprises.

Small-scale privatisation

By the end of 1993, over 350 small units had been privatised, mainly in the retail and trade sector. Privatised agricultural units account for more than 60 per cent of arable land. More than 10 per cent of housing entities have been privatised. The 1994 privatisation programme approved by parliament in January 1994 envisages accelerated privatisation of housing and the privatisation of 50 per cent of small-scale units (30 per cent of which are to be allocated to citizens in the form of mass privatisation vouchers).

Property restitution

No property restitution had taken place by summer 1994.

Growth of private enterprise

The growth of the private sector outside the disengagement of the state from its assets is considered to be substantial, but no precise estimates exist. Obstacles to growth include interruption in supply of vital commodities, damage to infrastructure and lack of finance.

Enterprise restructuring

Industry is dominated by large conglomerates. Heavy industry is still working to fulfil production quotas matching state-negotiated barter agreements within the former Soviet Union. A preliminary start has been made on restructuring of three large "pilot" enterprises ill-suited for mass privatisation. A draft Bankruptcy Law is to be resubmitted to parliament. There has been no significant incidence of bankruptcy.

Markets and trade

Commodity price liberalisation

Price liberalisation has been comprehensive, although 25 items remain subject to administrative price setting. Efforts have been made to bring administered prices closer to cost-recovery levels.

Trade liberalisation

Since 1992 there have been virtually no quantitative restrictions on imports and very few on exports. More details on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The exchange system is largely free of restrictions on current account transactions including for profit repatriation. Controls are maintained on capital transactions but not on repatriation of capital placements by foreign investors. The exchange rate is freely determined in the interbank market, which competes with a small number of private dealers and foreign exchange bureaux.

Wage liberalisation

The Law on the Power of Defining Wages (1992) regulates wage formation. In September 1992 the government introduced nominal wage ceilings. To allow well-performing enterprises to reward their employees, enterprises were permitted to exceed the wage ceilings by 5-20 per cent in early 1993 and by 30 per cent in the middle of the same year, subject to strict performance criteria. Wage ceilings were generally respected in 1993.

Interest rate liberalisation

There is no cap on deposit or lending rates, but banks have tended to set rates mainly by following the lead of the central bank. Real interest rates on both deposits and lending have been positive since the first quarter of 1993.

Commodity price liberalisation

After a limited start in mid-1991, comprehensive price liberalisation was introduced in January 1992. Controlled prices and subsidies still exist for bread, medical care, energy and certain public utilities.

Trade liberalisation

A system of state-negotiated barter agreements with other countries of the former Soviet Union still dominates trade. Otherwise there are few explicit tariff or non-tariff barriers to trade. More detail on trade agreements and trade regimes is contained in Table 8.3. A 50 per cent export surrender requirement of foreign exchange is in place.

Currency convertibility and exchange rate regime

A national currency, the dram, was introduced in November 1993 and became sole legal tender on 1 March 1994. The government adopted a floating exchange rate regime in the second half of December 1993, after a short period with a fixed peg to the dollar. The exchange rate is determined in an auction in which currency surrendered by enterprises is offered for sale to financial institutions. Full convertibility for current account purposes has not yet been achieved.

Wage liberalisation

A Wage Indexation Law was adopted in early 1992, which gives the government discretion on nominal wage adjustments. A "minimum consumption basket" is used to guide monthly minimum wage adjustments to price increases.

Interest rate liberalisation

Lending interest rates are controlled. Real interest rates were negative until at least the first quarter of 1994, but are expected to increase during 1994.

Financial institutions

Banking reform

A two-tier banking system was introduced in 1992. A law from 1992 defines the functions of the Bank of Albania to include implementation of monetary policy and supervision of banks. The central bank has the right to issue licences for commercial banks to operate, approve mergers and division of banks, and approve the issue of securities. A few banks dominate the market. The Savings Bank takes the bulk of household deposits and the National Commercial Bank undertakes more than half of all lending to enterprises. The household funds are at present channelled to the National Commercial Bank through the central bank.

In October 1992, the government provided state bonds to the banks to replace on their asset side non-performing loans to the former agricultural cooperatives (see the section above on privatisation). Issuance of government bonds to banks in exchange for non-performing loans to former state farms and state-owned enterprises has been deferred until an expected reorganisation of state commercial banks. None of the "old" commercial banks have yet been privatised or gone bankrupt.

Securities markets

Albania has no stock exchange. The introduction of an exchange for secondary market trading in government securities is scheduled for 1994.

Banking reform

The banking reforms within the former Soviet Union in 1987-88 created a two-tier system in which Armenian institutions participated. In 1991, two Armenian branches of Soviet sector-banks became independent; these are now the main commercial banks in Armenia. Former Soviet prudential guidelines are still in use. A draft Act on the National Bank of Armenia, which forms the basis for prudential regulation and banking supervision, is under discussion by parliament. The financial system is still highly concentrated and consists of: the National Bank of Armenia; four state joint-stock commercial banks (Agricultural Bank, Bank for Industry and Construction, Armenia State Commercial Bank, Export-Import Bank); the state-owned Sber Bank; about 50 domestic commercial banks (a third of which are private); several foreign banks, mostly from CIS republics; a state insurance company and several private insurance companies. The state-owned banks hold the vast majority of the assets, bank branches and staff. According to official estimates, bad debts comprise 13 per cent of the banks' portfolios. Unofficial estimates have put the figure far higher.

Securities markets

No stock exchange has been established yet.

Role of the state

Taxation

Until 1990, the state budget relied essentially on three revenue sources: the turnover tax, enterprise profit transfers and social security contributions. All of these were paid by the enterprises. Reforms since 1991 have introduced as new revenue sources a personal income tax, a property tax and customs duties. They have also replaced profit transfers by profit taxation and removed some of the most notable inefficiencies in the turnover tax system. The new sources of income for the government have only been a small counterweight to a very sharp drop in revenues collected from enterprises. In 1992 the profit tax rate was set at 30 per cent, the progressive rates for personal income taxation at 5-40 per cent, and the basic turnover tax at 15 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

Contribution rates of the social security system differ across the spectrum of economic activities. In 1992, the rate for private sector contributions was set at 19 per cent of the wage sum.

Taxation

A value added tax (VAT) was introduced in January 1992 to replace the former Soviet sales and turnover tax. The VAT rate was 20 per cent in 1993. An *ad valorem* excise tax (with rates between 10 and 73 per cent) was introduced in January 1992 to replace specific duties. Enterprise profit tax rates, introduced in April 1992, vary between 12 and 25 per cent. The Law on Personal Income Taxation was introduced in January 1992, making this tax more progressive; rates varied in July 1992 between 12 and 45 per cent. There is no separate tax on capital gains. By July 1994, parliament was considering a draft Property Tax Law (with a 0.2 per cent rate for citizens and a 0.208 per cent rate for enterprises), a draft Customs Tax Law and a draft Land Tax Law (with rates between 15 and 30 per cent). Tax conditions for foreign investors are described in more detail in Table 9.3.

Azerbaijan

Introductory remarks

The reform process was initiated as part of perestroika in 1987; it was continued in early 1992, after independence, by new tax legislation, a foreign ownership law, price liberalisation and property ownership reform. In autumn 1992, currency reform and improvements to banking legislation were introduced. However, no truly comprehensive reform programme is in place.

Enterprises

Size of the private sector

The size of the private sector, including informal activity, is likely to be within the 15-25 per cent range.

Large-scale privatisation

A government programme put forward in April 1994 envisages privatisation of medium-sized enterprises (50-300 employees) in 1996-98 and large-scale privatisation from 1998.

Small-scale privatisation

The government programme of April 1994 earmarks 8,000 small enterprises (about 30 per cent of the total) for privatisation in 1994-95. These comprise small trading and service enterprises (less than 50 employees), material production firms and public catering firms. So far, there has been a change of ownership of half the taxi cab fleet, some housing and a few construction projects. The privatisation of agriculture will be reviewed after approval of a land law.

Property restitution

In November 1991 all former Soviet property in Azerbaijan was nationalised. There is no individual property restitution law.

Growth of private enterprise

10,000 small private enterprises are registered with local authorities, but many are inactive.

Enterprise restructuring

The pre-independence management structure and relationship between enterprises and ministries remain largely intact, supported by budgetary subsidies and bank credits to enterprises. There is no bankruptcy law in Azerbaijan. There has been some managerial reform of large enterprises by division into smaller units. The 1993 Law on Anti-monopoly Activities established the State Anti-monopoly Committee, which is drawing up plans to curb monopolistic practices through institutional reform and establish a regulatory regime for natural monopolies.

Belarus

The reform process started in 1987 as part of perestroika. Since then, several reform programmes have been adopted (1992 liberalisation of prices, and 1993 reforms supported by the IMF and the World Bank), but a comprehensive package has yet to be implemented.

Size of the private sector

According to the State Committee for Statistics, the private sector in 1993 accounted for about 5 per cent of employment and 10 per cent of non-agricultural output. Estimates from other sources vary greatly.

Large-scale privatisation

Privatisation of state-owned enterprises began in 1991 on the basis of legislation passed within the former Soviet Union. Under this law, 272 enterprises (employing about 60,000 workers) were leased to private entities in 1991-92. In 1993, the Law on Privatisation of State Property and the Law on Privatisation Vouchers were approved. Privatisation of state enterprises under the new law began in June 1993, and about 300 enterprises were privatised at the end of that year. According to the legislation, two-thirds of state assets are to be privatised by 1997, with half being privatised by the distribution of vouchers to the general population. A voucher-based privatisation programme was launched in July 1994.

Small-scale privatisation

Most small enterprises are owned at the local level and their privatisation is controlled by the local authorities. The State Committee for the Management of State Property provides technical support. The status of small-scale privatisation varies, with the cities of Minsk and Brest and the regions of Mogilev and Gomel initiating auctions and tenders in 1993. A voucher-based privatisation programme started in July 1994.

Property restitution

No property restitution has taken place to date.

Growth of private enterprise

Private businesses accounted for about 20 per cent of enterprises in the non-agricultural sector in 1993, including about 15,000 small businesses and 1,200 joint ventures with foreign investors. The joint ventures are mostly small businesses in trade and services.

Enterprise restructuring

There has not yet been a significant restructuring of state enterprises. The Bankruptcy Law was enacted in 1992, but has been inoperative.

The State Anti-monopoly Committee was established in 1991, and in 1992-93 enabling legislation and administrative regulations were approved. As a first step, the Committee has begun to break up a major trading conglomerate. The Committee also monitors and regulates monopolistic enterprises.

Markets and trade

Commodity price liberalisation

In January 1992, 70-80 per cent of producer and consumer prices were liberalised, with further rounds later in 1992 and 1993, leaving bread and energy as the main goods subject to continued price controls. Energy prices are still at about a quarter of international market prices.

Trade liberalisation

Foreign trade is largely centrally controlled. Extensive export quotas are backed by a licensing system and export taxes. Most imports and exports are arranged by bilateral agreement. More detail on trade agreements is contained in Table 8.3.

Currency convertibility and exchange rate regime

Since May 1994, the official manat rate has been set weekly, based on a weighted average of exchange rates quoted by commercial banks authorised to deal in foreign exchange. Plans are being drawn up by the National Bank to promote an interbank foreign exchange market. Both current and capital account convertibility is heavily restricted. The official manat rate is used for all official transactions in foreign exchange and mandatory surrender of proceeds from non-strategic exports.

Wage liberalisation

A minimum wage, set by the government, is linked to nominal prices by a formula which falls short of full indexation. Since August 1993 public sector wages (and social benefit payments) have been linked to a minimum wage. Since May 1994, wage ceilings have been imposed on enterprises.

Interest rate liberalisation

Credit is rationed, largely through four state-owned commercial banks, at interest rates which continued in the first half of 1994 to fall far short of the rate of inflation.

Commodity price liberalisation

Producer prices were liberalised in early 1992; however, after prices were freed, ceilings on profit margins for traders were introduced to check the increase in retail prices. Prices on products produced by monopolistic enterprises are also controlled by ceilings on profit margins. These enterprises in 1993 accounted for about 30 per cent of industrial output.

Trade liberalisation

Quantitative restrictions and taxes on exports were substantially reduced in early 1994. There have been few quantitative restrictions on imports, although import taxes have varied widely. The tariff structure was harmonised at the end of 1993. Belarus broadly unified its export and import duty system *vis-à-vis* third countries with that of Russia in May 1994. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

There are a number of exchange restrictions. The national coupon is now the main means of exchange in Belarus. Belarussian and Russian governments signed a framework agreement on economic and monetary union in September 1993 and a union treaty in 1994. However, their implementation remains uncertain.

Wage liberalisation

The 1990 Law on Enterprises allowed for the free determination of wages; however, many enterprises follow adjustments in public wages. The minimum wage is set by parliament and is periodically adjusted for inflation.

Interest rate liberalisation

Although the level of interest rates in the largely state-owned commercial banks is not subject to restriction, the interest rate on central bank refinancing has been significantly lower than inflation, keeping the entire spectrum of interest rates low and negative in real terms.

Financial institutions

Banking reform

Following the absorption by the Azerbaijan branch of Gosbank of two Azerbaijan branches of Soviet specialised sector banks in February 1992, the rudiments of a new two-tier system were established in August 1992 through the National Bank Law and the Law on Banks and Banking Activities, which again split off the specialised banking operations into two separate institutions. So far, there has been little restructuring of state banks. Credit allocation is administered according to a plan subject to parliamentary approval. Since 1992, over 200 very small commercial banks have been created. As a result of new rules on capitalisation passed in July many new banks are not expected to survive.

Securities markets

Although a Law on Securities and Stock Exchange has been passed, no stock exchange has been established.

Banking reform

The 1990 Laws on the National Bank and on Banks and Banking Activities established the National Bank of Belarus, which operates as the central bank, and five banks constituted from former branches of the specialised banks of the former Soviet Union. The Belarussian financial system includes 28 new commercial banks owned by state enterprises and by private individuals and business interests, but the former specialised banks control a major share of banking activity.

Securities markets

The Law on Commercial Paper and Stock Exchanges was passed in 1992; however, an exchange has not yet been established.

Role of the state

Taxation

In 1992, turnover and sales taxes were replaced with a value added tax, and a new enterprise profits tax was introduced along with new excise duties, a car ownership tax, a royalty in petroleum production and a progressive personal income tax. Laws on import customs tariffs and export taxes were adopted; the latter is not yet effective. Plans are being drawn up to extend the base of VAT to non-CIS imports and to reduce exemptions.

Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

In 1992 the Social Protection Fund, created from a merger of two pre-existing social security programmes, was established to provide pensions and social allowances, financed by payroll contributions. A separate committee for refugees deals with the problems of war-displaced persons.

Taxation

A value added tax (VAT) was introduced in 1992. The general VAT rate was 28 per cent, except for agricultural products which were taxed at 14 per cent. Also, the enterprise profits tax was overhauled in 1992 and an excess-wage tax was introduced; but a number of distortions in enterprise taxation remained. The VAT rate was lowered to 25 per cent in 1993, when a special 12 per cent rate for certain services and a zero rate for agriculture products sold domestically were introduced. The 1994 budget called for the harmonisation of the enterprise profits tax rate at 30 per cent, elimination of elements of the personal income tax that discriminated against private activities, reduction in the top marginal income tax to 30 per cent from 60 per cent, and reduction in export taxes. To compensate for the loss in revenues, the tax base was broadened by eliminating exemptions from the profit tax and VAT. Many of these changes are consistent with movement toward harmonisation of tax legislation with Russia. Tax conditions for foreign investors are described in more detail in Table 9.3.

Introductory remarks

Bulgaria

The range of permissible private sector activities was expanded in 1987. A comprehensive programme was adopted in 1991 with the removal of price controls and subsidies on most goods and services, and liberalisation of interest rates.

Enterprises

Size of the private sector

30-50 per cent of GDP is generated in the private sector, mostly in the trade/retail and service sectors. About 30 per cent of the workforce is employed in the private sector.

Large-scale privatisation

Large-scale privatisation in Bulgaria has been slow but may be set to accelerate this autumn. The regulating laws are the Privatisation Law (1992) and the Privatisation of State Enterprises Programme (1993). By June 1994, one in 16 large-scale enterprises (defined in Bulgaria as those with assets exceeding Lv 200 million) had been privatised. From a total of 870 medium-sized state-owned enterprises (with assets of Lv 10-200 million), 17 had been privatised. Sales during 1993 represented less than 1 per cent of the book value of state-owned enterprises. Privatisation vouchers were, before it was known that an election would be called in for the autumn of 1994, meant to be distributed in early September this year in the context of a mass privatisation scheme, which was passed by parliament in the autumn of 1993 and involves 340 enterprises.

According to the Law on Ownership and Use of Agricultural Land (1991), foreigners cannot own land, although they may obtain user and building rights.

Small-scale privatisation

A law regulating small-scale privatisation was adopted in January 1993. By March 1994, 69 of the 5,000 small state-owned enterprises (those with assets below Lv 10 million) had been sold by ministries. In addition, 93 entities (most of them small-scale) had been sold by municipalities.

Property restitution

A substantial amount of restitution to dispossessed owners has taken place, following the Law on Ownership Restoration (1992) and the Compensation Law (1993). Approximately 25,000 privately owned and managed small and medium-sized businesses were created in 1992 through restitution of urban business properties. Land restitution has been relatively slow, partly because the new owner must pay a high fee for the issue of the title deed.

Growth of private enterprise

About 460,000 new businesses are currently registered, half of which are thought to be active. Around 1,940 are joint ventures and about 2,000 fully foreign-owned.

Enterprise restructuring

At the beginning of 1991, the government broke up 871 of the largest monopolies in manufacturing, construction, trade, transport and tourism into 3,485 independent state-owned enterprises.

There is no separate bankruptcy law. Provisions for bankruptcy are included in a law which was passed in 1989, but the environment is very protective of debtor enterprise and allows indefinite deferral of creditor claims.

Croatia

The first elements of "market socialism" were introduced in 1952. In 1976 a law on "associated labour" institutionalised "social ownership". In 1988, the so-called "Markovic reforms" included widespread price, import and foreign exchange liberalisation. A comprehensive programme was adopted in the second half of 1991, leading to the creation of the central banking system, the introduction of temporary currency, and a national budget. The framework for private ownership was laid down. A Labour Law and a Law on Business Association were adopted. In October 1993, parliament adopted a comprehensive macro economic stabilisation programme.

Size of the private sector

The private sector is likely to account for 30-40 per cent of total GDP, including a rough estimate of informal activity.

Large-scale privatisation

The inheritance of "social ownership" of former Yugoslavia provided a degree of self-management to the enterprises. The Law on the Transformation of Enterprises with Social Capital (April 1991), administered by the Privatisation Fund (after the merger of the Croatian Fund for Development and the Restructuring and Development Agency), requires the conversion of almost all "socially owned" enterprises into joint-stock companies. 2,877 applications for autonomous privatisation have been received, of which well over half (by number, less by capital value) have so far been privatised. The acceleration of privatisation is now a government priority.

Small-scale privatisation

Extensive small-scale private sector activity already existed under the former Yugoslav law. The small-scale privatisation process, started after independence, has now largely been completed.

Property restitution

No law on restitution has yet been sent to parliament, nor are there plans to do so.

Growth of private enterprise

Very low registration fees for new companies have resulted in a massive growth in the number of registered enterprises, from 55,000 in December 1992 to 96,000 in April 1994. Many of these are inactive. Nevertheless, the number of active enterprises has at least doubled over the past two years.

Enterprise restructuring

Workers' councils for enterprises have been replaced by management boards. There has so far been only limited success in the transformation of management structures, with or without privatisation. The acceleration of plans to break up large monopolies is now a government priority.

A draft Law on Competition and Monopoly is being considered by parliament. The draft law deals with conditions prohibiting restraints on trade, monopolistic practices, and abuse from mergers and dominant position. A competition protection agency is to be established to implement the policy.

Markets and trade

Commodity price liberalisation

In February 1991, 90 per cent of prices were liberalised. The government frequently adjusts administered prices.

Trade liberalisation

The foreign trade regime is liberal, following reforms started in 1989, though import tariff rates have recently tended to increase after large cuts in earlier years. Quantitative restrictions apply to only a limited number of imports and exports. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The lev has been floating freely since February 1991 and is internally convertible. Profits and invested capital may be repatriated by foreign investors in hard currency.

Wage liberalisation

The government imposes a ceiling on wage increases in enterprises. In 1993 wage ceilings began to be based on government discussions with unions and employers in order to check social tensions. Minimum wages are indexed 100 per cent to inflation with quarterly adjustments.

Interest rate liberalisation

Interest rates were liberalised in 1991. Commercial bank rates tend to follow the lead from central bank changes in refinancing rates. Spreads remain very large (up to 20 percentage points) due to an overhang of non-performing assets and undercapitalisation in the banks.

Commodity price liberalisation

All direct price controls have now been removed, including those on energy and food. Some indirect controls remain, largely through government influence on major enterprises, particularly in the energy sector.

Trade liberalisation

The foreign trade system is liberal. Most imports and exports are tariff free. An import tax of 10 per cent was introduced as part of the government's macroeconomic stabilisation programme in autumn 1993. All quantitative restrictions have been removed.

Currency convertibility and exchange rate regime

The currency is in principle floating but the National Bank intervenes in the light of market conditions in the interbank market. A new law on foreign exchange operations provides a high degree of current account convertibility. Capital controls are still in force for foreign direct investments abroad by Croatian residents and enterprises.

Wage liberalisation

A wage freeze is in place for the state-owned sector, supported until November 1994 by a "social agreement" with unions. There are no wage restrictions on private enterprises.

Interest rate liberalisation

Rates are set at a level that is regarded as positive in real terms, in support of rigorous macroeconomic stabilisation, introduced in October 1993.

Financial institutions

Banking reform

A two-tier banking system was introduced in 1989. During 1993 progress was made on consolidating the banking sector; 53 financially weak state banks were merged into five groups. Few foreign banks operate in Bulgaria. All the domestically owned commercial banks are going through a severe liquidity crisis. Only one commercial bank has been privatised. No bank has formally gone bankrupt.

Banking supervision has developed slowly. New rules on capital adequacy and liquidity were introduced in 1993, and the banks are to comply fully by March 1995.

The government plans to recapitalise the banks. Legislation to this effect was passed in December 1993; compensation is to be provided to the banks for loans that became non-performing before December 1990. Under the scheme, the state will buy from the banks a pool of non-performing loans with a total face value of Lv 107 billion. The state will pay for the loans in the form of state bonds.

Securities markets

There are two main functioning stock exchanges: the First Bulgarian (FBSE) and the Sofia (SSE). The FBSE has two weekly auctions with widely varying turnover, and trades mostly shares of financial institutions. The SSE has weekly auctions with a small volume of transactions.

Banking reform

At independence the National Bank of Croatia was made the regulatory authority of a two-tiered banking system. The Banking Law of 1993 provides the main regulatory framework for commercial banks. The National Bank is drawing up plans to restructure and privatise the major banks, whose shareholders are the major debtors. The intention is to swap holdings in the banks for government holdings in the enterprises, followed by bank recapitalisation and privatisation. The Law on Bank Rehabilitation (providing a procedure by which banks will be recapitalised) and the Law on the Deposit Insurance Agency were both passed by parliament in June 1994.

Securities markets

The securities markets are developing slowly. The Zagreb Stock Exchange auctions privatisation shares weekly but there is little activity. Very few shares are listed and traded. A new legal and accounting framework is to be introduced in autumn 1994. There has been some activity in a recently established informal over-the-counter market.

Role of the state

Taxation

In 1990-91, a dramatic terms-of-trade loss and drop in export demand caused a large decline in output that, coupled with increased wages, reduced both profit and turnover tax revenues. Meanwhile the government sharply cut direct and indirect enterprise subsidies, which reduced budgetary expenditures but added to the financial strain of the enterprise sector. Budget revenues dropped 52 per cent in real terms between 1990 and 1992.

Faced with this, from 1990 onwards the government began to cut its payroll and capital expenditure and reform the tax system, albeit in a limited way. Notably, interest deductibility and depreciation allowances were reduced in the early 1990s. The most significant tax reform to date has been the introduction in April 1994 of a VAT as a replacement for the previous turnover tax.

Personal income is taxed progressively at rates of 20-52 per cent. The dividend tax rate is 20 per cent and there are two basic profit tax rates: 30 per cent and 40 per cent. The tax rate on banks' profits is 50 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3. In August 1993 excise taxes were increased on a number of luxury goods (with rates between 30 and 60 per cent). The value added tax introduced this year is set at a uniform 18 per cent.

Social security

Social security is financed by a tax on wages of 40 per cent and transfers from the state budget. The bulk of social security outlays cover pensions to 2.4 million individuals. Some cuts in entitlements were implemented in 1992. However, at present entitlement levels and demographic trends, Bulgaria will face substantial increases in social security outlays in the medium to long term.

Taxation

In January 1994 laws on Tax Administration, Income Tax, Profit Tax and Sales Tax were enacted. Preparatory work has begun on a value added tax (VAT). There is a corporate tax on profits at 25 per cent, with relief for modernisation of production facilities and for war reparation. Tax conditions for foreign investors are described in more detail in Table 9.3. Payroll taxes paid by employees, including social security contributions, run at between 50 per cent and 70 per cent of gross salary. Turnover taxes on consumer goods have been halved to 20 per cent, with simplification planned in preparation for the introduction of the VAT. A draft budget law is in preparation, streamlining budgetary procedures.

Czech Republic

Introductory remarks

After the Velvet Revolution in the Czech and Slovak Federal Republic (CSFR) in November 1989, market-oriented reform was initiated during 1990 and a comprehensive programme was adopted in January 1991. The CSFR broke up at the end of 1992 and the Czech Republic became an independent country on 1 January 1993.

Enterprises

Size of the private sector

The private sector accounts for about 60 per cent of GDP (prior to the second wave of privatisation). Private sector employment (excluding cooperatives and associations) at the end of 1993 stood at 2.23 million, about 47 per cent of total employment.

Large-scale privatisation

A comprehensive sell-off of state assets has been pursued through two "privatisation waves". The first of these was launched by the CSFR in May 1992 and completed by mid-1993. It involved 1,900 enterprises (with book value of CZK 650 billion) in the Czech Republic. In this process, CZK 212 billion worth of shares in 988 firms in the Czech Republic were distributed through a voucher-based "mass privatisation" scheme which created 8.5 million shareholders in total in the Czech and Slovak Federal Republic. The second wave in the Czech Republic involves 2,000 enterprises (with estimated book value of CZK 550 billion) and was initiated in 1993. It is to be completed during autumn 1994. In this second wave, shares in 861 companies with a book value of CZK 155 billion will be distributed through the voucher scheme.

Direct foreign ownership of land is not allowed, but ownership through a Czech legal entity wholly owned by foreigners is permitted.

Small-scale privatisation

The sale of small state-owned enterprises was launched in January 1991. It was largely completed during 1992 with approximately 22,000 enterprises auctioned in what is now the Czech Republic. The yield to the state exceeded CZK 30 billion.

Property restitution

A restitution law was adopted by the CSFR in October 1990. About 30,000 industrial and

administrative buildings, forests and agricultural plots, which had been nationalised in 1948-55, as well as 70,000 commercial and residential entities nationalised during 1955-59, were handed back to the original owners. The value of assets returned has been estimated at between CZK 70 billion and CZK 120 billion.

Growth of private enterprise

At the end of 1993, about 1.2 million businesses had been registered, of which 60,000 were legal entities (joint-stock companies, etc.), and 1.1 million individuals were conducting business activities.

Enterprise restructuring

The main restructuring tools have been indirect: privatisation and tight access to credit and subsidies for enterprises. Restructuring has been left to the new private owners, although some restructuring may have taken place in the process of drawing up privatisation plans.

The initial law on bankruptcy was passed August 1991, with virtually no possibility of external creditors forcing companies into bankruptcy. The current law became effective in April 1993, allowing creditors to bring bankruptcy cases to court after a three-month protective period. Private farmers will be protected from bankruptcy until December 1994. Enterprises in the voucher scheme are protected until two months after the transfer of at least 34 per cent of shares to the new owners.

A competition law was passed in 1991 and amended in November 1993 to widen the definition of illegal practice and to increase maximum fines. Another objective was to bring the law closer to consistency with EU legislation. However, the law remains rudimentary and ineffectively enforced.

Estonia

The reform process started in 1987 as part of perestroika. In January 1989, while Estonia was still part of the former Soviet Union, a law on economic autonomy was approved which entailed independence in price and wage setting, fiscal strategy and financial policies. Market reforms accelerated following Estonia's independence in August 1991.

Size of the private sector

At the end of 1993, enterprises that were non-state and non-municipal accounted, according to official estimates, for 40 per cent of industrial output and more than 50 per cent of employment. Due to statistical problems and under-reporting, reliable estimates of the total GDP-share of the private sector do not exist but the share is likely to exceed 50 per cent.

Large-scale privatisation

Large-scale privatisation is accelerating after having been relatively slow immediately after independence. The process gathered pace with the adoption of the Privatisation Act (1993) which allowed for voucher payment in addition to cash only, partial sell-off of enterprises and repayments in instalments for domestic buyers. A sixth international privatisation tender has been announced (the second one in 1994). Between 40 and 56 large enterprises are offered in each tender. The first four tenders generated more than US\$ 63 million in sales proceeds. The government's ambition is to complete large-scale privatisation by the end of 1995.

Small-scale privatisation

The Privatisation of State-owned Trade and Service Enterprises Law (1991) and amendments to this law during 1992 launched a rapid small-scale privatisation. By May 1994 more than 85 per cent of small enterprises (representing more than 1,000 units) had been privatised through employee buy-outs and auctions. An Act on Privatisation of Housing was passed in May 1993 but implementation has been slow so far.

Property restitution

More than 200,000 claims for restitution (of homes, farms, and businesses expropriated during the communist period) had been submitted by the April 1993 deadline. By February 1994 approximately half of these had been validated. However, unresolved issues of restitution are slowing down the privatisation of housing.

Growth of private enterprise

The establishment of new private enterprises started with the adoption of the Enterprise Law in 1989. New private enterprises grew rapidly in number, primarily in retail trading, catering and commerce. During 1993 approximately 10,000 new enterprises were created. It is estimated, however, that 30 to 50 per cent of newly created enterprises exist only on paper.

Enterprise restructuring

Restructuring of privatised state enterprises is generally left to investors who have to present a business plan as part of their bid. However, certain turn-around programmes are planned for privatised enterprises with the help of international organisations. A bankruptcy law was passed in September 1992 and was quickly implemented, notably during the banking crisis of late 1992. Bankruptcy proceedings have been initiated for some 200-300 enterprises.

Markets and trade

Commodity price liberalisation

In January 1991, 85 per cent of consumer prices were decontrolled and further liberalisation measures were undertaken during that year. The only remaining significant controls pertain to utility charges, rents and public services. In addition, mark-ups are closely regulated in the energy sector.

Trade liberalisation

Most quantitative controls on imports and exports were removed in January 1991. This was initially combined with a surcharge on consumer goods imports of 20 per cent, but the surcharge was lowered gradually to 10 per cent by January 1992 and later abolished. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

Current account convertibility for enterprises was introduced in January 1991. Capital account transactions remain subject to some control. The exchange rate is pegged to a basket comprising the Deutschmark (65 per cent) and the US dollar (35 per cent).

Wage liberalisation

Wages are regulated through a tax on "excessive increases". This was initially imposed during 1991 in the context of a macroeconomic stabilisation package with agreement from unions (the so-called "social contract"). The intention was to regulate the rise in real wages. The tax was reintroduced in the second half of 1992 for enterprises with majority state or municipal ownership, taxing wage increases exceeding a measure which is linked to specific performance targets. The tax was reintroduced in July 1993, this time unilaterally by the government, and it now applies to all enterprises with more than 25 employees. Real wage increases are restricted to 5 per cent with allowances made for trends in sales.

Interest rate liberalisation

Interest rates were freed progressively from 1990 onwards, with complete liberalisation in April 1992.

Commodity price liberalisation

The removal of price controls started in late 1989 as part of the programme on economic autonomy, and continued incrementally until completion at the end of 1992. The few remaining subsidies (e.g. on housing) are currently being cut.

Trade liberalisation

Virtually no restrictions on foreign trade remain. Import tariffs apply only to furs and to sea and road vehicles (at a rate of 10 per cent), representing 14 per cent of total imports in 1993. Export controls have been removed with few exceptions. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

An independent national currency, the kroon (or EEK), was introduced in mid-June 1992 under a currency board arrangement. The kroon is pegged to the Deutschmark at 8 EEK/1 DM. There is full current account convertibility.

Wage liberalisation

Wage setting (apart from the minimum wage) became free as a result of wage reform in 1990. However, the government has subsequently relied in part on an incomes policy to contain wage inflation. Wages in government agencies are set according to pay scales approved by the government. The government also sets a ceiling for pay increases in state-owned enterprises. Wage setting in the private sector is free and wage negotiations are decentralised.

Interest rate liberalisation

A two-tier banking system with a domestic Estonian central bank has been in operation since mid-1992. The central bank (Bank of Estonia) does not interfere, except through indirect instruments, with the setting of interest rates by commercial banks. Real interest rates are positive for short-term lending, but are arguably negative for loans with longer maturities. The spread between average lending and time deposit rates remains more than 10 percentage points.

Financial institutions

Banking reform

A two-tier banking system was adopted in January 1990. Laws on the central bank and commercial banks were passed in February 1992. The former law grants the central bank supervisory powers. With the split of the CSFR, the Czech National Bank was established in January 1993 as the Czech successor to the former State Bank of Czechoslovakia. At the end of 1993, 43 banks, 10 foreign bank branches and four buildings and loan associations were operating in the Czech Republic. All commercial banks are now in private hands, including former state banks that were privatised during 1993.

The regulatory regime sets the required capital adequacy (following the Basle definition) at 6.25 per cent by the end of 1993 and 8 per cent by the end of 1996. During the CSFR-period, a state-owned Consolidation Bank was established in March 1991 to take over Kcs 110 billion (20 per cent of credits to enterprises) of "permanent revolving credits" (perpetual loans characterised by low interest rates and issued for inventory financing). Further state-financed recapitalisation of the banks totalling Kcs 50 billion was conducted in November 1991. The role of the Consolidation Bank (and its Czech successor) has expanded gradually to involve enterprise restructuring operations. The purchase by the Consolidation Bank of non-performing assets held by commercial banks is being considered to ensure that the state-owned banks will be able to comply with the capital adequacy requirement. Bad debt in the private banking system is estimated to represent about 20 per cent of bank assets.

Securities markets

The Law on the Stock Exchange and Securities was adopted in 1992. Prague Stock Exchange (PSE) and the RM-system (an over-the-counter exchange) began operation during the first half of 1993. Foreigners are free to buy and sell shares; profit repatriation is subject to payment of income taxes on capital gains.

The trading volume and prices on the Prague Stock Exchange have rocketed. Though erratic, monthly trading volumes of shares are well over CZK 1 billion. The index of share prices quadrupled between August 1993 and March 1994 but has subsequently fallen sharply. The frequency of trading days has increased from one per fortnight at opening to three days per week by the middle of March. Only a few shares that fulfil standards are listed, and most stock trading in the Czech Republic is in the unlisted segment of the market.

Trading via the RM-system remains limited due to less frequent trading (initially one per month) and long lags between order placement and actual trading.

Banking reform

The Bank of Estonia was established as a central bank in 1990 but the local branch of the Soviet Gosbank continued to carry out most central bank functions until January 1992. An Estonian-based two-tier banking system became fully operational after the currency reform in June 1992. Between 1989 and 1992, 42 commercial banks were established, mostly small and undercapitalised. After the banking crisis of late 1992 to early 1993, the number of commercial banks was halved, either through merger or liquidation. Following this the government raised the minimum capital requirement and more stringent supervision of commercial banks by the Bank of Estonia was introduced. Foreign banks (mainly Finnish) are starting to open offices in Estonia.

Securities markets

Although a Securities Market Act was adopted in 1993, the market for stocks and bonds is in an embryonic state. The only regularly traded securities are short-term certificates of deposit (28 days maturity) which are issued by the central bank and traded in the interbank money market.

Role of the state

Taxation

Stop-gap tax reforms were introduced in 1990, involving simplification of turnover tax rates and a lowering of corporate and individual tax rates. A comprehensive tax reform was implemented in January 1993, which introduced a value added tax (in two tiers at 23 per cent and 5 per cent), streamlined the corporate profit tax (at 42 per cent in 1994, down from 75 per cent in the mid-1980s) and individual income taxes (top rate 44 per cent). Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

The reform in January 1993 also transferred funding for social security from general taxation to an insurance-based system. Social security contributions amount to 37 per cent of the wage sum for employers and 13 per cent of wages for employees.

Taxation

A new taxation system became effective from January 1994. A flat income tax of 26 per cent for companies and individuals was introduced (this rate also applies to investment income). State-owned enterprises pay an additional 10 per cent of after-tax income in mandatory dividends to the budget. A value added tax was introduced in January 1992 at 10 per cent; the rate was increased to 18 per cent in June 1992. There are differential excise taxes on petrol, alcohol and tobacco. Other taxes include social security tax, gift and inheritance tax, land tax and gambling tax. Tax conditions for foreign investors are described in more detail in Table 9.3.

Introductory remarks

1952 saw the first Yugoslav experiments with "market socialism". Other landmarks were the Law on Associated Labour (1976), which institutionalised "social ownership", and the 1988 Markovic reforms which included widespread price, import and foreign exchange liberalisation. In April 1992 independence (approved by referendum the previous September) was translated into radical economic reform: a new currency was accompanied by a first attempt at macroeconomic stabilisation, further price liberalisation and elaboration of plans for privatisation.

Enterprises

Size of the private sector

Private activity, including in the informal sector, probably accounts for 25-40 per cent of GDP.

Large-scale privatisation

The "Agency of the Republic of FYR Macedonia for the Transformation of Enterprises with Social Capital" is to receive applications for privatisation from large-scale enterprises by the end of 1995. About 400 larger enterprises are expected to apply. Enterprises without proposals at that time will have privatisation or restructuring imposed on them by the Agency. In addition, the Agency has selected 25 large enterprises for immediate privatisation, with a further 40 under consideration. The Law excludes 58 enterprises, among them the utilities and transport system, from privatisation for the time being.

Small-scale privatisation

Over 90 per cent of all enterprises are already privately owned, almost all of them very small, with a share of total employment of probably 20-40 per cent. The Law for Transformation of Enterprises with Social Capital (June 1993) plans for privatisation of 1,069 socially owned small enterprises (less than 50 employees).

Property restitution

A draft law on restitution is in preparation.

Growth of private enterprise

Since 1989 there has been rapid growth from a low base in the number of private enterprises. Active small enterprises (generally with one or two employees) number 12,000-17,000. Statistics from FYR Macedonia's Social Accounting Office suggest that the main concentration is in "commerce" and financial/technical services.

Enterprise restructuring

A task force was established in 1994 to implement restructuring of large-scale enterprises. The 1989 Bankruptcy Law of former Yugoslavia is still in force.

Georgia

Partial reform was initiated in 1987 as part of perestroika. A comprehensive reform package has not been implemented.

Size of the private sector

The private sector probably accounts for about 20-30 per cent of GDP.

Large-scale privatisation

The Law on Privatisation of State Ownership was adopted on 1 October 1991. The government plans to use a voucher programme to privatise most medium or large-scale enterprises. So far three of the over 900 medium or large-scale state enterprises have been privatised.

Small-scale privatisation

By April 1994 about 22 per cent of the almost 5,000 state-owned small-scale enterprises (those with assets below Rb 30 million by end-1992 and fewer than 50 employees) had been privatised, mainly in the retail and trade sector, and another 15 per cent are to be privatised in 1994. Before independence a significant share of housing was already in private hands: privatisation of housing is now virtually complete. More than half of agricultural land has been privatised in small plots via leasing (private land ownership rights have not yet been granted). The government intends to keep approximately 25 per cent of agriculture in state hands.

Property restitution

No property restitution has taken place in Georgia.

Growth of private enterprise

Obstacles to growth of the private sector include civil unrest, interruption in supply of vital commodities, damage to infrastructure and lack of finance.

Enterprise restructuring

Most of the formal economy remains subject to a system of state orders, and industry continues to be highly monopolistic. Despite sharp falls in output, state enterprises have not fundamentally restructured and continue to have access to soft bank credits and fiscal transfers.

The Law on Bankruptcy was adopted by parliament in 1991. There has been no significant incidence of bankruptcy.

Markets and trade

Commodity price liberalisation

Liberalisation of the price system is advanced. A "notification requirement" remains for milk, municipal rent, water, central heating and vehicle insurance. There have been large increases in the relative price of electricity and oil derivatives, with further increases planned.

Trade liberalisation

The dismantling of the complex former Yugoslav trading system is well advanced; few tariff and non-tariff barriers remain in place. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The denar has been floating since the beginning of 1994. There is near full current account convertibility, except as regards access for FYR Macedonian citizens to foreign currency for tourism abroad.

Wage liberalisation

A rigorous incomes policy has been in place since the end of 1993.

Interest rate liberalisation

Real interest rates are positive. Interest rates are linked to the auction price of National Bank credits (first auction November 1993). The intention is to liberalise interest rates fully in 1994.

Commodity price liberalisation

Price controls were lifted for most goods and services during price liberalisation rounds in 1991 and 1992. Price controls continue to apply to, *inter alia*, bread and milk.

Trade liberalisation

A state order system, largely based on bilateral trade agreements and barter arrangements with countries of the former Soviet Union, remains in place. Outside this system, many export items are subject to export licensing and taxes, but imports are subject to few restrictions. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

An interim and parallel currency, the Georgian coupon, was introduced in April 1993 and declared sole legal tender in August 1993. Due to very high inflation, domestic transactions have increasingly taken place in foreign currency or in the form of barter. Georgia has adopted a floating unified exchange rate regime. A fully fledged national currency (the lari) is expected to be introduced after a certain degree of macroeconomic stability has been achieved.

Wage liberalisation

Adjustments to minimum wages have lagged behind inflation.

Interest rate liberalisation

Interest rates have not been fully liberalised and remained substantially negative in real terms during 1993.

Financial institutions

Banking reform

A comprehensive bank rehabilitation plan is being drawn up for implementation in 1994 and 1995, but the exact mode and amount of state-financed recapitalisation for the dominant bank remains unclear. The plan includes:

- the audits of four major banks accounting for 90 per cent of assets of the banking system;
- the establishment of a bank rehabilitation agency, amending the Law on Banks and Savings Institutions;
- legislation to improve the regulatory and supervisory framework.

Securities markets

No stock exchange has been established yet.

Banking reform

The Law on Banks and the Banking System was adopted in August 1991 but new laws are currently being drafted. An independent national two-tiered banking system was created in 1991. The financial system now consists of the National Bank of Georgia; five specialised state-owned banks (Agricultural Bank, Industry and Construction Bank, Social Development Bank, Export/Import Bank, Savings Bank); and about 200 small domestic commercial banks (about half have state enterprises as principal owner and only few are fully private). Only the Export/Import Bank has been corporatised. The state-owned banks hold more than 90 per cent of the assets, branches and personnel of the banking system. The central bank still plays an important role in the execution of government policy through its issuance of directed credits. Unofficial estimates indicate that bad debts comprise between 14 per cent and 35 per cent of the state-owned banks' portfolios.

Securities markets

No stock exchange has been established in Georgia.

Role of the state

Taxation

The January 1994 tax reform reduced sales tax rates from 21 to 3; there is now a general rate of 25 per cent, and rates of 5 per cent for food and 10 per cent for most services. Excise duties on oil, alcohol, cigarettes and cars were increased in April 1994. Income tax rates have been consolidated and many exemptions have been removed. An inland revenue service has been created from the merger of the Social Accounting Office and part of the Ministry of Finance. The 1994 budget provides much greater transparency as a result of a sharp curtailment of off-budget finance. Tax conditions for foreign investors are described in more detail in Table 9.3.

Taxation

A law passed in December 1993 set the value added tax at 14 per cent. Profit taxes (now governed by a law adopted in January 1994) vary between 10 per cent and 35 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3. The Law on Personal Taxation was adopted in January 1994 with marginal rates varying between 12 per cent and 20 per cent. Enterprise property is taxed at a rate of 1 per cent. There is no separate capital gains tax.

Social security

The social security system is under severe financial strain, faced with a rise in poverty and an inflow of refugees.

Hungary

Introductory remarks

A package of partial reform policies introduced in 1968 expanded enterprise influence on investment decisions, partially liberalised the price system, and eroded the power of the central government to set physical output targets for individual enterprises. Hungary embarked on more comprehensive market reforms in 1988.

Enterprises

Size of the private sector

The private sector share of GDP was estimated at the end of 1993 at more than 50 per cent. The private sector (excluding cooperatives) accounted at the end of 1993 for 42 per cent of total employment.

Large-scale privatisation

Large-scale privatisation has been gradual but steady. Out of almost 2,000 companies owned by the State Property Agency when it started operations in 1990, 569 are now (mid-1994) fully privately owned while state ownership in 167 has been reduced to a minority share. Another more than 400 of the initial 2,000 companies have been liquidated.

Small-scale privatisation

Out of 10,423 shops in state ownership in 1990, 9,065 have been transferred into private hands.

Property restitution

About 1.2 million Hungarians have been granted "compensation coupons" as restitution for property expropriated during the communist period. The coupons carry a total nominal value of Ft 300 billion and may be used to settle purchases for a number of items, including shares in state-owned companies and flats. The coupons are also traded at the Budapest Stock Exchange.

Growth of private enterprise

At end-1993, there were 773,600 registered businesses of which 85,600 were legal entities (joint-stock companies, etc.); the remainder were individuals conducting business activities.

Enterprise restructuring

The main restructuring tool has been subsidy reduction and a market-orientation of credit policies which has tightened access for loss-making enterprises to financing, resulting in production cutbacks, rationalisation, a scale-down of employment in large formerly or presently state-owned enterprises, and sales of enterprise assets to the private sector.

A much tighter bankruptcy regime from 1992 has also contributed to this process. Hungary's Law on Bankruptcy was enacted in October 1991 but was substantially amended in September 1993. In the new version of the law, companies with overdue liabilities are no longer forced to declare themselves bankrupt and a qualified majority of creditors may decide on an out-of-court restructuring against the will of minority shareholders. The earlier version had been criticised for forcing potentially profitable companies into liquidation. The results of the revision are evident in the following figures: the first quarter of 1994 saw the initiation of 182 new bankruptcy cases and the completion of 45 liquidations, down from 621 new bankruptcies and 181 completed liquidations in the first quarter of 1993.

The Law on the Prohibition of Unfair Market Practices was passed in 1990. It provided the legal framework for a newly established anti-monopoly office but has not in practice been used to break up large companies with a high degree of market power.

Kazakhstan

The reform process started in 1987 as part of perestroika. A package of partial reform policies had been introduced since independence in December 1988, but a more comprehensive reform programme was implemented in January 1993.

Size of the private sector

The private sector probably accounts for more than 20 per cent of GDP.

Large-scale privatisation

The National Privatisation Programme for 1993-95 launched the mass privatisation of medium-sized and large enterprises through auction-sale of shares to private investment funds. Kazakh citizens have received points-denominated vouchers from the state and have placed the vouchers under the administration of the investment funds. The first investment funds were created in July 1993; this was followed by the distribution of vouchers to citizens during the second half of last year. Since then two major waves of auctions have taken place but the government's goal of privatising 30 per cent of the assets of non-agricultural medium and large-scale enterprises has not yet been met. The privatisation of the largest enterprises started in July 1993 with the first successful tender and proceeds on a case-by-case basis.

Small-scale privatisation

Kazakhstan was the first former Soviet republic to introduce a law on privatisation (June 1991, amended April 1993). The aforementioned National Privatisation Programme includes a small-scale component: by mid-1994 about 10,000 small, service-sector entities - one-fifth of all such entities - had been privatised. The government aims to privatise in the near future all enterprises in wholesale, retail trade, storage and distribution.

Property restitution

There has been no property restitution to date in Kazakhstan.

Growth of private enterprise

At the beginning of April 1994, more than 11,000 private businesses (excluding farms), about 2,000 cooperatives, 1,400 joint ventures and 17,000 private farms were registered. Private farms and plots account for 35-70 per cent of the major agricultural outputs.

Enterprise restructuring

Restructuring has largely been left to the new owners following privatisation. A new anti-monopoly law was introduced in June 1994.

Markets and trade

Commodity price liberalisation

More than 90 per cent of prices, weighted by their share in the consumer price index, are free of administrative controls.

Trade liberalisation

Trade liberalisation has been phased in gradually. In 1989, licensing requirements and quotas were eliminated for 40 per cent of imports (weighted by the share of different goods-categories in 1988-imports). This ratio was raised to 65 per cent in 1990 and 90 per cent in 1991. By now there are very few remaining licensing/quota restrictions on imports and exports. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The forint is convertible for current account transactions other than tourism. Each Hungarian citizen is currently able to buy US\$ 800 worth of foreign currency a year at the official exchange rate for the purpose of tourism abroad. The limit was increased from US\$ 350 on 1 April 1994. Capital account transactions are gradually being liberalised.

The exchange rate is pegged to a basket of currencies. The basket was changed in May 1994 from 50 per cent US dollar and 50 per cent Deutschmark to 30 per cent US dollar and 70 per cent ECU.

The Law on Investment by Foreigners in Hungary (1988) guarantees the foreign investor the option of repatriating profits and capital in the currency of the original investment and full and immediate indemnification for any loss resulting from nationalisation or expropriation.

Wage liberalisation

Wages are now freely determined at the level of the firm in the competitive sector. Attempts to control wages by taxing wage increases above a defined limit were abolished in 1993.

Interest rate liberalisation

The government removed administrative control of interest rates on enterprise deposits and loans in 1987 and for household deposits and loans in 1991-92.

Commodity price liberalisation

In January 1992, most prices were freed. By June 1994, only prices for transportation and communication services, bread and bakery products, baby foods, some energy products and imported medicines remained subject to control.

Trade liberalisation

Though the foreign trade system was streamlined in 1994, state-owned trading continues to be prominent and taxation of imports and exports (at mostly low rates) remains somewhat discretionary. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

A new national currency, the tenge, was introduced on 12 November 1993. The tenge is convertible for the purpose of foreign trade undertaken by enterprises. There is a 50 per cent surrender requirement for export proceeds.

Wage liberalisation

The Law on Employment of the Population (1991) gives the government discretion on nominal wages and minimum wage adjustment.

Interest rate liberalisation

Lending interest rates remain centrally controlled and real interest rates were strongly negative in 1993.

Financial institutions

Banking reform

A two-tier banking system was introduced in 1986. The law on commercial banks, which became operative in January 1992, imposes the Basle-defined standard for capital adequacy on Hungarian banks, although temporary exemptions have been granted to the large state-owned banks.

The government launched in autumn 1992 a "consolidation scheme" covering banks that were partly state-owned and had a capital adequacy ratio below 7.25 per cent. In the first round of the scheme (effected in March 1993), banks exchanged non-performing loans for 20-year state bonds carrying a face value equivalent to 2.9 per cent of 1993-GDP. In the second round (December 1993), a state-financed capital injection of 20-year bonds worth nominally the equivalent of 3.4 per cent of 1993-GDP was combined with the purchase by the state of bank claims for state bonds worth 1.7 per cent of 1993-GDP to bring capital adequacy to zero in the large state-owned banks. Another injection of about HUF 30 billion in May 1994 (0.8 per cent of 1994-GDP) aimed to raise the ratio to 4 per cent.

The best-capitalised former state-owned bank, the Foreign Trade Bank, was privatised earlier this year. The law on commercial banks requires a reduction in state ownership in all banks, except the National Savings Bank, to less than 25 per cent by end-1997. There is a substantial presence on the Hungarian banking scene of smaller private banks, many with foreign participation.

Securities markets

In June 1990, the Budapest Stock Exchange was opened as a formalised stock market. From a low of 700 in mid-1993, the BSE-index moved up strongly in the second half to reach 1,257 by end-1993, and stood at 1,692 on 6 September 1994. Stock turnover remains dwarfed by the volume of trade in treasury bills.

Banking reform

A two-tier banking system was introduced in 1987. The main laws on banks and the operations of the banking system were adopted on 13 April 1993 and 22 June 1993. The banking system consists of the National Bank and about 200 commercial banks, while another 30 licensed banks deal with hard currency. Despite the large number of new commercial banks, financial resources have continued to be channelled mainly through four specialised state banks, which together hold 80 per cent of the assets in the country's banking system.

Securities markets

The Law on the Circulation of Securities and the Stock Exchange was adopted on 11 June 1991, and amended on 7 April 1993, but there is not yet a functioning stock exchange.

Role of the state

Taxation

The most radical measures were taken in 1988-89 when the government introduced both a value added tax and a personal income tax while streamlining taxation of enterprise income. Among the results was a drop in consumption taxes and direct taxation of enterprise income, largely offset by steep increases in taxation of personal income and rising social security contributions. However, the tax code remained plagued by distortions, including sector/activity-based tax reliefs, special preferences for foreign investors and diverging taxation of, respectively, wage and non-wage income for individuals.

Reforms of the tax system in the past few years have focused on removal of sector/activity-based tax reliefs. Tax conditions for foreign investors are described in more detail in Table 9.3.

At present, personal incomes are taxed progressively at rates up to 45 per cent and corporate income at 36 per cent. On a wage of Ft 100, employers and employees pay, respectively, Ft 52.5 and Ft 9 in payroll taxes. A large part of these are social security contributions. The new government is planning to raise the lower VAT-rate from 10 per cent to 12 per cent from 1 October (the standard rate is 25 per cent) and to move a number of services to the 25 per cent tier.

Social security

Social security reform is at a relatively early stage. An increase in the retirement age (which is now 55 for women and 60 for men) has been contemplated but not implemented. The population is currently shrinking and ageing and the cost of the pension system is expected to grow substantially over the next two decades in the absence of change in eligibility criteria. Eligibility for unemployment benefits has been tightened substantially over the past two years.

Taxation

Value added is taxed at a rate of 20 per cent; profits at 25 per cent (recently reduced from 30 per cent) with a special 45 per cent rate for banking and insurance; and personal incomes at 12-40 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3. Social security payments include an employment fund levy of 1 per cent of wages and a pension fund contribution of 37 per cent of the wage sum.

Introductory remarks

Limited reforms, granting a greater degree of financial autonomy to enterprises, were implemented in 1987 as part of perestroika. Following independence in December 1991 a more comprehensive reform programme was initiated in July 1992.

Enterprises

Size of the private sector

The private sector probably accounts for about 30 per cent of GDP.

Large-scale privatisation

The predominant method of privatisation has been to transform state-owned enterprises into joint-stock companies and transfer share ownership to the work collectives, with the state usually retaining significant portions of shares. No voucher auctions have taken place and competitive bidding has been used for only 1.4 per cent of total privatised assets. In industry, 99 per cent of privatised assets have been transferred through conversion to joint-stock companies.

At the end of 1993, the government significantly accelerated the pace of privatisation. By January 1994, about 4,450 state-owned enterprises (accounting for 33 per cent of total fixed enterprise assets) were privatised. In January 1994 the government passed a new Concept Note on Privatisation which provides for privatisation of all small-scale enterprises (with up to 100 employees) through auctions and/or competitive bidding with use of cash and vouchers. Medium (100 to 1,000 employees) and large-scale enterprises (over 1,000 employees) will be transformed into joint-stock companies as a first stage before privatisation. The main methods for future privatisation of those enterprises will be competitive cash bidding (by individual investors for up to 70 per cent of the equity) and voucher auctions (open to individuals and investment funds for 25 per cent of the equity), while 5 per cent of the equity would be reserved for the labour collectives.

Small-scale privatisation

Privatisation of small trade outlets, retail and service establishments is largely complete, comprising 80 per cent of fixed assets in these units.

Property restitution

Kyrgyzstan has no restitution programme.

Growth of private enterprise

While the formation of new private enterprises is accelerating, the process is impeded by unfavourable entry rules, lack of finance, a high tax burden, lack of access to commercial space, and low mobility of the labour force (artificially restricted by a system of residence permits).

Enterprise restructuring

The state-owned enterprise sector is characterised by weak financial discipline. The transformation of such enterprises into joint-stock companies has done little to enhance corporate governance. In May 1994 a presidential decree established the Enterprise Reform and Resolution Agency (ERRA) for a period of four years to oversee restructuring of 29 large, loss-making, state-owned enterprises.

The Insolvency Law, adopted on 15 December 1993, was followed by a number of decrees aiming to impose financial discipline on state-owned enterprises, improve corporate governance, and restructure or liquidate large, loss-making enterprises.

The Anti-monopoly Law of January 1994 defines "monopoly producers" as those with a domestic market share of at least 35 per cent. On 17 December 1993 the maximum profit margins for monopoly producers were eliminated. The number of firms classified as monopolists was reduced to 50 in September 1993, further to 15 in February 1994, and to nine on 16 May 1994 (five of which are classified as natural monopolies). The process of determining which firms constitute monopolies will be further examined with a view to limiting state regulation only to natural monopolies such as electricity, water and railways.

Latvia

Economic reforms were first introduced in 1987 as part of perestroika. After Latvia regained independence in 1991, price liberalisation accelerated and a comprehensive reform package centering on macrostabilisation was adopted in mid-1992.

Size of the private sector

The official estimate of the private sector's share of GNP in 1994 is 55 per cent. The non-state sector's share in industrial output was estimated at 30 per cent in 1993. State sector employment dropped to 50 per cent of total employment in 1993. Much private activity is small-scale and concentrated in trade, services, banking and selected export industries.

Large-scale privatisation

Large-scale privatisation is lagging behind other areas of reform; only 85 enterprises were privatised by April 1994, out of a total of 698 to be privatised. The legal framework is still incomplete, but the privatisation law of February 1994 streamlines the process of privatisation by creating an independent Privatisation Agency and State Property Fund. Methods will include tenders, auctions and liquidation. Privatisation vouchers are to be used for up to 25 per cent of capital but implementing legislation is incomplete. Following the Czech model, investment privatisation funds are to be set up. The government is committed to privatise 75 per cent of state property by end-1996.

Small-scale privatisation

Privatisation, mostly via auction of 4,000 municipally owned small enterprises, is advanced, with two-thirds of enterprises transferred by April 1994 (trade and services). The legal framework for privatisation of housing is almost complete; priority is given to tenants. Payment is in the form of privatisation vouchers or cash. Legislation regarding ownership rights over real estate and land is inconsistent. The Law on Lease and Purchase after Lease of February 1993 stipulates that land and real estate can be privatised only through leases up to 99 years; full ownership rights are only available via restitution.

Property restitution

There are over 300,000 restitution claims on land (including urban), of which 70,000 have been processed. Following the Law on Land Reform in Country Districts (1990), a first phase of land restitution and/or privatisation established user rights (over half of total land transferred); a second phase, to establish ownership rights, is proceeding more slowly with inconsistent legislation.

Growth of private enterprise

Between 1991 and early 1994, 20,000 new private enterprises were created. There are no serious administrative obstacles to entry but the absence of legislation covering secured transactions (collateral law) is acting as an impediment. There is unrecorded growth and informal sector activity, in particular in trade and services.

Enterprise restructuring

Outright credit and budgetary subsidies to enterprises have been eliminated, and have contributed to the highest unemployment rate in the former Soviet Union (over 6 per cent). However, while a Bankruptcy Law was passed in 1991 it is considered inadequate, since it does not set out criteria for initiating bankruptcy proceedings, nor does it provide mechanisms for the rehabilitation of enterprises. Similarly, court-ordered liquidation has occurred in only few cases. The Anti-Monopoly Law of December 1991 provided the basis for establishment of a Price and Tariff Council, with representatives from enterprises and consumers. The Council oversees price determination of monopolies (with limited enforcement powers) and can recommend the break-up of large enterprises.

Markets and trade

Commodity price liberalisation

There are few direct controls on prices. Significant adjustments were made to administered prices for bread, rents and other items during 1993. The maximum retail margins imposed on all goods after the introduction of the som (the national currency) were lifted on imported goods in August 1993 and on most domestically produced goods in November 1993. In March 1994, all retail margins were eliminated except for that on bread.

Trade liberalisation

After a first wave of reforms, when restrictions on imports, quotas for exports and foreign exchange surrender requirements were abolished, some momentum was lost in 1993. The government moved to reintroduce compulsory state orders, export licences and prohibitive export taxes. These measures, together with continued dominance of two ministries (of Industry, Trade and Material Resources and of Agriculture) in trade and distribution, created a system whereby about 70 per cent of output became subject to direct and indirect state control. In external trade, the state's direct involvement has been mainly through clearing agreements which allow goods to be exchanged between republics on a barter basis.

In early 1994, the trade system was substantially liberalised. Remaining import and export licensing agreements were lifted, and export taxes reduced. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The national currency, the som, was introduced in May 1993 and allowed to float (with some state intervention). The som is in principle convertible for transactions related to foreign trade of the enterprise sector.

Wage liberalisation

Increases in the budgetary wage bill are to be limited to targeted future inflation rates. For state-owned enterprises the total wage bill that is deductible for tax purposes in any enterprise cannot exceed 10 times the number of employees multiplied by the minimum wage.

Interest rate liberalisation

Deposit interest rates - freely set by banks - are substantially positive in real terms. In October 1993, the re-finance credit auctions were suspended, but they were resumed in April 1994.

Commodity price liberalisation

Price liberalisation began in early 1991, and was virtually completed by late 1992. No formal price controls remain. Rents and public transport and heating prices are set by municipalities, often with inadequate allowance for capital costs.

Trade liberalisation

Trade has been largely freed of quantitative restrictions. However, after tariff reform in March 1994, the basic import tariff rate is relatively high at 15 per cent; agricultural products enjoy an even higher degree of protection as the system has proved vulnerable to lobbying. Some export duties remain, e.g. on certain raw materials. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The lat is informally pegged to the SDR via central bank intervention in foreign exchange markets. Base money is fully backed by net international reserves. Latvia offers complete and effective current and capital account convertibility with no repatriation or surrender requirements.

Wage liberalisation

Wages are set freely by enterprise managers, with union influence remaining modest. The existing minimum wage legislation is without material impact on wage setting in the private sector.

Interest rate liberalisation

Banks have been free to set interest rates since 1992. The spread between lending and deposit rates remains very high at 25-35 per cent. Central bank open-market intervention to influence interest rates is largely ineffective because of the high liquidity of the banking system.

Financial institutions

Banking reform

A two-tier banking system was adopted in 1987. The banking system is dominated by three large state-owned banks: Agroprom, Promstroibank and Kyrgyzstan Bank, together accounting for about 85 per cent of total assets of the banking sector. Fifteen new commercial banks have been established by (and are almost exclusively owned by) state-owned enterprises and ministries. Little progress has been made towards improving the quality of banking services, especially in domestic and international payments. Prudential regulations regarding capital adequacy, exposure limits and lending to shareholders have been enacted, but are not being enforced. The National Bank's supervisory capacity is limited.

Securities markets

The Law on Securities and Stock Exchanges was passed in December 1991. A stock exchange is to be established before the end of 1994.

Banking reform

The Central Banking law of May 1992 established a two-tier banking system. Ownership of 49 commercial branches of the former Monobank passed to a Privatisation Fund; 21 were merged into Universal Bank in 1993, the rest liquidated or sold off to private commercial banks. The rehabilitation of Universal Bank and the State Savings Bank are under way (bad loans replaced with treasury bonds) with privatisation planned for early and late 1995 respectively. There is a buoyant private banking sector (over 50 institutions), with structural weaknesses, including large amounts of non-performing loans, undercapitalisation, high loan concentration and insider lending. Bank supervision, both on and off-site, is strengthening, but much remains to be done; several bank licences have been withdrawn and further closures are expected. Regulations are mostly in place. One foreign bank has set up office in Riga.

Securities markets

Treasury bill auctions were introduced in December 1993; a secondary market window has recently been established by the central bank to strengthen money-market operations. No stock exchanges are operating yet. Eleven commodity exchanges are operating, some of which are expected to be amalgamated.

Role of the state

Taxation

The basic rate of profit tax is 35 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3. Other taxes are as follows: a value added tax at 20 per cent; a sales tax at 5 per cent (since August 1993); and a personal income tax with marginal rates of up to 40 per cent.

Taxation

A tax package was introduced in November 1993, and has adjusted Latvia's tax structure to market economy standards. However, the corporate income tax schedule continues to differentiate between income sources, with rates varying from 25 per cent up to 45 per cent (with 35 per cent being the standard rate). The top rate of the progressive personal income tax schedule is 35 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3. The standard VAT rate was raised to 18 per cent and has become a key revenue source (29 per cent of central government revenue in the first quarter 1994). Budget and tax administrations were successfully tightened in 1993.

Social security

There is a social security payroll tax of 37 per cent paid by employers, and 1 per cent paid by employees. Latvia maintains a pay-as-you-go pension and unemployment benefits system, financed out of payroll taxes. The system is under strain, primarily since the ratio of pensioners to employed population is 53 per cent. There are plans for pension reform, including introduction of a private funded tier.

Lithuania

Introductory remarks

Economic reforms were first introduced in 1987 as part of perestroika. Since the country regained independence in 1991, reforms accelerated and a broad programme to achieve macroeconomic stability and structural reform was launched in mid-1992.

Enterprises

Size of the private sector

Estimates of private sector value added are highly unreliable, but it is likely to approach 50 per cent of GDP due to progress in privatisation and the presence of a dynamic, partly unrecorded private sector in trade, finance and other services. The share of the state sector in total employment dropped from 80 per cent in 1990 to 47 per cent in 1993. Individual private farmers, partnerships and households held 80 per cent of agricultural land at end-1993.

Large-scale privatisation

Privatisation is based on the Law on Initial Privatisation of State Property of late 1991, amended during 1993. Originally only voucher privatisation had been envisaged, but some cash auction sales have also taken place. Previous preferences for employees and management (up to 50 per cent of shares reserved) are being eliminated. By the end of 1993, 1,915 state-owned enterprises had been privatised (420 million litai asset value), out of 2,203 in the privatisation programme (524 million litai) and a total of some 5,500 state-owned enterprises.

Small-scale privatisation

Small-scale privatisation is based on the same law as large-scale privatisation. Progress on the sale of small units has been substantial. By December 1993, privatisation of housing had been completed, 80 per cent of farmland was under non-state ownership, and 2,318 of 2,660 eligible small enterprises had been privatised (9.4 million out of 12.4 million litai in asset value). However, there has been no privatisation yet of non-agricultural land.

The Constitution provides for the private ownership of land, but implementing legislation is lacking. Joint ventures and firms with foreign capital may only lease land and buildings necessary to carry out business. Leases are for up to 99 years. These restrictions may be eased shortly.

Property restitution

The deadline for applications by former land-owners was March 1994. So far, there have been 86,000

restitutions out of a total of 500,000 applications, and full resolution is likely to take many years. There is continuing ownership uncertainty because of complex procedures (which are now undergoing revision).

Growth of private enterprise

Various legal barriers to entry and restrictive licensing requirements for production and distribution have been progressively removed. At this stage, the often prohibitive real interest rates on or unavailability of medium- to long-term credit is probably the key obstacle to broad-based small enterprise growth, with property uncertainty also playing an important role.

Enterprise restructuring

Direct subsidies to enterprises have been discontinued (except for agriculture, energy and housing), but there has been little progress on restructuring in spite of broad privatisation. An indication of this is the low rate of unemployment (less than 2 per cent). Many firms are effectively worker-controlled because of privileged treatment during voucher privatisation (now being amended), hindering rationalisation and labour-shedding. Inter-enterprise arrears have stabilised in nominal terms and declined by half to 5.8 per cent as a share of GDP during 1993. A Bankruptcy Law was passed in September 1992, but it is cumbersome and ambiguous; implementing regulations and institutional arrangements for enforcement are still not in place. By end-1993, three enterprises had been liquidated, two reorganised, and eight were under bankruptcy proceedings. Some action has been taken to split up conglomerates, but there is no consistent policy. The newly created Ministry of Industry and Trade is to address enterprise reform and industrial policy. An Agency for Prices and Competition has been established, with the ability to negotiate margins with enterprises whose market share exceeds 40 per cent, but no effective power to break up monopoly enterprises. Profit margins of many distribution networks continue to be very high.

Moldova

First elements of market-oriented reform were introduced with perestroika in 1987. Parliamentary discussions in 1990 and detailed planning after the disintegration of the former Soviet Union in 1991 led to a reform programme in early 1992, the legal components of which included a Property Law, a Privatisation Law, and a law of Agrarian Reform and Land Code. In March 1993 parliament adopted the "Action Plan for the Stabilisation and Recovery of the Economy" and the Privatisation Plan. September 1993 saw the start of an IMF-supported stabilisation programme.

Size of the private sector

The private sector is thought to account for 10-25 per cent of GDP, including an allowance for informal sector activity.

Large-scale privatisation

The March 1993 Privatisation Plan envisages the privatisation within two years of about 1,600 enterprises, mostly through distribution of ownership vouchers to the whole population. According to government estimates, these 1,600 enterprises account for 40-45 per cent of the assets of the state. The programme also includes privatisation of 124 medium-sized and large-scale enterprises under control of the Ministry of Privatisation and State Property. Agricultural privatisation is under way (but not subject to the voucher scheme) with the transfer of shares of some state and collective farms to present and former farm employees. At least 10 per cent of state holdings in agriculture were transferred to private owners in 1992 and further sales took place in 1993. The intention is to privatise nearly two-thirds of farm assets. As part of the privatisation programme, agro-processing enterprises will be converted into joint-stock companies with 50 per cent share distribution to suppliers, 20 per cent to employees and 30 per cent to the Ministry of Privatisation. Some state corporations have been designated to remain in state ownership, including some utilities, scientific institutes, and large-scale food processing companies.

Small-scale privatisation

The sale to private entities of small-scale units began in September 1993 with the first, relatively modest, auctions under the privatisation

programme. Around 900 small-scale enterprises are to be auctioned as soon as possible. More than two-thirds of housing is already in private hands, and privatisation of the remaining 350,000 dwellings is under way. Some small-scale land ownership was already permitted before independence.

Property restitution

No property restitution for pre-communism owners has taken place.

Growth of private enterprise

About 23,000 private enterprises have been registered since independence. About half are active, most of which are in small trading and services. In December 1993 there were 256 registered joint ventures, of which 104 were said to be operational.

Enterprise restructuring

A presidential decree in December 1991, consolidated in the Law on Joint-stock Companies (1992), is designed to free enterprises from direct state control over commercial decisions, leaving the ownership function with the State Property Fund. Further legislation in September 1993 places day-to-day control of enterprises (except those exempted, classified as "state corporations") with a governing council of workers and branch ministry representatives. Implementation has been patchy: only 300 enterprises have so far been incorporated and there have been mixed results from management reforms.

A Bankruptcy Law was adopted in 1992 but was hardly used during 1993.

Markets and trade

Commodity price liberalisation

Prices of food, consumer and industrial goods were fully liberalised during 1991-92. Restrictions remain on energy and housing, and in general the setting of transport and utilities prices does not yet reflect capital replacement costs.

Trade liberalisation

Foreign trade has been largely freed of non-tariff restrictions. While taxes have been imposed on certain exports, import tariffs are generally moderate. However, the government appears to be responsive to pressures from lobbies, in the agricultural sector in particular. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

Lithuania introduced a currency board system of monetary management in early 1994, with a peg to the US dollar, thus displaying a very high degree of commitment to exchange rate stability. Convertibility of the litas on both current and capital account is virtually unrestricted. Most commercial banks are licensed to carry out international money transactions.

Wage liberalisation

Administrative wage guidelines for the state sector, in force until mid-1993, have been replaced by voluntary guidelines. A (low) minimum wage is enforced. There is little union activity.

Interest rate liberalisation

There are no restrictions on interest rate setting by commercial banks. However, real interest rates and spreads remain very high reflecting, *inter alia*, market segmentation and risk perceptions.

Commodity price liberalisation

In January 1992 most consumer goods prices were liberalised. The exceptions were prices of bread and dairy products, some transport prices, and utility charges. Initially indirect price control remained through heavy producer regulation and strict retail margin controls, but 1993 saw some liberalisation and an increase in milk prices to 75 per cent of production costs.

Trade liberalisation

The State Monopoly on foreign trade was abolished in 1992. In April 1993 the generalised export licensing system was replaced with a list of 155 categories, subsequently reduced to 77, mainly related to security, cultural goods and medical items. At the same time the licensing procedure was simplified. The import regime is fairly unrestricted though average tariff levels remain high by the standards of the transition economies. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

November 1993 saw the introduction of a new national currency, the leu. Before this, the national "coupons" had displaced the Russian rouble as the main means of payment. The exchange rate is now largely market determined with thrice-weekly currency auctions. The Transdnistr region introduced a separate currency in late August 1994.

January 1994 saw a new legal framework for regulation of foreign exchange transactions. Most payments and transfers for current transactions and some capital transfers are now free of controls. There has been a reduction in the surrender requirement: repatriation of export earnings is required, but only 35 per cent is compulsorily sold on the domestic interbank market.

Wage liberalisation

Before 1993, indicative wage levels were imposed by law. This practice has been replaced by wage floors.

Interest rate liberalisation

Since the introduction of the leu, Moldovan lending and deposit rates have been linked to the rate established at auctions for National Bank credit. On 12 May 1994 monthly interest rates were 15 per cent; well above the rate of inflation.

Financial institutions

Banking system

The Bank of Lithuania transferred its remaining commercial functions to the State Commercial Bank in early 1993. Twenty-two branches of the former monobank had been spun off previously and privatised. Twenty-seven commercial banks were in operation in mid-1994, including three with majority government ownership (holding 54 per cent of the non-consolidated assets of the banking system at end-1993). Plans for dealing with non-performing assets in remaining state banks and their privatisation have made little headway. In addition, unregulated non-bank enterprises are engaged in deposit-taking and lending, increasing the fragility of the financial system. There is no foreign ownership of banks as yet. The Commercial Banking Act of June 1992 introduced prudential regulation; it is in the process of being reformed in line with international standards. Central bank supervision capabilities are still weak, but an increasing resolve shows in various temporary suspensions.

Securities markets

A National Stock Exchange began operations in September 1993, but trading is limited (mostly privatisation vouchers). Turnover on the first day was US\$ 400. Seventy-three securities are registered, and 29 brokers. Money-market securities such as treasury bills are not yet in existence.

Banking reform

In mid-1991 a new national two-tier banking system was established. The direction of credit operations of the new central bank initially remained greatly influenced by the government and parliament. In 1993 the central bank's powers were enhanced.

Securities markets

In December 1993 a consortium of local banks and investment trusts announced the intention to establish a stock exchange. The Privatisation Law permits an open secondary market for fully privatised companies.

Role of the state

Taxation

A series of tax laws has been adopted since mid-1990, providing Lithuania with a tax structure broadly similar to market economies. The new VAT law, effective since 1 April 1994, establishes a basic rate of 18 per cent. Corporate income tax reform introduced a flat rate of 29 per cent but many exemptions severely erode the tax base. Tax conditions for foreign investors are described in more detail in Table 9.3. The personal income tax schedule is progressive up to a maximum marginal rate of 33 per cent. The tax administration is inadequate and has insufficient powers to cope with the new private sector; as a result, tax arrears are high and increasing, partly reflecting inter-enterprise arrears.

Social security

There is a social insurance payroll tax of 30 per cent assessed on the employer, and 1 per cent on the employee. Real levels of transfers to households have fallen sharply, but remain insufficiently targeted. Pension payments, on a pay-as-you-go basis, represented only 4 per cent of GDP in 1993; there are no serious reform plans yet.

Taxation

Major tax reforms in 1992 included the introduction of a VAT and restructuring of the personal income tax. In 1993, there was further reform with several new taxes including road tax, some import tariffs and an extension of the VAT base. A progressive enterprise profits tax (exporters and foreign joint ventures are exempted from the progressivity) was also introduced. Tax conditions for foreign investors are described in more detail in Table 9.3.

Poland

Introductory remarks

The reform process began in 1981-82 with measures aimed at reducing economic administration, increasing enterprise autonomy, and strengthening workers' self-management. Second stage reforms in 1987 reaffirmed the earlier measures and introduced wage-price controls. The 1989 Balcerowicz plan launched much more comprehensive market-oriented reforms.

Enterprises

Size of the private sector

The private sector accounted for more than an estimated 50 per cent of GDP and 46 per cent of total employment in 1993.

Large-scale privatisation

The 1990 Privatisation Law introduced a multi-track approach to privatisation. Enterprises can be liquidated and their assets sold, leased or transferred to a new private company; or can be commercialised and then privatised through share sales, restructuring (managed under contract), or inclusion in the recently authorised mass privatisation programme. At the end of 1993, 12 per cent of the 8,772 enterprises owned by central government agencies at the outset of reforms had been privatised. Under the National Investment Funds Law of 1993, 600 enterprises are targeted for the mass privatisation programme, which is expected to start operations at the end of 1994.

Small-scale privatisation

Most small retail, wholesale, and construction enterprises (approximately 20,000) were privatised by local governments early in the reform programme.

Property restitution

Legislation on property restitution for dispossessed owners is pending before parliament.

Growth of private enterprise

The number of private domestic companies increased by 14.2 per cent in 1993 to 66,457, whereas the number of private companies with

foreign capital participation increased by 49 per cent to 15,053. Obstacles to growth include an under-capitalised banking system (both state and private banks), an under-developed non-bank financial sector, and inadequate infrastructure.

Enterprise restructuring

The Law on the Financial Restructuring of Enterprises and Banks (1992) required the nine main state banks to set up special debt work-out departments and to enter into conciliation negotiations (outside of the courts) with those enterprises whose loans had been declared non-performing by the end of 1991. The agreements, for which the deadline was end-March 1994, can involve debt rescheduling, partial write-offs, and conversion of debt into equity. Loan-restructuring has been agreed between creditors and debtors for about 82 per cent (by value) of the loans that were slated for workouts, according to preliminary estimates.

The Bankruptcy Law (1934), as amended in 1990, provides for both liquidation and reorganisation of a private company under a court-appointed receiver. The State Enterprise Law (1981) provides for court-supervised liquidations of enterprises. At the end of 1993, 1,045 enterprises had entered into such proceedings, but only 191 cases had been concluded.

Romania

The most important reforms undertaken during the year after the revolution in December 1989 were radical price liberalisation in November 1990, and the devolution of decision-making power to enterprises. Gradual further reform steps, including small-scale privatisation, import liberalisation, subsidy reduction and improvements in tax management followed in 1991-92. Since mid-1993, a serious effort has been made to tighten the budget constraint facing enterprises and to improve efficiency in the allocation of credit and foreign exchange.

Size of the private sector

The private sector share of GDP was estimated by the end of 1993 at more than 31 per cent, up from 16 per cent in 1990 (government estimates). Private sector employment at end 1993 accounted for about 42 per cent of total employment.

Large-scale privatisation

For larger companies, the National Agency for Privatisation has designed a scheme involving the establishment of five "private ownership funds" and one "state ownership fund". The latter holds 70 per cent of the shares in 6,280 "commercial companies" while the rest are held in one of the "private" funds which are themselves joint-stock companies. During 1992, vouchers representing shares in the private ownership funds were distributed to all adult citizens. The management of these funds has been appointed by the government. About 270 small companies were privatised under this scheme in 1993 and another 250 during the first four months of 1994, mostly by management/employee buy-outs. The government intends to amend the voucher scheme before the end of the year. New vouchers are to be issued to the population; the new vouchers will carry a far greater nominal value than the old ones which will, nevertheless, continue to be usable for share purchases.

Under the Land Law of 1991, more than 90 per cent of farm-land has been distributed in small plots to farmers (up to 10 hectares per family), and the drawn-out process of providing formal titles to the new owners is almost complete.

Small-scale privatisation

More than 7,000 small-scale units have been put up for sale and about 3,000 have been privatised, involving 13,500 employees. These units include retail outlets, workshops and hotels.

Property restitution

A draft law granting limited restitution rights to former owners of around 250,000 residential properties confiscated after 1945 by the former communist regime was passed by the Romanian senate in June 1994, but must also be passed by the lower house of parliament before becoming law.

Growth of private enterprise

By March 1994, there were 2.4 million private farmers (although many were still waiting for the formal title to their land) and 334,000 other registered firms (up from 200,000 at end-1992). The average size of private units remains small and some new company registrations are used as a legal means of extending tax holidays for new companies.

Enterprise restructuring

The Romanian approach to enterprise restructuring has been gradual and sometimes erratic. The main restructuring tool has been subsidy reduction and attempts to introduce market-oriented credit policies. However, these efforts were interrupted on two occasions during 1991-93 by massive credit injections from the central bank aimed at "clearing" a rapidly growing stock of inter-enterprise arrears. A renewed effort at strengthening financial discipline in enterprises was initiated in the second half of 1993 and is still being pursued. Credit policies have been tightened, a restructuring agency has been established (with EC-PHARE support) and financial supervision has intensified for 25 enterprises that account for the bulk of inter-enterprise arrears.

Romania does not at present have a bankruptcy law or an anti-trust law. A draft bankruptcy law has for long been under debate in parliamentary commissions and an anti-trust law has recently been submitted to parliament.

Markets and trade

Commodity price liberalisation

Since 1992, all prices have been market determined except those for electricity, gas, central heating, hot water, basic medicines, rents in housing belonging to local authorities, television fees and spirits. In general, for those prices that remain centrally administered, the authorities aim at price adjustments that outpace inflation. Energy prices are adjusted periodically according to a schedule agreed with the World Bank.

Trade liberalisation

Most quantitative trade restrictions and export subsidies were eliminated in 1990. However, in particular sectors, such as the automobile sector, import barriers can be substantial, and Poland has undertaken several upward revisions to its import tariff structure after the sharp reductions in 1990. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

Restrictions on the availability of foreign exchange for current account transactions have been largely removed. Limits remain on individual travel allowances and the transfer abroad of resident-owned capital. The exchange rate follows a crawling peg to a basket of currencies; the pre-announced pace of adjustment in the rate *vis-à-vis* the basket is 1.5 per cent per month.

Wage liberalisation

For state enterprises, a tax is applied in the initial reform years to the excess of average wages over a predetermined norm, the so-called "Popiwek" tax. The excess wage tax expired in April 1994, but was re-introduced on 1 August 1994.

Interest rate liberalisation

Banks are free to set their own deposit and lending rates, which are typically positive in real terms.

Commodity price liberalisation

Having controlled virtually all prices for many years, Romania freed half of the prices in the consumer goods basket in November 1990. Price liberalisation picked up again in 1993 as consumer subsidies were phased out, mark-up limits were eliminated (in June) and the number of consumer goods under direct price control dropped to five.

Trade liberalisation

Most licensing requirements for export and import were eliminated in May 1992, leaving quantitative import restrictions only for a few products related to public health or security. There are no duties on exports, and the tariff treatment of imports is fairly liberal. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The leu is virtually fully convertible for the purpose of foreign trade transactions and for capital and profits of foreign investors. Residents may purchase up to US\$ 500 per year for tourism abroad.

In April 1994, the interbank foreign exchange rate was unified with the rate quoted by the so-called "bureaux" as the interbank market was freed of administrative intervention after a large gradual depreciation during the first quarter. The exchange rate of the leu is floating.

Wage liberalisation

Collective bargaining is well established. The government pursues an incomes policy by taxing "excessive" wage increases.

Interest rate liberalisation

During the first half of 1994 the combination of declining inflation rates and rising interest rates has brought what is arguably positive real interest rates on a large share of central bank refinancing. The banks are free to set their lending rates.

Financial institutions

Banking reform

In 1989, nine commercial banks were established from branch offices of the National Bank of Poland, following the creation of the PKO Savings Bank and other specialised lending institutions (including the Agricultural Bank) in 1987. The Banking Law (1989) and Act on the National Bank of Poland (1989), both as amended in 1992, provided the regulatory framework for banking operations. The Law on the Financial Restructuring of Enterprises and Banks (1993) provided for the recapitalisation of seven state-owned commercial banks, the agricultural bank and the main savings bank. This was done during 1993 by issuing to the banks state bonds worth PZL 21 trillion (1½ per cent of GDP). The aim was to bring banks into line with international bank capital adequacy standards. The two state banks less tainted by bad loans were privatised in 1993 and early 1994. Further recapitalisation of the Agricultural Bank is expected during the autumn of 1994.

Securities markets

The Warsaw Stock Exchange was reopened in 1991. The Act on Public Trading and Trust Funds (1991) provides a legal and regulatory framework for securities activities that is intended to conform with EU standards. The Securities Commission supervises the Stock Exchange and its members. At the end of 1993 there were 22 companies listed on the Exchange.

Banking reform

A two-tier banking system was created in December 1990 as the commercial functions of the National Bank of Romania (NBR) were spun off to the Romanian Commercial Bank (RCB), allowing the NBR to function as a central bank. There are now four state-owned banks. A number of private banks began operations in 1990 and more have been established in subsequent years. Five foreign banks have branches in Bucharest.

In 1991, the government bought from the banks 90 per cent of their non-performing claims and then cancelled the loans, the total nominal value of which was 7.5 per cent of 1991-GDP. The banks' balance sheets are now much better than in 1990 due to this recapitalisation, reinforced by another injection of state capital in 1992 (through which three state-owned banks received the equivalent of 0.8 per cent of GDP), highly negative real interest rates, and large spreads between lending and deposit rates during much of 1991-93.

Securities markets

The National Bank of Romania issued the first treasury bills in more than 50 years at the end of March 1994. The bills were of three months maturity and carried a monthly yield of slightly more than the April inflation rate of 6 per cent.

Role of the state

Taxation

There has been a substantial overhaul of the tax system. An enterprise income tax with a uniform rate of 40 per cent was introduced in 1989 (this was still the rate in 1993); an unemployment insurance scheme (Labour Fund) financed by a 2 per cent payroll tax was initiated in 1990; a personal income tax was launched in 1992 with a top marginal rate of 40 per cent; and a value added tax was introduced in 1993 with a standard rate of 22 per cent and a reduced rate of 7 per cent. In 1993, the payroll tax for the Labour Fund was increased to 3 per cent, while the top marginal income tax rate was raised to 45 per cent in 1994. Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

The payroll tax to finance the Social Insurance Fund was increased in two steps to 45 per cent in 1992 from 38 per cent in 1989. A revision of the system through which pensions are indexed to wage increases has been considered by the government but a decision on this has been put off until 1995.

Taxation

Substantial tax reforms have been implemented. In 1990, revenues dropped by the equivalent of 10 per cent of GDP as profit transfers to the government were replaced by a less onerous profit tax. The 1990 reforms also introduced an "individual wage tax" to replace the old system's "wage fund tax" which was levied on the total enterprise wage bill. On 1 July 1993, the turnover tax was replaced by a VAT.

Previously large state subsidies on food, electricity and transportation were eliminated during 1992-93. After rising sharply in the initial post-revolution years, total government outlays on subsidies and transfers dropped from 22 per cent of GDP in 1992 to 14 per cent in 1993. Capital expenditure was reduced from 18 per cent of GDP in 1989 to about 4 per cent in 1993.

At present, the enterprise profit tax is levied progressively at rates of 6-45 per cent, whereas personal income is taxed at rates from 5 per cent to 60 per cent. The value added tax is levied at a flat 18 per cent with basic consumer goods and exports exempted. The government has made proposals that will set the corporate tax rate at 38 per cent (25 per cent for agriculture) from January 1995, and has taken to parliament during the summer of 1994 a draft law which will index the profit tax base to inflation. Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

Employers contribute to Romania's social security system through a payroll tax amounting to 32.5 per cent of the wage sum; employees pay 1 per cent of the wage sum. Social security rates have risen substantially since 1991. In addition, all companies are subject to a 1.5 per cent tax on their turnover.

Russian Federation

Introductory remarks

Partial reforms were introduced in 1987 in the framework of perestroika. A comprehensive reform package was adopted in January 1992.

Enterprises

Size of the private sector

The private sector represents about 50 per cent of both GDP and employment.

Large-scale privatisation

About 15,000 medium- and large-scale enterprises employing more than 70 per cent of the industrial workforce had been privatised through the Russian mass privatisation programme by July 1994. Voucher privatisation was largely completed by then. A proposed framework for the second (post-voucher) phase of the privatisation programme has twice been rejected by parliament but was launched by presidential decree in late July 1994. In this phase, privatisation will focus on cash-based sales to strategic investors.

Land and buildings may also be privatised. Farm privatisation has made limited progress so far, with most large farms choosing to re-register under collective ownership. Sales of farm assets are expected to proceed slowly.

Small-scale privatisation

By mid-1994 more than 70 per cent of state-owned small-scale businesses in retail trade, public catering and consumer services (about one-third of the estimated total of 250,000 small enterprises) had been privatised. The number of private farms, however, had increased at a comparatively slow pace to 270,000, covering about 5 per cent of total agricultural land. Housing privatisation began in late 1992 and more than 30 per cent of units nationwide had been privatised by mid-1994.

Property restitution

No property restitution to former owners has taken place to date.

Growth of private enterprise

There are currently about 700,000 registered small businesses operating in Russia. By June 1994 the number of joint ventures and foreign companies amounted to 14,000, of which only about 4,000 were operational.

Enterprise restructuring

In response to sharp output falls, working hours have been reduced and real wages cut. Redundancies have been much less common. About 10 per cent of the privatised enterprises have changed management after the shift in ownership. Restructuring is impeded by the important role of enterprise-insiders in the privatisation process and the related lack of effective corporate governance. The pressure to restructure has also been weakened by a low degree of competition and slow progress in financial sector reform. The second privatisation phase is to include measures to speed up restructuring.

A Bankruptcy Law was adopted in November 1992 and became effective on 1 March 1993. Until March 1994, bankruptcy proceedings had been initiated against about 50 enterprises. None had been liquidated. By June 1994 an initial list of 1,150 insolvent enterprises, some of which are candidates for bankruptcy, had been drawn up. The first bankruptcies were declared in July 1994.

The primary body for the management of the bankruptcy process is the Federal Agency on Insolvency Affairs, created on 20 September 1993 at the State Committee on State Property Management.

The Law on Competition and Limitation of Monopolistic Activity in the Goods Market was adopted in March 1991. A state programme for the demonopolisation of the economy was approved by the government in December 1993, but pro-competition policies have remained ineffective so far. A register of dominant firms was established in 1992; at the outset it contained around 2,000 enterprises. Anti-trust activities have focused so far on *ex-ante* price, profitability controls over monopolies and controls on concentration of ownership during the privatisation process. Current plans to establish financial-industrial groupings (24 in 1994, increasing to about 150 over the next two to three years) threatens to cartelise further the Russian economy.

Markets and trade

Commodity price liberalisation

In early 1992 about 80 per cent of wholesale prices and 90 per cent of retail prices were freed of administrative controls. Only basic necessities and a restricted list of producer goods and services remained subject to price controls. In 1993, prices of petrol, coal, grain and bread were also de-controlled. There are, however, widespread direct and indirect price controls set by local authorities (on about 30 per cent of consumer prices). In addition, price and profitability ceilings apply to monopolies.

Trade liberalisation

Trade with CIS countries is still largely dominated by bilateral trade agreements. Virtually all quotas on imports from non-CIS countries were removed in 1992. Import subsidies were phased out in 1993. The export regime was liberalised in the first half of 1994 as the scope of the export quota and licensing system was reduced and export taxes were cut. However, restrictions remain particularly on raw material exports. A special "commodity passport" system has been introduced to rein in capital flight. The import tariff regime has become increasingly restrictive after the drastic liberalisation in 1992. The July 1994 revision of import tariffs raised average rates by about 50 per cent, with particularly strong increases in the consumer goods sector. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The exchange rate was unified in mid-1992 and the rouble has been floating since then. The rouble is convertible for most current account purposes, including profit repatriation for foreign investors. There is a 50 per cent export surrender requirement for foreign exchange. In January 1994 the use of foreign currencies for cash transactions within Russia was prohibited.

Wage liberalisation

"Excessive" wage increases are subject to punitive taxation. Minimum wages and pensions are indexed quarterly. A "General Agreement Between All-Russia Associations of Trade Unions, All-Russia Associations of Employers and the Government of Russia for 1994" contains general guidelines for wage-setting and social protection.

Interest rate liberalisation

Interest rates have been liberalised. Since July 1993 the refinancing rate has closely followed the benchmark interbank market rate. Real interest rates have been positive since October 1993.

Financial institutions

Banking reform

A two-tier banking system was created in 1987 as part of the perestroika reforms. Independent Russian laws on, respectively, the central bank and commercial banking activities were adopted in December 1991. New draft banking laws have been prepared by the parliament's budget committee. On 1 June there were 2,214 commercial banks, operating as universal banks.

Prudential regulations have been very liberal. However, the minimum capital requirement for new banks was raised in March 1994 to Rb 2 billion and will be raised gradually to reach ECU 5 million in 1999. Existing banks have to reach the capital level of Rb 2 billion only by January 1995.

Banking supervision remains weak and poorly enforced. The financial system includes banks that mainly channel directed credits to state enterprises and banks created by enterprises to act as their house banks. In 1992-93 about 20 small banks were shut down. A recently launched reform programme aims to create a core group of 30-40 banks that would be capable of complying with international prudential standards and which would in return become eligible for certain privileges.

Privatisation of banks is to proceed gradually in parallel with the privatisation of enterprises. Tight restrictions on the access of foreign banks to establish themselves in Russia were imposed in November 1993 but were eased in June 1994. Foreign banks' aggregate capital may not exceed 12 per cent of the total capital of the Russian banking system.

Securities markets

The first Russian stock exchanges opened in the summer of 1991, and there are currently close to 70 authorised stock exchanges. The securities market is still largely unregulated and segmented and has been dominated by trade in 3-6 months' T-bills, gold certificates and privatisation vouchers (trade in the latter ceased in mid-1994). The range of traded paper is widening; it includes shares in commercial banks and investment funds (of which there are currently about 650) and shares and bonds issued by a growing number of privatised companies, promissory notes, currency futures and hard currency-denominated certificates of deposits.

Outside the organised share market there is significant trading in shares over the counter. During the first half of 1994, portfolio investments by foreigners amounted to an estimated US\$ 1-2 billion. A presidential decree issued in October 1993 "On Measures to Ensure the Rights of Stockholders" and another issued in June 1994 "On the Protection of Investor Interests" represent significant steps towards the creation of elementary rules for the securities market, including registration, rights to issue securities and information disclosure.

Role of the state

Taxation

The main taxation reforms took place in late 1991 and during 1992, including the introduction of a value added tax (VAT) and excise taxes, the creation of the legal base for the tax system comprising a Law on the Basic Principles of Taxation (December 1991) and a series of individual tax laws. Since then tax legislation has been introduced in an ad hoc fashion. The overall tax burden is high, regulatory changes are frequent, while tax exemptions are widespread. Tax evasion is rampant.

Russia has a three-level taxation system consisting of federal, regional and local taxes. Revenue shares and expenditure assignments between the different levels of government are still not clearly defined.

The main tax rates were as follows in 1994: the enterprise profit tax was at 35-38 per cent, the VAT at 23 per cent and the progressive personal income tax at 12-40 per cent. In addition, excise taxes ranged from 0 per cent to 90 per cent and export taxes were an important source of income for the budget. Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

Russia's social security system is financed mainly through extra-budgetary funds and through expenditure undertaken by enterprises on social services. Social security contributions are set at 40 per cent of the wage sum.

Slovak Republic

Introductory remarks

After the Velvet Revolution in the Czech and Slovak Federal Republic (CSFR) in November 1989, market-oriented reform was initiated during 1990 and a comprehensive programme was adopted in January 1991. The CSFR broke up at the end of 1992 and the Slovak Republic became an independent country on 1 January 1993.

Enterprises

Size of the private sector

The private sector share of GDP was estimated at more than 50 per cent at the end of 1993, before the second wave of privatisation.

Large-scale privatisation

A comprehensive sell-off of state assets has been pursued through two "privatisation waves". The first of these was launched by the CSFR in May 1992 and was completed by mid-1993. It involved 750 enterprises with a book value of SKK 166 billion in the Slovak Republic. In this process, SKK 80 billion worth of shares in 503 firms in Slovakia were distributed through a voucher-based "mass privatisation" scheme which created 8.5 million shareholders in total in the Czech and Slovak Republics. The second wave in the Slovak Republic involves 514 enterprises with an estimated book value of SKK 220 billion. It was initiated in 1994 after delays pending an internal debate over the appropriate method of privatisation. Roughly one-third of the shares will be distributed through voucher-based distribution, expected to begin in autumn 1994.

Small-scale privatisation

The sale of small state-owned enterprises was launched in January 1991. It was largely completed during 1992 with approximately 10,000 enterprises auctioned off. The yield to the state was almost Kcs 13 billion.

Property restitution

A restitution law was adopted by the CSFR in October 1990. About 30,000 industrial and administrative buildings, forests and agricultural plots, which had been nationalised during 1948-55, as well as 70,000 commercial and residential entities nationalised during 1955-59, were handed back to the original owners.

The value of assets returned has been estimated at between 70 billion and 120 billion Kcs. A further law on restitution covering former church property was adopted in October 1993.

Growth of private enterprise

The number of incorporated private economic organisations (i.e. excluding self-employed) was 6,090 at end-1991 and 13,819 at end-1992.

Enterprise restructuring

The main restructuring tools have been indirect: privatisation and tight access to credit and subsidies for enterprises. Restructuring has essentially been left to the new private owners, although some restructuring may have taken place in the process of drawing up privatisation plans.

The initial Law on Bankruptcy was passed in August 1991 with virtually no possibility of external creditors forcing companies into bankruptcy. The current law became effective in June 1993, allowing creditors to bring bankruptcy cases to court after a three-month protective period. Until June 1994, courts could declare bankruptcy only if liabilities exceeded assets and the enterprise was not in the transportation or communications sector. Agricultural producers were exempt from bankruptcy until September 1994.

A competition law was passed in 1991 and amended in October 1993 to bring it close to consistency with EU legislation.

Slovenia

The first elements of "market socialism" were introduced in 1952. In 1976 a law on "associated labour" institutionalised "social ownership". In 1988 the so-called "Markovic-reforms" included widespread price, import and foreign exchange liberalisation. A comprehensive reform programme was adopted in 1990 after independence.

Size of the private sector

According to official estimates, the share of the private sector in total employment amounted to 9.5 per cent in 1993. Unofficial assessments put the share substantially higher.

Large-scale privatisation

Large-scale privatisation has been slow to materialise in Slovenia but is likely to become comprehensive by about the end of 1995. Privatisation of the more than 2,500 "socially owned" enterprises is guided by a law passed in December 1992. Enterprises with "socially owned capital" that fail to produce "acceptable" privatisation plans by the end of 1994 will become the responsibility of the Privatisation Agency. Subsequently all 2,500 companies are to be privatised.

For this purpose, a voucher-based mass-privatisation programme has been initiated. All citizens have received from the state "ownership certificates" with a value of 100,000-400,000 tolar, depending on the age of the recipient. Twenty per cent of the shares are reserved for employees. Another 40 per cent must be sold by way of employee purchases, public tender or auction (with strong incentives favouring employee buy-outs). The remaining 40 per cent are to be allocated without payment to three types of state-owned funds. Of these, half will be auctioned to "investment funds" which are to be created by the state but which will be owned exclusively by private individuals who will be offered participation (using their ownership certificates) in auctions for shares in these funds.

Small-scale privatisation

Almost all small-scale trade and service activity is operated by the private sector. Extensive small-scale private activity already existed under former Yugoslav law.

Property restitution

Under the Law on Denationalisation (1993), land and buildings can be returned to former owners.

Growth of private enterprise

The number of small businesses (with less than 50 employees) increased by 40 per cent during 1993; a total of 26,165 were registered at the end of 1993. The majority of private sector companies is concentrated in the services sector.

Enterprise restructuring

A lot has been done to break up large "socially managed" enterprises into smaller units. Slovenia's law on bankruptcy and liquidation was approved in 1989.

Markets and trade

Commodity price liberalisation

In January 1991, 85 per cent of consumer prices were decontrolled. Further liberalisation measures were undertaken during that year. The only remaining significant controls pertain to utility charges, rents and public services. In addition, mark-ups are closely regulated in the energy sector.

Trade liberalisation

Most quantitative controls on imports and exports were removed in January 1991. This was initially combined with a surcharge on consumer goods imports of 20 per cent, but the surcharge was lowered gradually to 10 per cent by January 1992 and later abolished. The average weighted tariff is extremely low at about 4.7 per cent. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

Current account convertibility for enterprises was introduced in January 1991. Some restrictions on capital remain. The exchange rate is pegged to a basket in which the Deutschmark has a weight of 60 per cent and the US dollar a weight of 40 per cent.

Wage liberalisation

Wage increases are regulated through a tax on "excessive increases". This was initially imposed during 1991 in the context of a macroeconomic stabilisation package with agreement from unions (the so-called "social contract"). The intention was to regulate the rise in real wages. The tax was reintroduced in the second half of 1992 for enterprises with majority state or municipal ownership, taxing wage increases above a measure which is linked to specific performance targets. The tax expired at the end of 1992.

Interest rate liberalisation

Interest rates were freed progressively from 1990 onwards, with complete liberalisation in April 1992.

Commodity price liberalisation

Price liberalisation is almost complete.

Trade liberalisation

The Law on Foreign Trade Transactions adopted in February 1993 simplified foreign trade transactions and abolished unnecessary permits and obstacles to foreign trade. Imports and exports of goods are generally free from quantitative restrictions and duties, except where, for developmental or protection reasons, the government decides to revert to quotas. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

The Law on Foreign Exchange Transactions and the Law on Foreign Credit Transactions were adopted in January 1991. The national currency, the tolar, was introduced in October 1991. The exchange rate is floating. Convertibility is full for current account purposes. Some restrictions on capital account convertibility remain but are to be phased out.

Wage liberalisation

The Labour Code of 1989 liberalised wages. In August 1990, the first general agreement between the Chamber of Economy of Slovenia and the old trade union set the minimum wage for each category of worker and introduced a collective bargaining system. Incomes policy laws have also been used (1991, 1993).

Interest rate liberalisation

Commercial banks are free to set their deposit and lending rates. Since the establishment of the national currency, the tolar, rates have been highly positive in real terms.

Financial institutions

Banking reform

A two-tiered banking system was adopted in January 1990. Laws on the central bank and commercial banks were passed in February 1992. The former of these grants the central bank supervisory powers. With the split of the CSFR, the Slovak National Bank was established in January 1993 as the Slovak successor to the former State Bank of Czechoslovakia. At the beginning of 1994, 28 commercial banks, including a number of foreign bank branches/representative offices, were operating in the Slovak Republic. All commercial banks, except the Slovak Savings Bank, are now in private hands.

The regulatory regime sets the required capital adequacy (following the Basle definition) at 6.25 per cent by the end of 1993 and 8 per cent by the end of 1996. During the CSFR-period, a state-owned Consolidation Bank was established in March 1991 to take over Kcs 110 billion (20 per cent of credits to enterprises) of "permanent revolving credits" (perpetual loans characterised by low interest rates and issued for inventory financing). Further state-financed recapitalisation of the banks totalling Kcs 50 billion was conducted in November 1991.

Securities markets

The Bratislava Stock Exchange, the RM-system (an over-the-counter exchange) and the Bratislava Options Exchange began operation during the first half of 1993. The Bratislava Stock Exchange opened in April 1993 with trading in shares and bonds. In March 1994, nine companies were listed. The RM-system provides individuals with direct access to the system for sales and purchases of shares in nearly 600 companies distributed under the voucher privatisation scheme. Foreigners are free to participate in the market for shares; profit repatriation is subject to payment of income taxes on capital gains. The monthly trading volume during February and March 1994 was around SKK 500 million.

Banking system

A national two-tiered banking system was introduced in 1991. The Bank of Slovenia became the central bank responsible for monetary policy, exchange rate management and the regulation of commercial banks. In order to reduce the dominance of the largest bank, Ljubljanska Banka (LB), the government has created separate banks out of some of LB's subsidiaries. Two Austrian banks are the only foreign banks to have opened subsidiaries in Slovenia with a full banking licence. In 1993, a state agency recapitalised two state-owned banks, swapping state-bonds for bad loans.

Securities markets

Securities markets are regulated by the Law on Securities (1989 and 1990), and the Law on Money Market and Capital Market. The Ljubljana Stock Exchange was founded in December 1989. A total of 34 securities are listed and 57 members are registered for trading on the Exchange. Government, municipal and enterprise bonds are traded. There are two trading sessions per week.

Role of the state

Taxation

Stop-gap tax reforms were introduced in 1990, involving simplification of turnover tax rates and lowering of corporate and individual tax rates. A comprehensive tax reform was implemented in January 1993, introducing a value added tax (VAT) in two tiers at 23 per cent and 5 per cent and streamlining corporate and individual income taxes. In July 1993, the VAT rates were raised to 25 per cent and 6 per cent.

Further revisions in January 1994 reduced the corporate tax rate from 45 per cent to 40 per cent, and the maximum personal income tax rate from 47 per cent to 42 per cent.

Social security

The 1993 reforms also transferred funding of social security from general taxation to an insurance based system.

Taxation

Following a comprehensive revamping of tax legislation in 1990-93, there are four main categories of taxation: a corporate profit tax (the present rate is 30 per cent, to be reduced to 25 per cent according to a draft legal amendment); a personal income tax (at marginal rates of up to 50 per cent); a sales tax (20 per cent); and contributions to social security (in 1993 employers and employees each contributed at a rate of 23.9 per cent of the wage sum). Dividends are taxed at a 25 per cent rate for residents and 15 per cent for non-residents. Tax conditions for foreign investors are described in more detail in Table 9.3.

Tajikistan

Introductory remarks

In 1987 limited reforms were introduced as part of perestroika. A comprehensive economic reform programme has not yet been adopted.

Enterprises

Size of the private sector

At least 10-20 per cent of GDP is generated in the private sector including informal sector activity.

Large-scale privatisation

The Law on De-statisation and Privatisation of Property was adopted in February 1991. Privatisation methods include lease (with or without option to buy), creation of joint-stock company, sale by instalment to work collectives and others, employee buy-out, and free transfer of state property. Privatisation started in 1991 but was stalled due to political instability. The 1991-92 privatisation programme, approved in October 1991, targeted the sale of 1,276 enterprises of all sizes and in different sectors of the economy.

By mid-1994, 152 of a total 1,304 medium-sized and large-scale enterprises had been privatised in the agriculture, trade, transport and construction sectors. The 1993-95 privatisation programme proposes to add 79 medium-sized and large-scale enterprises to the list.

Small-scale privatisation

About 600 small-scale enterprises (less than 50 employees) were privatised in the 1991-92 privatisation programme. By October 1993, more than 50 per cent of all dwellings had been privatised.

Property restitution

There has been no property restitution to pre-communism owners in Tajikistan.

Growth of private enterprise

Obstacles to the growth of the private sector include entry and exit rules, lack of finance, limited access to business information, labour regulations and an incomplete legal framework.

As of October 1993, 182 joint ventures and 12 fully foreign-owned companies were registered. About 40 of these companies were active.

Enterprise restructuring

Enterprises still operate under the system of state orders and state instructions to enterprise management. A clear strategy to improve the performance of state-owned enterprises is lacking.

Turkmenistan

The right to administer resources for investment was partially delegated to the enterprises during the perestroika period, especially in 1987. Since gaining independence in 1991, Turkmenistan has made some progress on price reform and has established a national currency. However, no comprehensive market-oriented reform package has been designed.

Size of the private sector

No official estimate for the private sector share of GDP is available but the share is likely to be around 15 per cent.

Large-scale privatisation

Privatisation remains largely at the planning stage. No significant effort has been made to privatise large-scale state-owned enterprises.

Small-scale privatisation

The government's policy is to initiate the privatisation process with the sale of small service units, but little has been achieved to date. In agriculture, a small share of the land has been leased to private individuals. Land ownership has been legalised. The maximum plot size that can be owned privately is 15 ha.

Property restitution

Turkmenistan has no programme of property restitution.

Growth of private enterprise

Spontaneous growth in the number of small-scale private enterprises has been substantial. In mid-1993, one-third of the 9,000 registered small-scale enterprises were in private hands. By March 1994, there were 10 fully foreign-owned companies and 109 joint ventures with more than 30 per cent foreign ownership.

Enterprise restructuring

Little effort has been made to initiate orderly restructuring of enterprises. The enterprises have been faced since the second half of 1993 with shortages of imported production materials due to a sudden drop in the country's gas-related hard currency revenues, but have been helped to keep employees on the payroll through the rapid extension of credits from the banking system.

The Law on Bankruptcy was passed in June 1992 but few companies have been forced into bankruptcy to date. There is no anti-trust law.

Markets and trade

Commodity price liberalisation

Limited price liberalisation was introduced in April 1991. In January 1992 the government lifted price controls on 80 per cent of goods. Further liberalisation of prices has reduced the number of goods and services under price controls to about 2 per cent of the total. Price controls apply mostly to the staple consumer goods - such as flour and milk.

Trade liberalisation

A command system, based on state orders, quotas, export licences and centralised trading, still dominates production and trade. Until October 1993, export licences were classified in 33 categories and were subject to 10 different rates of surrender requirement, ranging from 32 per cent to 100 per cent of export proceeds. In November 1993 a new decree unified different surrender requirements at 30 per cent of export proceeds for exports not traded by the general contractors. Customs duties range from 5 per cent to 100 per cent of the rouble value of imports, and lower rates if the imports are paid in foreign exchange at the rate set by the National Bank of Tajikistan. Information on trade agreements is contained in Table 8.3.

Currency convertibility and exchange rate regime

The Russian rouble remains the official currency. In September 1993, Tajikistan signed an agreement with the Russian Federation, which envisages the establishment of monetary union with Russia. This agreement was ratified in December 1993 by Tajikistan's parliament. The framework and operational arrangements for the joint monetary zone have not yet been finalised.

Wage liberalisation

Wages in the state-owned enterprises tend to be adjusted proportionately and at the same time.

Interest rate liberalisation

Interest rates have remained centrally controlled and negative in real terms.

Commodity price liberalisation

Prices for 19 consumer goods remain controlled and subsidised by the state, including bread, butter and vodka. Certain other items, including electricity and gas, are provided free to the population (with the subsidy showing up as absent revenues in the accounts of state-owned enterprises).

Trade liberalisation

Centralised state trading remains a prevalent influence on both foreign trade and production. Outside this system, licenses can be obtained for most imports and exports. However duties and tariffs can be very high. More detail on trade agreements and the trade regime is contained in Table 8.3.

Currency convertibility and exchange rate regime

In principle, Turkmenistan introduced full currency convertibility and a unified exchange rate for the purpose of trade transactions when the manat was introduced on 1 November 1993. The initial official exchange rate of 2 manat per US dollar was adjusted on 6 November to 1.98 manat per US dollar. In mid-March 1994 it was moved to 10 manat per US dollar, except regarding obligatory currency surrender for the gas companies for which the exchange rate remained 1.98. Meanwhile the government eliminated for non-state entities the previous 100 per cent surrender requirement and reduced it for state-owned enterprises to a less onerous 50 per cent. At that point the kerb exchange rate was about 60-70 manat per US dollar. On 2 May a new "commercial" rate of 60 manat per dollar was introduced for sales of hard currency to the central bank; however, the exchange rate for obligatory surrender stayed at 1.98 for the gas companies and 10 for other exporters. These rates remained the same in mid-July, at which point the black market rate had reached 100 manat per US dollar.

Wage liberalisation

A statutory minimum wage is set by the state. Wages throughout the state-owned sector tend to be adjusted in parallel.

Interest rate liberalisation

The commercial banks have some freedom to set interest rates, while rates in the Savings Bank are government-determined. Rates have in practice been highly negative in real terms.

Financial institutions

Banking reform

The Law on Banks and Banking Activities and the Law on the National Bank were adopted in February 1991. Amendments to these laws have been proposed but have not yet been adopted. As well as the National Bank there are 14 banks, a state insurance company and seven new cooperative insurance companies. Adequate data related to bank solvency are not available. The banking sector is dominated by large specialised banks - Agroprombank, Orienbank and Tajikbankbusiness - which account for over 96 per cent of bank lending.

Securities markets

A stock exchange has not yet been established.

Banking reform

Like other republics of the former Soviet Union, Turkmenistan established in the late 1980s a number of so-called "specialised banks" to handle commercial lending and deposit-taking previously undertaken by the State Bank. The State Bank was thereby left mainly with the task of being the link to the Soviet Gosbank. Upon the introduction of the manat, in November 1993, the State Bank became Turkmenistan's central bank.

Turkmenistan's banking sector now includes - besides the central bank - two sector banks, plus the National Savings Bank, the Foreign Trade Bank, and 20 commercial banks. The sector banks are owned by state enterprises that are also the main recipients of loans from these banks. Eight of the commercial banks are privately owned: three in the form of cooperatives and two in the form of joint-stock companies.

Securities markets

There is no securities market in Turkmenistan.

Role of the state

Taxation

A value added tax has since early 1992 been set at 20 per cent. The basic profit tax rates range from 30 to 45 per cent (in banking and insurance). Personal income is taxed at progressive rates with a maximum of 40 per cent for monthly income more than 43 times the minimum wage. Tax conditions for foreign investors are described in more detail in Table 9.3.

Taxation

The standard rate of profit taxation (introduced in 1991 to replace profit transfers to the budget) was reduced from 45 per cent to 35 per cent in January 1992 and further to 25 per cent a year later. Some sector-specific rates apply. Tax conditions for foreign investors are described in more detail in Table 9.3. The top marginal personal income tax rate was reduced from 40 per cent to 30 per cent in January 1993; the rate applying to most taxpayers was lowered from 12 per cent to 6 per cent. The VAT was reduced to 20 per cent in 1993 with preferential rates of 0-10 per cent for certain staple goods. In March 1994, the rate was reduced to 11 per cent for value added in state-owned enterprises and VAT was suspended for non-state-owned enterprises. There is a 50 per cent tax (reduced in March 1994 from 80 per cent) on sales of natural gas abroad for hard currency (the rate is 20 per cent for oil).

Price subsidies in 1992 accounted for about one-third of central and local government expenditure (with the latter, which excludes outlays from a number of extra-budgetary funds, totalling 31 per cent of GDP).

The secession from the Soviet Union led to a sudden interruption in transfers from the Union budget and an even more massive increase in tax revenues from the gas sector. Gas-related revenues dropped sharply in 1993 as Russia phased out the practice followed during 1992 of settling 15-20 per cent of gas deliveries from Turkmenistan in hard currency at world market prices.

Social security

A generous social security system is partly financed by payroll taxes, which are set at 37 per cent for enterprises.

Ukraine

Introductory remarks

The right to administer resources for investment was partially delegated to enterprises during the perestroika period, especially in 1987. Since then several reform programmes have been adopted only to be abandoned. A comprehensive reform package has never been implemented and the central authorities still have great control over the economy.

Enterprises

Size of the private sector

The private sector may account for up to 30 per cent of GDP if the contribution of the large informal sector is taken into account.

Large-scale privatisation

The Law on Privatisation of Assets of State Owned Enterprises was adopted in March 1992. However, so far little progress has been made on large-scale privatisation.

Small-scale privatisation

Parliament adopted the Law on Privatisation of Small State-owned Enterprises in March 1992. By early 1994 about 4 per cent of the 60,000 small-scale units to be privatised had been sold. Pilot mass privatisation auctions are scheduled for the end of 1994. The 1994 privatisation programme targets the sale of 20,000 small-scale units (30 per cent of the total number of state-owned small units). However, the target is unlikely to be reached. Privatisation has been most active in wood-processing, light industry, trade and public catering. About 17 per cent of housing units had been privatised by March 1994.

Property restitution

There has been no restitution for former owners in Ukraine.

Growth of private enterprise

The informal economy is growing rapidly.

Enterprise restructuring

Virtually the entire formal economy is still highly monopolised and exhibits a high degree of integration and concentration. Enterprise budget constraints have remained soft because of budgetary subsidies and directed credits from the banking system.

The Law on Bankruptcy was adopted in May 1992. There has been little enforcement of bankruptcy legislation.

Uzbekistan

Limited reforms have been introduced since 1987 as part of perestroika. Following relatively comprehensive price reform in early 1992, a more gradual path of further market-oriented reforms was initiated. A comprehensive reform programme is under preparation with assistance from the World Bank.

Size of the private sector

About 20 per cent of GDP is thought to be generated in the private sector.

Large-scale privatisation

The presidential decree on Denationalisation and Privatisation of March 1994 sets the broad guidelines for the sale of state assets. About 4,000 medium-sized or large companies are marked for privatisation this year. The first auctions took place in March 1994. About a quarter of the state farms are to be privatised before the end of 1994.

Small-scale privatisation

Laws on Denationalisation and Privatisation and on Leasing were introduced in November 1991, with implementation in late 1992. By mid-1994, more than 50,000 enterprises, mostly small-scale businesses, had been privatised or leased, mainly in retail trade, consumer services, public catering and local industry. Housing privatisation is almost complete.

Property restitution

There has been no property restitution for former owners in Uzbekistan.

Growth of private enterprise

By April 1994 more than 11,000 private enterprises had been registered and 560,000 hectares of farm-land (over 10 per cent of the cultivated land) had been leased to private farmers. The main obstacles to the growth of the private sector include unfavourable entry rules, financial constraints, a high tax burden, lack of access to commercial space and low labour mobility.

Enterprise restructuring

Enterprise restructuring is hindered by the insider nature of the privatisation process together with the continued soft budget constraints, and the low degree of competition throughout the economy. Joint-stock companies will be transformed from their typically closed forms to allow ownership participation of outsiders. State farms have been transformed into cooperatives or joint-stock companies.

The Law on Bankruptcy was adopted in May 1994. No bankruptcy proceedings have yet been initiated.

The Law on Restrictions of Monopolistic Activities was adopted in July 1992 and further anti-monopoly regulation was approved by the government in March 1993. A Directorate for Anti-monopoly monitors market activity. About 350 enterprises are classified as monopolies and their output prices remain controlled.

Markets and trade

Commodity price liberalisation

Price regulations have intensified since the beginning of 1993 after price liberalisation in 1991 and 1992. Prices are set administratively for housing and transport, goods of "social significance" and goods produced in monopolistic sectors. In addition, profit margins are subject to regulatory limits.

Trade liberalisation

A system of state contracts and barter arrangements still dominates exports and imports. While virtually all exports are subject to restrictive licensing, imports outside the trade order system are relatively free of tariff and non-tariff restrictions. More detail on trade agreements and trade regimes is contained in Table 8.3.

Currency convertibility and exchange rate regime

An interim national currency, the karbovanets, was introduced in March 1993. Although the rate has in principle been floating since then, state intervention to reduce the pace of depreciation, including through limitations on convertibility, has been pervasive. A multiple exchange rate regime was reintroduced in August 1993 following a period of market-based exchange rate policies.

Wage liberalisation

A law on the indexation of wages and social benefits was passed in October 1991. Several measures and decisions have been taken to limit wage increases.

Interest rate liberalisation

A large share of bank lending is represented by state-directed credits at heavily subsidised interest rates. Real interest rates on non-directed credits remained strongly negative during 1993 but appeared to have become positive during the first quarter of 1994 (this is based on a comparison of monthly interest rates with actual inflation rates during this period).

Commodity price liberalisation

The bulk of consumer prices were liberalised in January 1992. After a partial reversal of these steps, liberalisation was resumed in mid-1993. By early 1994 only the prices of basic necessities remained fixed. However, on other goods there are indirect price controls through ceilings on mark-ups for trade organisations and profitability ceilings for a range of producers in monopolistic positions.

Trade liberalisation

Trade with CIS countries is largely determined by bilateral intergovernmental agreements. In early 1994, it was made legal for private individuals to engage in foreign trade. At the same time customs duties on all imports were suspended until mid-1995 and the number of product categories subject to export quotas and export licensing systems was reduced from 70 to 26.

Export taxes apply to 65 product groups and range from 5 per cent to 50 per cent. Exporters must surrender 30 per cent of export proceeds at exchange rates set by the central bank. Information on trade agreements is contained in Table 8.3.

Currency convertibility and exchange rate regime

The som-coupon, a temporary national currency, was introduced in mid-November 1993, first as a parallel currency alongside the rouble and since early 1994 as the sole legal tender. Originally the som-coupon was pegged at one som to one rouble, but since mid-April 1994 the exchange rate has been determined via a managed floating system. Nevertheless, there is still a wedge between the official rate and the street rate reflecting less than full convertibility, including for current account transition. A fully fledged national currency was introduced in July 1994.

Wage liberalisation

Minimum wages and pensions are adjusted every few months to keep pace with inflation.

Interest rate liberalisation

Interest rates are linked to the central bank's refinancing rate and are negative in real terms. Preferential rates still exist for directed credits to priority sectors.

Financial institutions

Banking system

The banking system consists of the National Bank of Ukraine, the five successor banks of the Ukrainian branches of former state-owned specialised banks, and over 200 other smaller (often undercapitalised) domestic private banks. The former state-owned specialised banks hold more than 90 per cent of the assets, branches and personnel.

Securities markets

The Law on Securities and Stock Exchange has been in effect since January 1992. Seven stock exchanges have been established, of which the Ukrainian Stock Exchange is most prominent (with at least 15 branches and more than 50 registered brokers).

Banking system

A two-tiered banking system was introduced in early 1988. The Republican Law on Banks and Banking Activities was adopted in February 1991 and amended in May 1993. The statute of the central bank was approved in March 1992. Prudential regulations are fairly loose compared with international standards. There are over 40 commercial banks, including a few domestic private banks and an Uzbek-Turkish bank. Corporate banking remains dominated by Agroprombank and Promstroibank with about 90 per cent of total credit to enterprises. The National bank for Foreign Economic Affairs provides the bulk of foreign exchange services and administers the hard currency funds for the government.

Securities markets

A stock exchange was established in January 1992. The Law on Securities and Stock Exchange was adopted in September 1993.

Role of the state

Taxation

A number of new tax laws and decrees have been introduced since independence in 1991. A decree from December 1992 sets the rates for the two-tiered value added tax at 22 per cent and 28 per cent. Another decree adopted the same day set excise taxes on a string of goods at rates of 10-85 per cent. The Law on Income Taxation of Enterprises and Organisations (1992) provides for the taxation of enterprise revenues at 35 per cent. The Decree on Income Taxation of Individuals, effective since 1 January 1993, sets marginal rates at 10-50 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3.

Taxation

Enterprise profits are taxed at a rate of 18 per cent (for some branches between 12 per cent and 35 per cent); the VAT was reduced from 25 per cent to 20 per cent in June 1994; personal income is taxed at rates between 15 per cent and 50 per cent; excise taxes on selected goods range from 5 per cent to 130 per cent; there is a tax on foreign exchange receipts of 15 per cent; and export taxes are 5-50 per cent. Tax conditions for foreign investors are described in more detail in Table 9.3.

Social security

Attempts to streamline and improve targeting of the social security system have been made since the end of 1993.



Institutional change

Chapter 3 Transition strategies

- 3.1 Faster reform not always preferable
- 3.2 Liquidation of unprofitable enterprises has been avoided
- 3.3 Credibility necessary for successful gradualism
- 3.4 Stability sought by investors is not easily obtained

Chapter 4 Restructuring, privatisation and financial deepening

- 4.1 Approaches to restructuring, privatisation and governance
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Chapter 5 The framework of law in transition

- 5.1 Property law
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Chapter 6 Taxation and transition

- 6.1 Introduction
- 6.2 Taxation in transition
- 6.3 Enterprises and taxation
- 6.4 Fiscal decentralisation
- 6.5 Concluding remarks

3. Transition strategies

This chapter addresses a number of strategic issues relating to the speed and sequence of reform. Consistently with the emphasis of the previous chapters and of this Report as a whole, its focus is on the individual enterprise while recognising the macroeconomic consequences of certain policies towards enterprises. The roles of financial institutions and of legislative structures, which are taken up in subsequent chapters (notably Chapters 4 and 5), are stressed.

The early literature on transition concentrated on the issue of *sequencing*, interpreted as the order of priority between stabilisation, liberalisation, privatisation and restructuring. The debate was never resolved, and, as was argued in Chapter 1, there is no unique optimal path of transition. Much depends on the starting point and the events preceding it. Many countries have moved sufficiently far that there is little point in suggesting embarking on a new path which might involve retracing steps. But, while no single path should be seen as the “model” or “right” way, there are some basic elements that are central to the success of the process. Much of the Report, including this chapter, is devoted to the analysis of some of these crucial ingredients.

Most now argue that macroeconomic stabilisation, if not a necessary condition for transition, greatly facilitates it. It has certainly been learned from the range of countries’ experience that those that pressed ahead more radically on all four fronts have been rewarded not only with relatively rapid movement towards a market economy but also, in most cases, by more modest falls or earlier recovery in output. But even the relatively rapid reformers have been slower than the most ardent advocates of shock therapy would have hoped. Would things have gone even better if they had gone even faster with these reforms? This chapter examines this question, as well as that of the sequence according to which the hardening of budget constraints, privatisation and industrial restructuring are introduced.

3.1 Faster reform not always preferable

The link between the speed and the sequence can be seen by considering the limiting case of immediate institutional liberalisation and reform. Suppose that a full set of market institutions, including a well functioning tax and banking system, bankruptcy and social safety nets, functioning legal institutions (laws, courts and their personnel) had been introduced literally overnight along with the liberalisation of trade and prices. While the infeasibility of such a step is universally acknowledged, there are those who give the impression that it represents an ideal towards which reformers should strive. While the distorted economies inherited from decades of central planning may have

appeared to offer ample scope for reforms making virtually every one of their inhabitants better off, nothing in economic theory suggests that such a one-step movement to a market economy would have that effect. Nevertheless, the case provides a benchmark which helps structure the discussion of more realistic sets of policies.

With foreign trade liberalisation, producers of traded goods have become the subjects of competition from the world market. In the absence of some form of subsidisation or protection, certain industries, such as those manufacturing armaments or using previously heavily subsidised energy to make inferior consumer goods, would have contracted rapidly. They might have been forced into bankruptcy or liquidation, possibly being unprofitable at almost any real wage rate. If the capital equipment of other enterprises was suitable for only a narrow range of operations and could usefully absorb only a limited amount of labour, the redundant labour shed by those sectors could only have been re-employed in subsistence sectors at subsistence wages. This downward pressure on real wages might have extended throughout the economy. At the same time, the value of output at world prices would have risen (as enterprises contributing negatively to the value of output were being phased out), and if household consumption had followed real wages downwards there would have been a sharp rise in profits and investment, speeding the reorientation of the economy towards the sectors in which it had a comparative advantage.

The difficulty with this scenario is the fall in real wages which, in the presence of a highly imperfect personal capital market, which characterises nearly all market economies, requires a cut in living standards which would not help to build a constituency for reform. If the market economy included a minimum wage above that obtainable in subsistence agriculture or services, the reduced market-clearing real wage might be translated into transitory unemployment. Moreover, the length of the transition would be extended as the support of the unemployed would reduce the funds and resources available for investment (while the effect of the minimum wage on profitability would reduce capital inflows).

There are several ways in which this difficulty could be mitigated. Some of those most attractive in theory would only be available to a government capable of making credible commitments over several years. These would include a temporary employment subsidy (or reduced liability to payroll taxes) introduced at the time of the one-step reforms and phased out on a pre-announced schedule over, say, 10 years. Less demanding of revenue would be a

structure of transitory protection so designed that freed prices of tradable goods moved steadily rather than instantly to their world market relativities. The importance of the credibility of the commitment to the course of phased reduction of the subsidy or protection is that it ensures that investment is concentrated in the sectors that have a long-term future because they represent the country's long-term comparative advantage. The role of the policy intervention is to raise the utilisation of existing capital, both physical and human, during the transition and to ensure a more acceptable distribution of income.

This argument suggests that, even under "ideal" conditions as far as the availability of the institutions of a market economy is concerned, overnight liberalisation of trade, prices, etc. should perhaps be accompanied by temporary mitigating measures introducing an element of gradualism into the programme for reorientating the patterns of production and trade.

3.2 Liquidation of unprofitable enterprises has been avoided

In practice, no country has come very close to overnight reform with its relatively extensive incidence of liquidation. It has been argued that some averting of the liquidations might in any case have been desirable. How has the averting of liquidations been achieved and how have those measures by which it has been achieved related to the inevitably extended programme of institutional and other reforms?

The main devices of governments and banks for delaying liquidation of enterprises have been retention in state ownership and continued access to credit as a form of implicit and off-budget subsidy, not formally related either to payroll or to protection. In many cases it appears that priority may have been given by banks to loans for enterprises to pay wages while little attention has been given to the enterprises' creditworthiness. This could amount to an implicit payroll subsidy, though unfortunately not one extended to new business in the private sector.

One might reasonably have a concern that continuing access to credit would be very subversive of financial discipline or require continuing close central supervision of the allocation and use of credit to avoid abuse, especially by enterprises with no long-term future. One potential form of such abuse, the payment of excessive wages and salaries financed by soft credits, has probably been to some extent controlled directly by taxation and by banks monitoring payroll per person, even if they cannot tell how many workers are needed for production.

Even though the worst fears of the consequences for financial discipline of continued soft credit have not been fulfilled, it has undoubtedly had several consequences. The

first is macroeconomic. Credit to state-owned enterprises accounts for a large part of credit creation in many countries, particularly in the CIS, and is a large contributor to the continuing inflationary tendencies in several countries. In some of them, Russia and Ukraine for instance, the inflationary consequences are being controlled by very high real interest rates, up to 5 per cent per month in some recent cases. Such rates are unlikely to be affordable by any legitimate business and, if rolled over by unprofitable enterprises, merely accelerate the growth of debts never likely to be repaid. In these countries, such high real interest rates are symptomatic of the unsustainability of current policy, notably the weight imposed on monetary policy to control inflation when reported budget deficits are in the region of 10 per cent of GDP and further credit is issued off-budget to enterprises (for a discussion of budget issues, see Chapter 6).

Second, the process can delay privatisation relative to an alternative in which the enterprise might have been sold at a positive price if an arm's-length employment subsidy or temporary protection had enabled it to earn positive cash flows rather than relying on soft credit to finance negative ones. Privatisation of other enterprises or banks with claims on enterprises enjoying access to credit in this way is also liable to be hindered by the problematic question of the value of those claims (see Chapter 4 for links between privatisation and financial sector restructuring).

While temporary subsidy or protection schemes could be designed to provide those enterprises without a long-term future with a dignified and orderly decline, the maintenance of financial discipline, while exercising restraint in implementing bankruptcy and liquidation, has consigned some enterprises to a form of suspended animation. They may be technically insolvent and have no access to credit, but they are not liquidated and may continue to trade and operate to the extent that they can hire labour or required inputs despite the reluctance of suppliers to give such an enterprise credit. They may still be able to operate on a cash or barter basis.

It is also worth noting that transition economies do seem increasingly to be resorting to protective tariffs, sometimes to protect existing industries from threatened decline and sometimes in an endeavour to attract foreign investment (see Chapter 7 in Part III). It would be preferable for those countries to enter into commitments that their tariffs would not exceed a ceiling level which itself declined over time. Such a path might have emerged from negotiations, for instance with the EC, had the leading transition economies not at that early stage of transition been inclined to dispense with import duties almost entirely.

The early reformers have reached a point at which the hardening of budget constraints, the application of

bankruptcy and liquidation procedures, the restructuring of the balance sheets of banks and enterprises, and their subsequent privatisation can proceed in that order. For those not yet at that point, it might be appropriate to rely less on continuing access to credit and more on explicit temporary fiscal measures. This is not only because more explicit and transparent measures are generally to be preferred, since they are more easily understood and removed, but also because the less rapidly reforming countries are less likely (because of the weakness of their financial systems) to be able to rely on the credit approach without incurring more of its potential disadvantages than have those who have gone before them. Indeed, one factor discriminating between those that have and those that have not succeeded in making progress on this front may be the greater abuse of credit on the part of those who have so far failed.

3.3 Credibility necessary for successful gradualism

The same countries might, however, also have difficulty in achieving the credibility required for transitory fiscal measures to be beneficial. It may be appropriate for them to bolster credibility from an external source, for example through the conditionality of a trading arrangement with a body such as the EC, or by means of a "Structural Transformation Facility" (STF) agreement with the IMF.

An IMF stand-by agreement (which is slightly more demanding than an STF with respect to macroeconomic stabilisation) might also need to be modified if the current off-budget credit relief to state-owned enterprises were to be replaced by any form of explicit fiscal relief. In the interests of establishing financial discipline, it may be worth conceding quite a large increase in the negotiated budget limit in exchange for the extinction of a given category of off-budget financing.

It has been argued that some elements of gradualism, particularly associated with the restructuring of unprofitable enterprises, would be a sensible part of a transition programme. Such gradualism could, in principle, be built into an initial legislative package. Not doing so creates a situation in which a number of enterprises are arbitrarily kept going rather than liquidated although they are unsaleable, being technically insolvent and having negative operating cash flows. Arguably, the less explicit the gradualism, the more likely it is that decisions on legislation and privatisation have to be postponed. This, in turn, means a slow transition.

The legislative programme itself is also likely to be enacted gradually. This would be even more likely where there are major distractions associated with the break-up of a federation or the need to build some of the most basic organs of state and government, where the national entity

was previously only nominally distinct. There have been proposals for the wholesale incorporation of another country's legal system into the statute book of a reforming economy, but this approach has not been followed anywhere in eastern Europe, the Baltics or the CIS, despite the fact that in the historical precedents elsewhere the administration of the borrowed laws has rapidly taken on the cultural colouring of the host society.

In the absence of this approach, legislative programmes are inevitably piecemeal. An important question is whether a clear conception of the final shape of the whole statute book is sufficient for each chapter of it to be rewritten only once. Suppose that the book consists of 10 chapters (property, contract, company, bankruptcy, competition, foreign exchange, foreign investment, banking, securities and taxation); could each of these in turn be replaced by a new law in its final state? This seems unlikely because of the links and cross references between chapters.

It would be possible to revise each chapter in turn while delaying the application of the new law until the whole book had been rewritten and enacted. This would leave very unsatisfactory laws in operation for some time. The practical difficulties presented by laws inappropriate to the emerging market economy - whose emergence will not wait upon the completion of the legislative process and tolerate the enforcement of the old illiberal legislation - makes the legislative equivalent of fire-fighting unavoidable and a major demand on the time of legislators, ministers and decree-givers.

It follows from these considerations that the process of legislative reform is likely to be quite lengthy. The amount of legislative work to be done is not only large but is likely to have to be repeated: a chapter once revised may well have to be further amended in the light of changes in subsequent chapters, and of experience both with the effect of amendments and the emerging requirements of agents as the transition process itself evolves. The interpretation of experience does not take place in a political vacuum, and the formulation of acceptable amending legislation may be a particularly lengthy and painful process where governments are formed of coalitions, often of inexperienced and volatile constituents.

The result is that the whole process advances more slowly than most people, whose primary concern is only with a small section of it, would hope. They will tend to regard their segment as the most important and as being relatively neglected by the political system - at least as far as the implementation of their preferred reforms is concerned. They may also feel themselves to be the victims of excessive legislative attention, tinkering, and repeated changes in the course of the process whose virtual inevitability was argued above.

3.4 Stability sought by investors is not easily obtained

Although economic progress, and especially its vital vehicle investment, prefers a more stable legislative, fiscal and regulatory regime, it is unlikely to prove possible to supply it in any great measure. What can be supplied, if political circumstances permit, is a clear sense of direction and purpose in the successive reforms. This allows agents to predict not only the implications of each individual measure but also to see how it fits into a larger programme. This calls for a sense of commitment and vision on the part of the political leadership and also an understanding of the type of economic process that they are guiding. This is not easy to deliver in countries with little history of democratic political autonomy and even less experience of or contact with a functioning market economy.

It is unsurprising that, for the most part, reform has been more rapid and more effective in the economies of eastern Europe where the memory of market institutions lingers from the 1930s and 1940s. This appears to be a more important factor than governmental stability itself. The momentum of reform in Poland and the Baltic states has survived governmental change, as is also likely in the Slovak Republic and Hungary, possibly assisted by incoming governments' inclination to commit themselves to assuming the previous governments' commitments to the international financial institutions.

Where the memory of markets lingers, or a cultural ethos compatible with trade and entrepreneurship has survived, there is fertile ground for new private sector activity not based on privatised assets or activities but filling wants not previously supplied - especially for services. If reform is slow and liberalisation incomplete, much of this activity will be channelled into arbitrage operations often involving international trade.

An important turning point occurs when the economic environment is perceived as being sufficiently stable for people to begin to risk resources in commitments by way of productive investments with their prospect for the organic growth of private sector employment. Policy has a crucial role to play in providing a context of financial and regulatory stability in which individuals, often well educated particularly in the physical sciences and engineering, can be brought to make this commitment.

Another important element of support for such private initiatives relates to the physical infrastructure: access to suitable property and buildings with adequate security of tenure; a reliable supply of water, electricity, gas, etc.; and a good transport and communications network. Each of these takes time to provide, whether it is the time to build institutions or the time to plan, arrange finance for and

build, roads, ports, communications centres, etc., the value of each of which often depends on other segments being in place.

The implication of the preceding argument is that elements of gradualism in reform are not only inevitable but, suitably structured and sequenced, may also be positively desirable. The chances of "optimisation" in this respect are, however, low. Much of the inevitable gradualism reflects the arbitrary determination of the sequence of items reaching the top of the political agenda. Moreover, the political context itself is likely to be somewhat unstable and thus to militate against any coherently planned sequence of reform measures.

None the less, over the past 4-5 years a pattern of reform has emerged among the countries at the forefront of reform. Most of these tried early on to bring about macroeconomic stabilisation and to liberalise foreign trade and prices. This hardened the budget constraints of state-owned enterprises and forced them to undertake restructuring but in a more gradual manner than would have been required if bankruptcy and liquidation procedures had been implemented up-front. Having lived for years with this gradual enterprise restructuring mainly in response to subsidy reduction and tightening of company access to bank credits, some of these countries are now seeing rapid private sector growth. This facilitates application, without unbearable employment consequences, of bankruptcy procedures and/or debt restructuring for enterprises in financial difficulty alongside recapitalisation and privatisation of banks. The extent to which such steps will in fact be taken in the immediate future remains unclear in some countries.

The broad coalitions that toppled communism included both the prospective government and opposition parties whose transition from allies to opponents was inevitably difficult. Moreover, the level of voter identification with any party was low, which made pre-electoral pacts difficult as putative leaders could not be expected to deliver any particular number of followers. Furthermore, the disappointments inherent in the transition process have led to elements of nostalgia for the previous regime, particularly on the part of those whose living standards have fallen most and those whose satisfaction came from the exercise of bureaucratic powers they have not been able to replace with market power and authority.

Although the resurgence of politicians and parties expressing some continuity with the old regime does not portend any return to effective central planning, it does underline the uncertainty which will continue to dominate the context in which institutions and enterprises are built in the process of transition.

4. Restructuring, privatisation and financial deepening

A key element in the transition is the restructuring and privatisation of state enterprises, for which an important first step is the imposition of product market discipline. Operational restructuring involves the adaptation of existing enterprises to product market reforms, through adjustments in labour and capital inputs, and in volume, design, and composition of outputs; while financial restructuring pertains to the recontracting or conversion of loans, including those that are non-performing, and asset liquidations. Product market discipline requires price and trade liberalisation and hardening of enterprise budget constraints, through the cut-back of fiscal subsidies and directed credits and the stiffening of conditions associated with any remaining discretionary government support. Most countries in eastern Europe and the CIS opened the transition with comprehensive liberalisation of prices and foreign trade.¹ Supportive of these measures are effective anti-monopoly and bankruptcy policies.² One indication of the impact of product market pressures over the past few years is the significant retrenchment in output and employment in industrial sectors over-expanded by central planning, as enterprises have strived to survive in the new market-oriented environment.

Enterprises undergoing restructuring and the new private sector require finance for investment to exploit newly created market opportunities and to sustain recovery. For some of the “old” companies, laying the groundwork for this recovery involves balance sheet restructuring to resolve any overhang of bad loans so as to strengthen the incentives for decentralised investment and establishment of effective enterprise governance structures by outside debt and equity investors. An overhang of bad enterprise loans can weaken the incentive for making profitable new investments since the incremental returns would accrue in the first instance to old creditors. Corporate governance refers both to the institutional structures through which debt and outside equity investors can influence the behaviour of inside managers and the extent to which these investors act to secure their financial interests.³

Two broad policy approaches to restructuring and privatisation can be found: early mass privatisation on the one hand and comprehensive financial restructuring before privatisation on the other. Key differences between these approaches are the quality of governance and

management provided by new owners of enterprises at the time of privatisation and the methods of resolving any debt overhang.

The first approach achieves rapid privatisation, but often at the expense of ownership and governance quality at privatisation. Ownership typically becomes dispersed among voucher funds, managers, workers and private investors. One potential source of governance is the funds that intermediate investment of vouchers; however, their ability to perform tasks beyond portfolio diversification has yet to be convincingly demonstrated. Another is the managers and workers who may become significant shareholders; although, in some cases, incumbent managers can be an obstacle to restructuring. Possible methods of resolving any debt overhang include selective debt write-downs by the government, high inflation, and, in cases of insolvency, legal bankruptcy proceedings for privatised enterprises.

The second approach aims to attract high-quality owners for enterprises at the time of privatisation by implementing comprehensive financial restructuring before the sale takes place, but this is often at the expense of privatisation speed. The lead agents in financial restructuring are either state banks or a government agency. However, there appear to be limits to the ability of these institutions to support those aspects of restructuring that require fixed investment, and private cash investors in enterprises can be difficult to attract.

The scale of the investment demand created by new market opportunities, in addition, calls for the strengthening of domestic financial institutions. Given its size, the bulk of this investment must be financed from domestic savings; mobilising savings, and allocating them efficiently, is the task of domestic banks and non-bank financial institutions. While domestic financial institutions are vital to sustained growth, the internal cash flows of enterprises are likely to be a significant source of finance for fixed investment early in the transition. Importantly, the ability and willingness of enterprise managers to fund fixed investments out of internal cash flows may help to unlock the supply of debt and external equity finance for fixed investment.

¹ See Chapter 2 on the progress in transition.

² Chapter 5 provides a discussion of legal reforms. On the design of bankruptcy laws, see Aghion, Hart and Moore (1994).

³ EBRD *Annual Economic Outlook* (1993), pp. 9-24 and 121-25, examines the issue of governance in depth.

This chapter examines some policy trade-offs arising from the observed approaches to restructuring and privatisation and describes how the EBRD's operations serve to advance these efforts (Appendix 4.1). It also highlights the importance of financial deepening in economic development, and illustrates how the EBRD's operations serve to strengthen domestic financial institutions.

4.1 Approaches to restructuring, privatisation and governance

Many countries in eastern Europe and the CIS share common elements in their approaches to restructuring and privatisation. These include reliance on product market pressures to down-size some industries, and selective privatisation of large, financially viable enterprises to strategic foreign investors. The approaches tend to diverge, however, for medium-sized enterprises and those in need of financial restructuring or liquidation.

Pressures emanating from price and trade liberalisation, and sharp declines in domestic demand and trade, coupled with a hardening of enterprise budget constraints, have forced a widespread retrenchment in industrial production and employment.⁴ Evidence from enterprise surveys also points to considerable adjustment, largely in the form of better matching of production to demand, in terms of both volume and product mix, and initiatives to develop new markets.⁵ However, there have been relatively few fixed investment programmes of size, except by enterprises with foreign owners.

While the freeing of product market forces can precipitate the down-sizing of the industrial sector, new investment and sustained recovery require supportive institutions. Foremost among them is effective governance of privatised enterprises.

Two approaches to governance are often contrasted.⁶ One relies on the widely dispersed share ownership and efficient, liquid securities markets, as in the United States and United Kingdom. There, the market valuation of a company and the threat of take-over impose discipline on managers. The other relies on a concentration of claims so that the dominant investors in companies have an incentive to exercise effective control over their managers. In

Germany and Japan, this function is performed by lead banks that hold both debt and equity claims on companies. Evidence from the major industrial countries, however, suggests that these two stylised systems impose about the same degree of discipline on company managers.⁷ The choice between these two systems based on their potential effectiveness is thus not clear cut.

Regarding eastern Europe and the CIS, the debate on governance has focused in part on the feasibility of the alternative approaches. Governance through anonymous securities markets has not been possible in the early stages of transition, although these markets are developing rapidly in the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia.⁸ At the same time, state banks have been ill-equipped to perform a governance role effectively.⁹ However, there are indications that state banks are responding to the demands of market-oriented finance in some countries that are more advanced in the transition.¹⁰ The evidence thus suggests that institutions necessary to implement effective systems of governance can be expected to develop as countries progress in their transition.

The issue remains, nevertheless, how to establish effective governance in the short run, thereby allowing the private sector to take over the restructuring process at the earliest feasible stage. To some extent, an answer can be ascertained from the experience to date.

Some large, financially viable state-owned enterprises in the Czech Republic, Hungary, Poland and the Slovak Republic were sold to foreign strategic investors.¹¹ In these cases, effective corporate control was established through concentrated share ownership by foreign industrial companies, ultimately relying on governance mechanisms in the parent countries. These controlling stakes also established incentives to make and finance investments needed to complete restructuring.

An alternative is necessary, however, for medium-sized enterprises, as their number appears to outstrip that of possible strategic foreign investors. In Hungary and Poland, a few private holding companies and funds are emerging that specialise in turning around medium-sized enterprises by making controlling investments.¹² In these cases,

⁴ Chapter 10 examines developments in industrial production and employment.

⁵ For examples of the enterprise survey literature, see Pinto, Balka and Krajewski (1993), Estrin, Gelb and Singh (1993), Fan and Schaffer (1993), and Pinto and van Wijnbergen (1994). For a survey, see Carlin, van Reenen and Wolfe (1994).

⁶ Franks and Mayer (1990) pp. 189-231, and Prowse (1994).

⁷ Kaplan (1993a, 1993b), and Kaplan and Minton (1993).

⁸ Stock exchanges have also been established in Bulgaria, Estonia, Latvia, Lithuania, Russia and Ukraine. However, the ability of these markets to contribute to effective governance remains open to debate. See Corbett and Mayer (1991), Phelps, Frydman, Rapaczynski and Shleifer (1993), Bloomstein and Spencer (1994) and Pohl and Claessens (1994).

⁹ Phelps, Frydman, Rapaczynski and Shleifer (1993), and EBRD *Annual Economic Outlook* (1993).

¹⁰ Hrnčir (forthcoming, 1994) and Dittus (1994).

¹¹ Chapter 9 examines the flow of foreign direct investment to eastern Europe and the CIS.

¹² These examples come from the EBRD's pipeline of private sector projects.

effective governance is established through concentrated ownership by institutional investors with experience in industrial restructuring. These ownership structures allow for the spreading of scarce managerial resources across a number of enterprises, as well as for some diversification of risk associated with controlling stakes in individual, high-risk enterprises.¹³ Similar approaches have also been pursued in eastern Germany by the Treuhandanstalt with its establishment of the Management Kommandit Gesellschaft, a form of limited liability partnership, and in Poland and Romania with the establishment of government-sponsored funds as part of their voucher privatisation programmes.¹⁴

These examples of strategic investors and private holding companies and funds are suggestive of possible solutions to the governance problem early in the transition. Forms of governance at this stage may not endure as domestic securities markets and banks develop, and as enterprises mature, making alternative governance mechanisms possible.

Two approaches to wholesale restructuring and privatisation of medium-sized enterprises, large enterprises not sold to strategic investors, and those in financial difficulty can be broadly distinguished by the point at which the government withdraws and leaves the balance of restructuring to the private sector. In one group of countries, including the Czech Republic, Lithuania, Russia, and the Slovak Republic, the privatisation of enterprises occurred relatively early in the transition, leaving the bulk of restructuring to private owners and relying on market pressures to hasten establishment of effective governance mechanisms. Romania appears poised to follow a similar route. In a second group, including Estonia, Hungary, Poland and Slovenia, the government initiated the financial restructuring of those enterprises and banks that were burdened with bad loans before launching privatisation, with the aim of attracting high quality investors to enterprises. However, the pace of financial restructuring has been slow in these cases and qualified private investors have proved difficult to attract.

4.2 Early mass privatisation

Early mass privatisation, which leaves the bulk of restructuring to private owners, frees enterprises from direct state influence and control. It may also reduce pressure on governments and banks to provide subsidies and credits for insolvent enterprises. These have been

overriding objectives in the privatisation programmes in the Czech Republic, Lithuania, Romania, Russia and the Slovak Republic (Appendix 4.2).¹⁵ The basic elements of these programmes are the mandatory conversion of the majority of enterprises into joint-stock companies, a fixed time-frame for their sale, and broad participation in the new ownership structure through government issuance of vouchers to the public for free or at a nominal charge.

The creation of intermediaries was a key element in some initial schemes for mass privatisation programmes using vouchers.¹⁶ Intermediaries in these programmes provide a means to diversify risks, which can be considerable due to the unstable economic setting and limited information about enterprise earnings, and to delegate the evaluation of alternative investment opportunities to specialists. Such intermediaries may also eventually develop a role in enterprise governance.

In the mass privatisation programme in the former Czechoslovakia and its successor states, the Investment Privatisation Funds (IPFs) created to intermediate the investment of vouchers appear to have performed the diversification and investment evaluation roles. About three-quarters of the vouchers in the first privatisation phase implemented in 1992 were invested through 430 IPFs (265 in the Czech Republic and 165 in the Slovak Republic). Many of the largest funds in the two countries were founded by the major domestic banks. The sizeable flow of vouchers through the IPFs has also resulted in concentrated ownership structures for most companies, with two to three funds typically in combined possession of a controlling stake. Regulations limit a single fund to no more than a 20 per cent stake in any one enterprise. However, the ability of these funds to perform an effective governance role has yet to be demonstrated.¹⁷

Over 600 investment funds have emerged during the voucher privatisation programme in Russia. An individual voucher investment fund can acquire no more than 25 per cent of the share capital of an enterprise and can invest no more than 5 per cent of its own capital in the shares of any one enterprise. While these limits aim to ensure sufficient diversification, they can constrain the ability of investment funds to influence enterprise managers. Nevertheless, managers in about 10 per cent of privatised enterprises have been replaced since implementation of the mass privatisation programme.¹⁸

¹³ Tirole (1991).

¹⁴ The approach to privatisation in eastern Germany is examined in Carlin and Mayer (1994) and Schott and Reilley (1994).

¹⁵ Charap and Zemplinerova (1993), and Boycko, Shleifer and Vishney (1993).

¹⁶ For example, see Frydman and Rapczynski (1992).

¹⁷ See Anderson (1994).

¹⁸ Chubais and Vishnevskaya (1994).

The push for privatisation ahead of restructuring can leave unresolved an overhang of bad loans. In the former Czechoslovakia and its successor states, the government pursued a policy of targeted measures to tackle specific bad loan problems of state enterprises and banks. For example, in two separate operations, low-interest loans were removed from the balance sheets of two state banks and the pre-1990 debts of potentially viable enterprises were written down. The associated moral hazard problem is managed by writing down only debts clearly originated under central planning. Moral hazard refers to the possibility that the present writing down of loans weakens financial discipline by raising the expectation of future government bailouts.

For those problem loans in the Czech Republic not resolved through direct government intervention, enterprises and their creditors have recourse to legal bankruptcy proceedings. As amended in 1993, Czech bankruptcy law provides for a three-month protective period after a case has been filed to allow for a negotiated settlement. Also, in order to prevent bankruptcies of privatised firms before the new shareholders gained control, enterprises in the voucher privatisation scheme were protected from bankruptcy until after the transfer of at least 34 per cent of the shares to the actual holders, even though one would not expect anyone to use good vouchers to buy worthless firms.

In 1993 and the first half of 1994, there have been relatively few court-adjudicated bankruptcy settlements.¹⁹ One reason for slow progress is a possible conflict of interest for state banks in their role as both creditors and shareholders, through their affiliated IPFs, of state enterprises. There is also the concern that the shake-out of inefficient firms should not trigger a banking crisis. In this regard, the government has set up schemes for the netting of inter-enterprise arrears and the purchase of problem assets at a discount by the Consolidation Bank.

In Lithuania, Romania and Russia, high inflation and negative real interest rates have trimmed back the overhang of bad loan, at least temporarily. The ratio of broad money to GDP in all three countries fell sharply with the surge in inflation (Chart 4.1). This may point to some decline in the real burden of bank loans on the enterprise sector.

The establishment of ownership structures that provide high-quality governance to oversee, and to facilitate the financing of, those aspects of restructuring that require

fixed investment is a priority in those countries that have pursued early mass privatisation. In this setting, a market for corporate control could emerge in the form of strategic take-overs of voucher funds or in more conventional secondary market purchases of equities, possibly from the funds. New institutions could also develop in partnership with existing voucher funds to provide more active governance for selected enterprises. Measures that support development of these markets and institutions could thus have a significant impact on the transition in countries such as the Czech Republic, Lithuania, Romania, Russia and the Slovak Republic.

For enterprises with adequate management in place, keys to restructuring lie in the provision of new equity finance and the strengthening of enterprise governance. The Russian Regional Venture Funds being established by the EBRD, with the support of the Russian and G-7 governments, aim to meet these needs by undertaking significant minority equity investments in recently privatised enterprises, supplemented in some cases by enhanced voting rights. The funds also manage sizeable technical assistance programmes that aim to strengthen the existing management and operations of these enterprises.

4.3 Comprehensive financial restructuring before privatisation

It can be argued that it is easier to restructure the balance sheets of state enterprises and banks in financial difficulty if this is done prior to their privatisation. This has been the approach in Estonia, Hungary, Poland and Slovenia (Appendix 4.3). As long as enterprises and banks remain within the domain of the state, the write-down of enterprise loans and recapitalisation of banks remains largely an internal accounting exercise.²⁰ The extent to which bank deposit values are protected in real terms determines the transfer of wealth between the government and the current generation of householders. However, a systematic recontracting or conversion of problem loans can raise a moral hazard problem that is difficult to manage effectively.

Two approaches to the financial restructuring of enterprises and banks in eastern Europe are often contrasted.²¹ One approach carves out the bad loans to enterprises on the books of state banks and places them in a state agency for management.²² The government then recapitalises the state banks to restore their capital adequacy. This approach was adopted in Estonia, in the 1992-element of the Hungarian bank recapitalisation, and in Slovenia. The other approach assigns responsibility for resolving the bad loans to “work-

¹⁹ On the limits of using legal bankruptcy to promote restructuring in eastern Europe, see Kirchner and Mizsei (1993).

²⁰ Begg and Portes (1993).

²¹ Fries and Lane (1994).

²² In principle, the management of these assets could also be contracted out to the private sector.

out units” in state banks and provides them with a set of incentives to perform the task. These incentives can include conditional bank recapitalisations, strengthened government monitoring, and commitment to bank privatisation.²³ This approach has been pursued in components of the 1993-94 Hungarian bank recapitalisation, in Poland and, on a limited scale, in Slovenia. A precedent for this approach is the close involvement of banks in the post-war restructuring of the Japanese industrial sector.²⁴

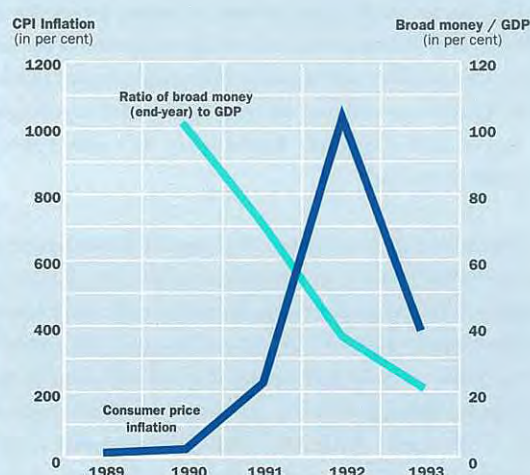
Provided that appropriate incentives for banks can be established, there are several reasons to delegate responsibility for financial restructuring of enterprises to banks, which relate to the costs of financial restructuring and intermediation.²⁵ First, the banks know the enterprises well, as under central planning these institutions and their monobank predecessors monitored the inventories and accounts of the enterprises, even though they did not make credit decisions *per se*. Second, those enterprises that regain viability will require sustained financing throughout their restructuring, and any disruption to credit relations would be costly. Third, the banks would be the main repositories of nascent financial skills that are built up from the restructuring activities.

Under the carve-out approach, banks would be freed quickly from the burden of bad loans and would be able to concentrate on the making of new high-quality loans. However, any complementarities between financial restructuring and new lending would be lost.

The choice between the two approaches is not clear cut, and indeed some countries have pursued both options. Under the bank-led work-out approach to the financial restructuring of enterprises in Poland, over 80 per cent by value of the bad loans involved in the exercise have been resolved. A similar scheme recently implemented in Hungary, however, has yet to produce comparable results. In Slovenia, bad loans made by banks undergoing rehabilitation to the larger, more troubled enterprises have been assigned to a state agency, while the remainder have been left with banks for renegotiation with debtors.

In an initiative to restructure the balance sheets of state enterprises and banks in Hungary in 1992, the government assigned some of the bad loans to a holding company for management and injected capital into the banks. Because of a lack of implementation capacity, however, the state holding company contracted with the banks to manage part of the bad loan portfolio.

Chart 4.1 Broad money and inflation



Source: see Appendix 10.1

²³ Aghion and Fries (1994) examines how to establish the incentives for banks to lead enterprise restructuring when the banks themselves are insolvent.

²⁴ Corbett and Mayer (1991), van Wijnbergen (1993), and Hoshi (1994).

²⁵ McNaughton (1994).

Regardless of which institution takes the lead in financial restructuring, firm conditions must be associated with the restructuring of the balance sheets of state enterprises and banks to quell expectations of future government bailouts and to impart incentives for commercial operations. This requires privatisation of enterprises and banks, their effective governance, adequate prudential supervision of banks, and ultimately bankruptcy to enforce strict financial discipline.

In countries that have pursued comprehensive financial restructuring before privatisation, a key to sustaining progress is the creation of opportunities for the state banks or government agencies to exit and to open the restructuring process to new participants that can add value to the enterprises through effective governance and oversight of new investment. Industrial holding companies and restructuring funds are possible examples of private market solutions to these governance and financing problems.

The Special Restructuring Programmes (SRPs) of the EBRD establish holding companies to sustain the restructuring of enterprises initiated by state banks or government agencies. These programmes aim to assist in the privatisation of enterprises that have been financially restructured, but that require new investment to complete their turnaround. The SRP holding companies provide equity finance for new investment and technical assistance to strengthen the existing management of a portfolio of enterprises undergoing privatisation.

4.4 Securing access for enterprises to debt and external equity finance

While the new market opportunities created by the transition call for significant restructuring of enterprises, the resulting long-run investment demands of enterprises and the new private sector must also be financed. Estimates of the annual investment required in eastern Europe and the CIS to achieve an annual growth rate of 7 per cent over 10 years lie in the range of US\$ 150 billion to US\$ 915 billion, depending on the methodology and estimate of the region's GDP used in the calculation.²⁶ Since the scale of recent and prospective international capital flows to the region amounts to only a fraction of even the lower figure, US\$ 10 billion to US\$ 32 billion in 1993-95, the bulk of the finance needed to satisfy investment demands must in all likelihood come from domestic sources.²⁷

Development of domestic financial institutions and markets can contribute significantly to long-run growth. The potential links between the financial and real sides of an

economy are several. Financial institutions mobilise domestic savings using a range of instruments, including bank deposits, mutual fund shares, insurance contracts and pensions. Suppliers and demanders of savings can also meet directly in markets for debt and equity. The instruments offered to savers involve the provision of services by institutions – the evaluation of alternative investments, governance, and diversification and management of risk – that enhance the efficiency of investment and return to capital. Financial instruments are also more liquid than the underlying real investments, allowing savers to respond more flexibly to unexpected developments.

While there are a range of possible channels through which the provision of financial services can influence the real economy and growth, the empirical evidence points to a strong overall impact. Three measures of the scale of financial services provided to the private sector are often used: (1) the ratio of currency plus demand and interest-bearing liabilities of banks and non-bank financial institutions to GDP as an indicator of the overall size of the formal financial sector; (2) the proportion of domestic credit intermediated by the banking sector as opposed to the central bank; and (3) the proportion of credit that goes to the private as opposed to the public sector.

A comprehensive assessment of over 80 countries for the period 1960-89 reveals that each of the average measures of financial depth are positively and significantly related to real GDP growth per capita and ratio of investment to GDP.²⁸ Moreover, the results suggest that measures of the depth of financial services at the outset of the period are significant in predicting future growth rates. Importantly, the latter suggests that financial sector development contributes to growth, and is not simply a consequence thereof.

While the evidence points to a strong relationship between measures of financial services and growth, the issue remains how to expand the provision of these services in countries where they are in short supply. A major impediment to the supply of financial services is typically the excessive weight of government controls. Although a sound prudential and regulatory framework for banks and other financial institutions is clearly necessary, intervention in the form of directed credits, administered interest rates, high reserve requirements, and limits on permissible activities and competition can hold back the financial sector.

²⁶ See EBRD *Annual Economic Outlook* (1993), pp. 82-83, for a range of estimates of the region's investment needs.

²⁷ International Monetary Fund (1994), p. 152.

²⁸ Levine and King (1993).

An examination of the financial reforms in a number of countries reveals that an increase in (measures of) financial services tends to follow the rolling back of the financial controls. This result holds across Argentina, Chile, Indonesia, Korea and the Philippines, despite differences in the design and speed of their financial liberalisation.²⁹ In all but one country examined, two or more measures of the scale of the financial sector increased in the post-reform period compared with their pre-reform levels (with one measure increasing in the other country). However, in three countries, these episodes of financial liberalisation were followed by crises and institutional insolvencies that stemmed in part from shortcomings in prudential regulation and supervision.

In eastern Europe and the CIS, extensive controls on credit allocation and interest rates are a pervasive legacy of central planning. Substantial headway in dismantling these has been made in eastern Europe; in the CIS, however, less has been achieved.³⁰

Another legacy of central planning is the limited range of financial services and instruments provided by domestic institutions. Typically, a single savings bank provided retail deposits to the household sector, while specialised banks provided credits to various branches of industry and agriculture according to planned credit allocations. The state banks that were created from the former specialised banks and regional branches of the central bank were thus initially ill-equipped to provide the mix of retail and wholesale commercial banking services typically found in industrial economies. Loan portfolios of the new state banks were also concentrated by economic sector or geographic region, while new private banks were often owned by the enterprises to which they were major creditors. Thus lending risks were often both concentrated and connected – especially in the CIS. In addition, non-bank financial services were extremely limited.

The EBRD, in its financial sector operations, aims to fill the many gaps in the domestic financial systems through credit lines and long-term investments in banks and non-bank financial institutions that serve to strengthen their operations (Appendix 4.1).³¹ These operations include significant equity investments in state banks to facilitate their privatisation.

4.5 Enterprise cash flows and hard budget constraints

While institutional sources of finance, both domestic and foreign, are important for investment and long-run growth, internal cash flows of enterprises are likely to be a significant source of finance early in the transition. In the major industrial countries, retained earnings and depreciation finance about three-quarters of gross investment expenditure; while in a sample of nine developing countries, internal cash flows provided about one-third of the funds for investment (Chart 4.2). In general, internal cash flows are an attractive source of finance because they escape the costs associated with the issuance and monitoring of debt and outside equity investments.

In transition economies, the funding of investment from internal cash flows can take on added significance. Whether an enterprise can generate a positive cash flow provides a gauge of the impact of product market liberalisation and the extent of enterprise adjustment. Moreover, whether an enterprise's managers are willing to invest cash flows in their enterprise can reveal their commitment to the enterprise and their judgements about its future profitability. In a very uncertain economic setting, these signals can convey particularly valuable information to potential suppliers of debt and outside equity.

Developments in the three countries in eastern Europe that achieved a recovery of investment in 1993 (Hungary, Poland and Romania) serve to illustrate the importance of internal cash flows in the early stages of transition. Hungarian and Polish enterprises experienced significant credit squeezes from 1990 to 1992, with the ratio of credit expansion to enterprise investment dropping sharply and with the overall level of real investment declining significantly (Chart 4.3). Given the lack of alternatives, this suggests that internal cash flows became the major source of finance for investment.³² In contrast, in Romania during 1991-92 the flow of credit to enterprises exceeded investment by a wide margin and supported operating losses. At the same time, the level of real fixed investment dropped sharply and then stabilised, with high inflation and negative real interest rates leading to a sharp reduction in the real supply of deposits and credit.³³

Though preliminary, the evidence suggests that forcing enterprises to rely heavily on internal finance by imposing hard budget constraints and tight credit policies early in the transition can lay the foundation for a recovery in fixed investment. The funding of the initial upturn in fixed

²⁹ Levine and King (1993).

³⁰ Appendix 2.1 records progress in financial sector reform in the region.

³¹ Hexter (1994).

³² Evidence from enterprise surveys also points to heavy reliance on internal finance to fund investment in the Czech Republic, Hungary, Poland, Russia, the Slovak Republic and Ukraine. See Carlin, Van Reenen and Wolfe (1994).

³³ Calvo and Kumar (1994).

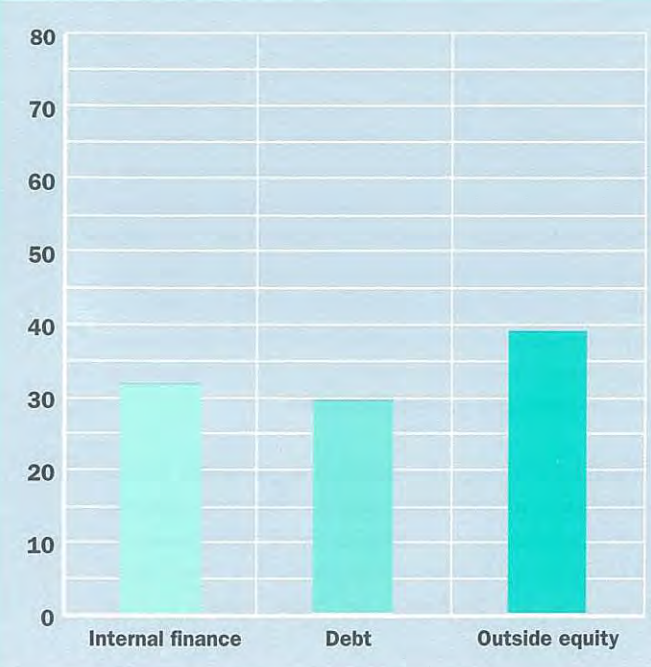
Chart 4.2 Structure of finance for non-financial enterprises

Major industrial countries ¹
(in per cent of total sources of financing)



¹ Unweighed average for Canada, France, Germany, Italy, Japan, United Kingdom and United States.
Source: Mayer (1990).

Selected developing countries ²
(in per cent of total sources of financing)



² Unweighed average for India, Jordan, Korea, Malaysia, Mexico, Pakistan, Thailand, Turkey and Zimbabwe.
Source: Sing and Hamid (1992).

investment with internal enterprise cash flows may, in turn, help to unlock sources of external finance for enterprises. While expansionary credit policies may be able to put a floor under the decline in investment, the prospects for a sustained recovery from that basis remain uncertain, with the ability of enterprises to survive in a market-oriented economy obscured by financial laxity, and the scope for an expansion in the real supply of credit constrained by inflation.

4.6 Concluding remarks

One difference between the two approaches to restructuring and privatisation – early mass privatisation and comprehensive financial restructuring before privatisation – is the quality of governance provided by the new owners of the enterprises after privatisation. The first approach rapidly frees enterprises from state involvement, but often at the expense of quality of governance provided by the new owners. It also makes it easier for governments and banks to resist requests for subsidies and soft credits. The hope is that market pressures will hasten improvements in governance. The second approach aims to attract high quality owners for enterprises at the time of privatisation through prior comprehensive financial restructuring, but at the expense of implementation speed. The lead agents in financial restructuring of enterprises have been either state banks or government agencies. However, there may be limits to the ability of these institutions to support subsequent phases of restructuring; and private cash investors can be difficult to attract.

A second difference between the two approaches is the method of resolving any overhang of bad loans. The explicit write-down of bad loans under the early mass privatisation approach has been confined to specific types of debt clearly originated under central planning. Outside the Czech Republic and the Slovak Republic, however, high inflation and negative real interest rates have been the main instrument of financial restructuring in countries pursuing early mass privatisation. In countries pursuing comprehensive financial restructuring before privatisation, the writing down of debts has been determined either by a government agency or through negotiation between enterprises and their creditor banks. As long as enterprises and banks remain within the domain of the state, the writing down of enterprise loans and recapitalisation of banks remains largely an internal accounting exercise.

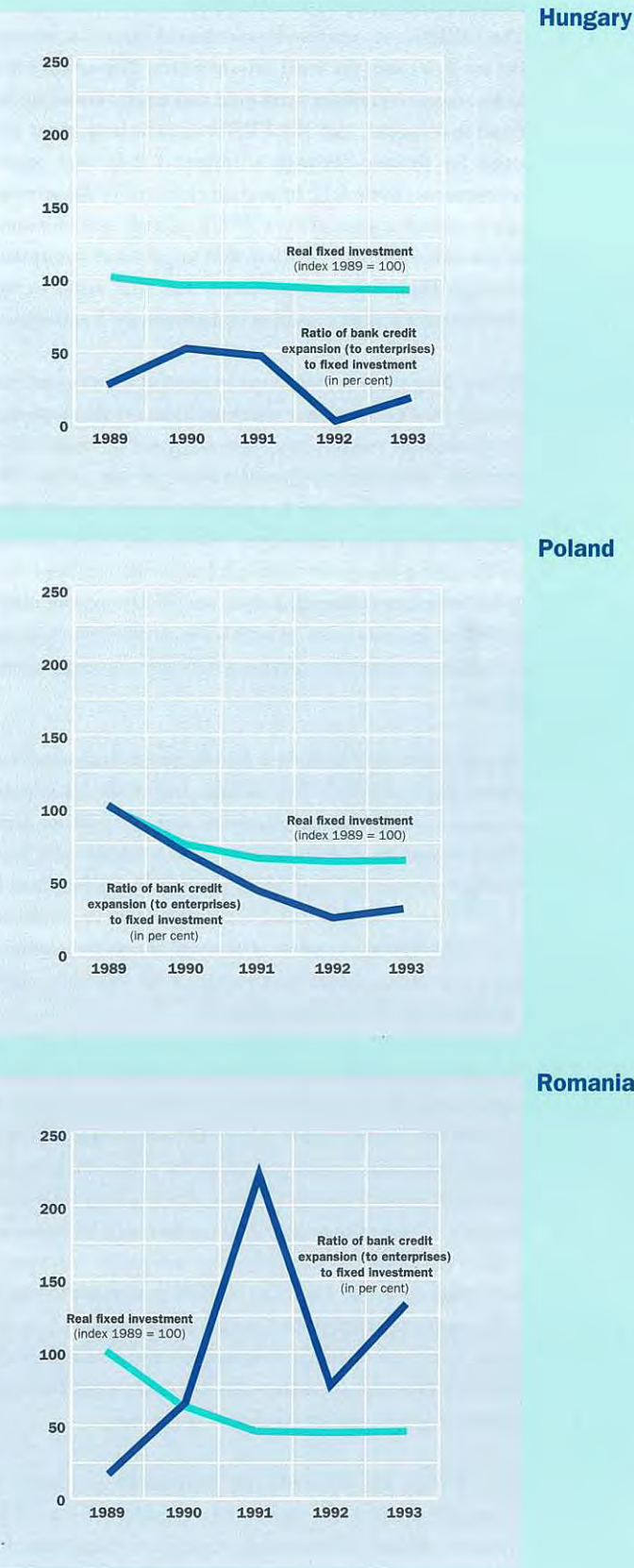
The EBRD supports both approaches to restructuring and privatisation with early-stage equity. Provision of equity finance through special-purpose institutions is combined with technical assistance to strengthen the management

and operations of participating enterprises. The equity investments flow through two types of institutions that allow for a portfolio approach to equity investments in high-risk enterprises. Post-privatisation Funds, of which the Russian Regional Venture Funds are examples, provide support to recently privatised enterprises in countries that have pursued early mass privatisation; Special Restructuring Programmes establish holding companies to facilitate the privatisation of state enterprises in those countries that have pursued comprehensive financial restructuring before privatisation. The institutions differ in the degree to which they displace the previous owners of the enterprise. The Post-privatisation Funds aim to preserve to the extent possible the existing private ownership structure, while the SRP holding companies replace the state as the sole owner of the enterprises. Nevertheless, both institutions work to strengthen enterprise governance, while technical assistance funds provided by donor governments and managed by the funds or holding companies aim to improve management skills and operational efficiency.

The scale of the investment demand created by new market opportunities in transitional economies calls for strengthening domestic financial institutions. Given its size, the bulk of this investment must be financed from domestic savings; mobilising savings and allocating them efficiently is the task of domestic banks and non-bank financial institutions. The EBRD supports their development through credit lines and long-term investments that serve to strengthen domestic financial institutions, including significant equity stakes in state banks to facilitate their privatisation.

While domestic financial institutions are vital to sustained growth, the internal cash flows of enterprises are likely to be a significant source of finance for fixed investment early in the transition. The ability of an enterprise to generate a positive cash flow provides a gauge of the impact of product market liberalisation and the extent of enterprise adjustment, while the willingness of an enterprise's managers to invest cash flows in the enterprise can reveal their commitment to the enterprise and their judgements about its future profitability. In a very uncertain economic setting, these signals can help to unlock the supply of debt and external equity finance for investment. However, soft budget constraints and inflationary credit policies can obscure the ability of an enterprise to survive in a market-oriented economy and limit its eventual access to external finance for investment.

Chart 4.3 Bank credit and real investment



Source: See Appendix 10.1

Appendix 4.1 EBRD operations that strengthen financial institutions and support enterprise restructuring and privatisation

The EBRD, in its refocused operational priorities, stresses the need to reach the local private sector. This sector often lacks access to medium-term debt and equity financing for fixed investment, and the EBRD aims to help meet this need for finance through a range of debt and equity instruments (Table 4.1). Important elements of this strategy can be found in some of the EBRD's existing operations and in a number of new initiatives that target local enterprises through financial intermediaries and that assist in the restructuring and privatisation of medium-sized enterprises.

Where long-term investments in domestic banks are not possible, owing to balance sheet problems or shortcomings in prudential regulations, various types of credit lines facilitate debt financing for the local private sector. The EBRD has implemented a variety of such credit lines and has worked to refine these instruments. They include co-financing alongside domestic banks, agency lines with local branches of foreign banks, and Bank-to-bank credit lines that in some cases benefit from credit enhancements (sovereign guarantees and apex credit lines through central banks).

Recent initiatives include a Russia Small Business Fund that could reach ECU 275 million, with half this amount coming from donor governments and the balance from Bank resources. EBRD staff are now working with local banks to screen and to monitor projects in a pilot phase in Tula, Nizhniy Novgorod and Tomsk. All in all, the Bank has 21 credit-line agreements with institutions operating in nine countries. Total commitments at end-July 1994 amounted to ECU 652.8 million.³⁴

In addition to facilitating the supply of debt finance, EBRD operations serve to enhance the flow of equity to the local private sector, especially where the economic setting is highly uncertain. Equity can meet the substantial need of the local private sector for risk sharing and long-term finance. It also allows the EBRD to leverage its resources and to contribute to strengthening enterprise governance and management. From an EBRD perspective, equity offers participation in the upside of projects and, in the long term, can make a substantial contribution to the EBRD's financial soundness. In the short term, however, equity requires greater provisioning for risk.

The EBRD has invested, or committed to invest, in 13 equity funds in the region to help address the need for venture capital. These funds cover nine countries, and several operate on a region-wide basis. Total commitments at end-July 1994 amounted to ECU 128 million.

In addition to conventional investment funds, the Bank has developed an early-stage equity instrument that combines equity finance through special-purpose institutions with technical assistance to strengthen the management and operations of participating enterprises. The Regional Venture Funds being developed in Russia are examples of Post-privatisation Funds that take significant minority stakes in recently privatised enterprises, providing new equity finance, strengthened governance and managerial assistance. Two are now being launched – the Smolensk and Urals Regional Venture Funds – and several more are in preparation.

Special Restructuring Programmes (SRPs) use a holding company structure to take over the ownership of state enterprises as an interim step toward their full privatisation. The Polish SRP is nearing implementation, while preparation of a similar programme in Slovenia is well advanced. These programmes are designed to allow state-owned enterprises access to both new equity finance and management assistance and to encourage initiatives at the enterprise level that promote turnaround and privatisation within a few years.

Where the conditions permit, equity and long-term debt investments in banks and non-bank financial institutions are important means of reaching the local private sector. The domestic financial system is not only the heart of a market economy, providing vital financial services to improve efficiency of investment and mobilisation of savings, but is also crucial to the EBRD because it cannot operate at the retail level. Working to strengthen domestic financial institutions wherever possible is a cost-effective way to reach the local private sector, especially small- and medium-sized enterprises. By making long-term investments in domestic financial institutions, the EBRD leverages additional loans to the private sector and gains the capacity to upgrade facilities and to promote market-oriented financial practices.

The EBRD has facilitated the privatisation of Wielkopolski Bank Kredytowy in Poland and the Hungarian Foreign Trade Bank with significant equity investments. Along with the World Bank, the EBRD is also funding the Financial Institutions Development Project in Russia, which aims to create a core group of banks that satisfy international banking standards. Overall, the EBRD has approved long-term investments in 15 banks in 10 countries, the commitments for which totalled ECU 209 million at end-July 1994. The EBRD has also made several long-term investments in non-bank financial institutions with the aims of deepening financial markets and promoting competition.

³⁴ This amount includes a credit guarantee facility that is part of a co-financing agreement.

Table 4.1 The EBRD's financial Instruments to reach the local private sector

This table describes the financial instruments that the EBRD uses to reach the local private sector directly or through financial intermediaries. Instruments to promote debt and equity finance are listed in an order which broadly reflects the intensity of their use in different stages of transition. In early stages of transition, the emphasis is to alleviate quickly shortages of finance to the local private sector, while encouraging the development of sound institutions. In more advanced stages, the focus is on long-term investments that serve to strengthen domestic financial institutions. Facilitating trade finance is important at all stages of transition.

Instruments	Functions	Number to date	Commitments ¹ (ECU million)
To promote debt finance			
Credit lines ²	Reach local private sector without necessarily taking an exposure to domestic financial institutions; strengthen credit assessments	21	652.8
Credit guarantees	Facilitate provision of local currency loans	3	47.6
Long-term investments in banks	Increase the capital base of banks which can be leveraged for additional lending; strengthen operational efficiency	15	209.3
To promote equity finance			
Equity funds	Provide long-term finance without short-term cash drain; create scope for strengthening local management	13	147.6
Early stage equity	Combine equity finance with technical cooperation to strengthen management in preparation for privatisation or shortly thereafter	3	100.9
Long-term investments in non-bank financial institutions	Increase competition and depth of financial markets	6	33.2
Trade finance	Compensate for lack of access to international inter-bank credit lines	3	107.9

¹ The table gives commitments as of 29 July 1994. Disbursements take place over time as conditions permit.

² Includes co-financing alongside domestic banks, agency lines with local branches of foreign banks, and Bank-to-bank credit lines that in some cases benefit from credit enhancements (sovereign guarantees and apex credit lines through central banks).

Appendix 4.2 Examples of early mass privatisation

*Czech Republic*³⁵

The approach to restructuring and privatisation in the Czech Republic consists largely of a mass privatisation programme with vouchers and targeted measures to address problems with specific types of loans. Restructuring is usually the responsibility of the new private owners of enterprises and banks. However, the government pursues a policy of restructuring for some large enterprises. This is managed by the ministry that handled the enterprise prior to privatisation or the Ministry of Privatisation. The government has also recapitalised some state banks.

By late 1994, over half of Czech national assets will have been distributed through voucher privatisation in two waves. An important feature of the programme has been the formation of 430 Investment Privatisation Funds (IPFs) in the first wave, implemented while Czechoslovakia remained a federation, of which 265 are in the Czech Republic. These funds competed for the vouchers which the government had sold to citizens for a nominal fee, and invested these vouchers on their behalf in enterprises slated for privatisation. The original voucher holders then became shareholders in the IPFs when the privatisation wave was completed. The larger IPFs are affiliated with the major Czech banks. Individual voucher holders could also invest directly in enterprises that were being privatised.

The first wave was completed in 1993. It involved 988 enterprises and included the main state banks. The share of capital in individual enterprises made available to voucher privatisation varied from 7 per cent to 97 per cent. The remaining shares were sold to foreign investors, transferred without charge to municipalities, or left temporarily with the National Property Fund. About 72 per cent of vouchers were entrusted to IPFs. This transfer of ownership claims to the IPFs resulted in relatively concentrated ownership structures in most companies, with two or three core investors. The second wave of voucher privatisation, to be completed in 1994, involves 861 enterprises.

Financial restructuring began in March 1991 with the founding of the Consolidation Bank by the Ministry of Finance and National Property Fund of the former Czechoslovakia. The first operation of the Consolidation Bank involved the transfer of Kcs 110 billion (10.9 per cent of GDP) in revolving credits (low-interest loans originally provided to finance inventories) from Komerční Banka and Ivestiční Banka, along with deposit and other liabilities of an equal amount. The Consolidation Bank then renegotiated the terms of the loans and pursued collections.

In November 1991, the state-owned National Property Fund transferred bonds worth Kcs 50 billion (7.0 per cent of GDP) to the banks. One-third of this amount was meant as a cushion against the effects of bankruptcy in subsequent years, while the remainder was compensation for the partial write down of pre-1990 bank loans to enterprises that were considered viable in the medium term. The government has also undertaken some measures to assist larger enterprises that pose systemic problems, including selective debt reductions and government guarantees for credits.

*Lithuania*³⁶

The Lithuanian approach to restructuring and privatisation consists primarily of a mass privatisation programme using vouchers. Enterprise restructuring is generally the responsibility of the new owners. While working to strengthen prudential supervision and regulation, the authorities allowed a number of unlicensed banks to fail in 1993 and early 1994.

The 1991 Law on Initiation of Privatisation of State Property launched the sale of enterprises. Initially, this was done exclusively through voucher privatisation, with privileges given to managers and employees. However, some hard currency and auction sales have now taken place, and the employee and management preferences are being eliminated. As required by the privatisation law, a number of enterprises were broken up prior to privatisation. The government also financially restructured some larger enterprises prior to their privatisation; however, this programme has been discontinued.

By the end of 1993, 1,915 enterprises had been privatised, out of a total of 2,203 in the privatisation programme. The total number of state enterprises at the end of 1993 was 4,251.

Inflation in Lithuania has led to the significant scaling back of the banking sector relative to the economy as a whole. As inflation surged from 8 per cent in 1990 to 1,021 per cent in 1992, before easing to 390 per cent in 1993, the ratio of broad money to GDP declined from 101 per cent of GDP to 20 per cent of GDP. A number of the unlicensed deposit-taking companies also failed in late 1993.

³⁵ EBRD *Quarterly Economic Review* (1993), pp. 11-17, Charap and Zemlinerova (1993), and Anderson (1994).

³⁶ Semeta (1994).

Romania³⁷

In Romania, the pace of restructuring and privatisation has so far been gradual; however, an initiative is under way to significantly accelerate the transfer of state assets to the private sector through a revitalised mass privatisation programme with vouchers.

The 1991 Privatisation Law provided for a mass privatisation programme in which 30 per cent of the share capital in each of 6,280 enterprises was transferred to one of five Private Ownership Funds (POFs) established by the government. The other 70 per cent was transferred to the State Ownership Fund (SOF). In 1992, tradable certificates of ownership in the POFs were distributed to all adult citizens. The value of the vouchers has declined significantly since their issuance.

The SOF is obligated to reduce its shareholdings by at least 10 per cent per year. The SOF and POFs are also expected to reach agreements on the division of responsibility for leading the restructuring and privatisation of medium-sized enterprises, while the SOF is to take charge of large enterprises. By mid-1994, the SOF had privatised about 500 enterprises, mostly through management/employee buy-outs.

The government intends to amend the mass privatisation by issuing new vouchers that will carry a much larger nominal value than the outstanding ownership certificates and by increasing the proportion of enterprise shares eligible for voucher privatisation to 60 per cent from previously 30 per cent. The government is also committed to increasing sharply the number of enterprise privatisations and to recasting the roles of the SOF and POFs.

Financial restructuring was initiated in 1991, when the government exchanged with the state banks bonds with a nominal value of 165 billion lei (7.5 per cent of GDP) for 90 per cent of the banks' non-performing loans. This measure was supplemented with another injection of state capital into three state banks in 1992, which amounted to 50 billion lei (0.8 per cent of GDP). Another aspect of financial restructuring has been a period of high inflation and negative real interest rates. As inflation accelerated from about 5 per cent in 1990 to 256 per cent in 1993, the ratio of broad money to GDP declined from 60 per cent of GDP to 24 per cent of GDP.

Russia³⁸

The approach to restructuring and privatisation in Russia has involved a mass privatisation programme using vouchers, in which responsibility for enterprise restructuring has been left to the new owners. The government has adopted a largely *laissez-faire* policy toward the banking industry, relying on free entry and exit of commercial banks to discipline the industry. Prudential regulation and supervision has been minimal; although initiatives are under way to strengthen these. The financial restructuring of enterprises and banks has been the by-product of high inflation and negative real interest rates, which have eroded the real value of loans and deposits.

A presidential decree issued in July 1992 launched the large-scale privatisation programme. This decree required all large enterprises with more than 1,000 employees to undergo compulsory privatisation. Medium-sized firms with between 200 and 1,000 employees, including divisions of large enterprises, could choose to become privatised. In total, 29,000 large and medium-sized enterprises were marked for privatisation. The first step in the large-scale privatisation is to register as a joint-stock company. By mid-1994, approximately 19,000 enterprises had registered as joint-stock companies.

A second presidential decree in August 1992 introduced vouchers to create an effective demand for shares in the joint-stock companies. The State Committee for the Management of State Property issued the vouchers freely to the population in late 1992 and early 1993. The vouchers, which have a face value of Rb 10,000, were used to buy shares in those medium-sized and large enterprises offering their shares to the public through the voucher auction system. Vouchers were also used by employees to purchase shares under preferential employee stock-ownership options.

A presidential decree in October 1992 also created "voucher investment funds." These were permitted to acquire and to invest both vouchers and cash on behalf of individuals. By mid-1994, there were over 600 registered voucher investment funds, with approximately 40 million shareholders.

About 15,000 medium-sized and large enterprises employing more than 70 per cent of the industrial workforce were privatised in the first phase of the large-scale privatisation programme, which was completed at end-June 1994. The preferential employee stock-ownership options resulted in workers and managers acquiring in most cases more than 50 per cent of the shares in their workplaces. About 22 per cent of shares in

³⁷ EBRD *Quarterly Economic Review* (1993), pp. 106-110, and Hicks (1994).

³⁸ Boycko, Shleifer and Vishney (1993), World Bank (1993), Long and Talley (1994), and Chubais and Vishnevskaya (1994).

privatised enterprises were sold through the voucher auction system. The next phase of the privatisation programme will focus on cash sales to strategic investors.

While privatisation has proceeded rapidly, the restructuring of enterprises has been hindered in some cases by the controlling ownership stakes obtained by insiders (managers and workers) in privatised enterprises and the resulting lack of effective governance. Product market pressures have also been attenuated by import protection, lack of effective anti-monopoly enforcement, and continued inter-enterprise arrears and producer subsidies.

Privatised enterprises have a pressing need for capital as well as managerial and technical know-how to enhance their survival prospects. To meet these needs, the EBRD is working with the Russian and G-7 governments to establish 10 Regional Venture Funds to provide privatised enterprises with equity financing combined with technical assistance. The capitalisation of each fund will be approximately US\$ 50 million. Apart from the technical assistance fund provided by donor governments, these funds are to operate on a purely commercial basis.

The main instrument used to achieve the financial restructuring of enterprises and banks has been high inflation. As inflation soared from less than 6 per cent in 1990 to the region of 1,000 per cent in 1992-93, the ratio of broad money to GDP fell from 79 per cent in 1990 to 10 per cent in 1993. This points to a very large contraction in the real value of bank credit.

There are over 1,700 commercial banks in Russia, most of which are small. The largest commercial bank (Rosselkhozbank) has about US\$ 2 billion in assets, and the largest 65 banks account for about 70 per cent of total assets in the banking system. Almost all banks are joint-stock companies which have been created within the last three years. About 700 commercial banks, including most of the larger ones, were spun off from the former Soviet specialised banks. The remaining 1,000 banks were start-ups, most of which are owned by state enterprises. The Sberbank (Savings Bank) has a virtually monopoly on household deposits, with by far the largest nationwide branch network.

Within this setting, the government has adopted an approach supported by the World Bank/EBRD Financial Institutions Development Project which aims to strengthen a core of commercial banks to lay the basis for an efficient and competitive banking system. The basic strategy is to create a separate tier of international standard banks (ISBs) that will have more capital, adhere to better banking practices, and be supervised more closely than other

commercial banks. The free play of market forces is expected to induce the stronger banks to become ISBs and the weaker banks to exit from the industry through merger or closures.

The *laissez-faire* banking policy in Russia reflects a number of special factors. First, most commercial banks are small and thus pose little systemic risk in the event of an isolated failure. Second, most commercial banks deal exclusively with enterprises, and in fact many are owned by the enterprises to which they provide services. Depositors are thus well positioned to evaluate the risks of commercial banks. Third, most household deposits are concentrated in the Sberbank and not in the commercial banks.

Slovak Republic³⁹

In the Slovak Republic, the approach to privatisation and restructuring parallels that in the Czech Republic. The mass privatisation programme with vouchers has left the bulk of restructuring to the new private owners of enterprises. There have also been targeted policies to address problems with specific types of loans.

The first wave of the mass privatisation programme, involving 750 enterprises, was launched in 1992 (while the two states were federated as Czechoslovakia) and completed in 1993. Of these, shares in 503 enterprises were offered through the voucher scheme. All banks were privatised in the initial wave, except for the Slovak Savings Bank. The second wave will involve 660 enterprises and will use vouchers for about one-third of the assets. The programme is to be implemented in late 1994.

The financial restructuring of enterprises and banks has been largely confined to the operations that were undertaken in the former Czechoslovakia. These include the transfer of permanent revolving credits to the Consolidation Bank and the partial write down of pre-1990 debts of insolvent enterprises that are expected to regain viability in the medium term.

³⁹ EBRD *Quarterly Economic Review* (1993), pp. 11-17, and Anderson (1994).

Appendix 4.3 Examples of comprehensive financial restructuring before privatisation

*Estonia*⁴⁰

The Estonian approach to restructuring and privatisation has relied primarily on a series of international tenders for the large state enterprises; however, the pace of implementation has been slow. In 1993, 54 large enterprises were privatised out of a total of 155. Negotiations are pending on a number of further transactions. There has been little restructuring of enterprises prior to their sale, except for the splitting up of some large enterprises.

The 1993 Privatisation Act aimed to provide momentum to restructuring and privatisation by establishing the Estonian Privatisation Agency through a merger of the Department of State Property and the Estonian Privatisation Enterprise to eliminate overlaps. This agency has the authority to restructure state enterprises to facilitate their privatisation. The law also allows for the use of vouchers, in addition to cash and installment purchases for domestic buyers.

There has been no explicit policy toward financial restructuring in Estonia. However, high inflation has contributed to a significant scaling back of the banking sector relative to the economy as a whole. As inflation surged from 23 per cent in 1990 to 1,076 per cent in 1992, before decelerating sharply to 90 per cent in 1993, the ratio of broad money to GDP declined from over 100 per cent of GDP to 27 per cent of GDP. The banking crisis in 1992-93 also led to a sharp reduction in the number of banks through mergers and liquidations.

*Hungary*⁴¹

The approach to restructuring and privatisation in Hungary has undergone several modifications since the late 1980s. The first steps involved spontaneous "privatisation" in which state enterprises through legal means established subsidiary companies on the basis of their plants and factories. This decentralisation led to some organisational and financial restructuring (along with some financial abuses), but left state ownership largely intact.

In 1990, the newly elected government established the State Property Agency (SPA) to strengthen the government's control over state assets and to oversee the sale of enterprises. The SPA's initial strategy involved selling large state enterprises to strategic investors, without prior financial restructuring, and leaving the new owners (mostly foreign) to restructure them as necessary. Progress was slow, however. At the same time, the 1990 Separation Law gave some impetus to the splitting up of state enterprises. However, the SPA generally lacked the experience and information needed to assess the effects of splitting up on

operational efficiency. The agency may also have found it easier to sell enterprises with substantial market shares.

The 1992 Privatisation Law created the State Holding Company (SHC) to administer certain strategic enterprises in which the state intended to retain a controlling interest. The law also provided for the compulsory corporatisation of all other state enterprises and for the transfer of their shares to the SPA, leading to the centralisation of ownership rights, which had previously been at least partly in the hands of worker-elected enterprise councils. In addition, the government adopted a new privatisation strategy at end-1993, which called for greater domestic participation in privatisation through employee ownership, leasing, and voucher programmes and the splitting up of large enterprises.

By end-1993, the SPA had, through share sales to private investors, phased out entirely state ownership in 404 enterprises and reduced the state's share to less than 50 per cent in another 144. The SPA retained majority ownership of 775 enterprises at the end of the year, while the SHC administered 254 enterprises. The SPA has liquidated over 400 enterprises. By mid-1994, the number of enterprises sold to private investor through share sales increased to 569.

In the autumn of 1992, the government launched a loan consolidation scheme, following the sharp deterioration in the financial position of the enterprise sector and the imposition of more rigorous bank accounting standards in 1991 and early 1992. This scheme involved the transfer of Ft 102.6 billion in bad loans from the three largest state banks to a state holding company, the Hungarian Investment and Development Bank (HIDB), in exchange for Ft 79.4 billion (2.3 per cent of GDP) in government bonds. The HIDB then entered into contracts with the state banks to manage some of the bad loans and attempted to recover directly on the remainder. By design, this bank recapitalisation was incomplete and little effort was expended by the banks and HIDB to manage the bad loans.

A second bank consolidation scheme was introduced in 1993. It required the participating banks to improve their operating performance and to enter into debt conciliation proceedings in exchange for the additional capital. These requirements were enforced through incentive contracts with the managers of the participating banks. The programme raised the banks' capital ratios to about 4 per cent in two steps (December 1993 and May 1994). The December 1993 recapitalisation, which brought the state banks' capital adequacy ratio to about zero after specific

⁴⁰ Rasmann (1994).

⁴¹ Lajtai (1994), Simóka (1994), and Szekeres (1994).

provisions, amounted to Ft 114.4 billion (3.4 per cent of GDP) in the form of government bonds. At the same time, bank claims with a nominal value of Ft 61.3 billion were swapped for Ft 57.3 billion (1.7 per cent of GDP) in government bonds. The recapitalisation in May 1994, which brought the capital ratios to about 4 per cent, amounted to Ft 30 billion (0.8 per cent of GDP).

The bad loan work-out programme requires the participating enterprises to propose restructuring plans to their bank creditors. Rejection opens the door to legal liquidation proceedings.

The two recapitalisation programmes have restored, at least temporarily, the capital base of the Hungarian banking system, but have contributed relatively little to enterprise restructuring (in both financial and real terms). Only a limited number of restructuring plans have been accepted to date. The mild conditions associated with the repeated bank recapitalisations have also aggravated the associated moral hazard problem.

*Poland*⁴²

Poland has pursued a multi-track approach to privatisation, in which the responsibility for initiating privatisation rested at the enterprise level. The initial aim, as reflected in the 1990 Privatisation Law and in the initial strategic goals for privatisation, was to achieve the rapid privatisation of state assets through three primary channels and to leave restructuring to the new owners of the assets. Implementation was slower than anticipated, however. To provide further impetus to privatisation, a number of additional measures were adopted in 1993. These include the Law on the Financial Restructuring of Enterprises and Banks, the Pact on State Enterprises, and the Law on National Investment Funds (the mass privatisation programme).

The 1990 Privatisation Law stipulates that state enterprises can be privatised at the initiative of their own managements and workers' councils through two tracks. The first consists of converting the enterprise into a joint-stock company or limited-liability company owned by the state treasury. These shares must then be sold within two years through an initial public offering, auction or invitation to tender. The second provides for the liquidation of an enterprise subject to the approval of the Ministry of Privatisation. In this case, the assets can be sold, used as a contribution to the equity of a new company, or leased for a fixed period.

The 1991 Law on State Enterprises provides a third track to privatisation of assets for those enterprises encountering financial difficulties. This law provides for the legal bankruptcy and liquidation of state enterprises.

At end-1993, 32 per cent of the 8,772 enterprises owned by central government agencies at the outset of reforms (and about 20 per cent of the 4,500 owned by regional governments) had initiated privatisation proceedings; however, only 12 per cent of these enterprises had achieved private ownership. Of the 522 enterprises converted to state Treasury-owned companies, 98 had been sold to private investors. Another 887 enterprises had applied to the Ministry of Privatisation to liquidate their assets under the 1990 Privatisation Law. Of these, 734 liquidations had been completed, 68 per cent of which were leased to employees' companies. Another 1,111 enterprises had initiated legal bankruptcy and liquidation proceedings under the 1981 Law on State Enterprises, but only 215 cases had been adjudicated.

Several new measures were launched in 1993 to quicken the pace of full privatisation. These were aimed at increasing support for privatisation by enterprises' managers and workers, introducing a mass privatisation programme for large and medium-sized enterprises in relatively good financial condition, and establishing an efficient, decentralised means for the financial restructuring of enterprises and banks.

The 1993 Pact on State Enterprises aims to encourage privatisation initiatives on the part of enterprise managers and workers by giving them a fixed time period to submit a privatisation proposal to the Ministry of Privatisation, after the parliament approves the necessary legislation. If no acceptable proposal is forthcoming, the Minister of Privatisation or the appropriate founding body would be free to determine the method of privatisation. The Pact also changed the rules on preferential allocation of shares. Pending the necessary legislation, the Pact would provide for the allocation of 10 per cent of shares to employees free of charge, while another 10 per cent would be reserved for employees at the market price. Under the 1990 Privatisation Law, employees can purchase up to 20 per cent of the shares at half the offering price.

The 1993 Law on National Investment Funds initiated a mass privatisation programme, which is now expected to begin operations in late 1994. The programme will allow for the rapid privatisation of about 450 large and medium-sized enterprises that are in relative good financial standing. The enterprises selected for the programme will be converted into joint-stock companies and their shares will be transferred to newly established national investment funds (NIFs), of which there will be about 20. Each company will have the same initial shareholding structure: 33 per cent will be held by a lead NIF; 27 per cent will be distributed equally to all other NIFs; 25 per cent will be retained by the state; and 15 per cent will be allocated to

⁴² Lipton and Sachs (1991), Berg (1994), Wojciechowski and Michel (1994), Kawalec, Sikora and Rymaszewski (1994a, 1994b), Rosati (1994).

employees free of charge. The selection of the initial group of NIFs is to be completed by autumn 1994. Once the programme is in operation, the shares in the NIFs will be listed on the Warsaw Stock Exchange.

The 1993 Law on the Financial Restructuring of Enterprises and Banks targets those enterprises that have found it difficult to service their loan obligations to the state banks. The first step in the Polish programme involved a recapitalisation of the state banks, including the savings bank and agriculture bank, to raise their capital adequacy ratios to 12 per cent, after allowing for provisions against bad loans. This recapitalisation, which was completed in 1993, amounted to Pzł 21 trillion (1.5 per cent of GDP). The necessary loan loss provisions were based on special audits of the banks carried out in 1991. The bad loans were then separated in the banks' accounts and assigned to work-out departments within the banks for management.

Those banks that received capital from the government were obliged by March 1994 to restructure their bad loans. This could be achieved through a conciliation agreement with debtors that were not fully servicing their obligations. To implement these plans, the creditors could write off or reschedule part of their claims or convert them into equity. Plans that received approval of creditors holding at least 50 per cent of the claims by value became binding on all creditors (cram-down procedure). The other options to reaching a conciliation agreement were debt sales on the open market, court declared bankruptcy, or liquidation of the enterprise under the privatisation law or Law on State Enterprises.

The incentive for banks to participate in the restructuring arose from the *ex ante* recapitalisation, the commercialisation and privatisation of strategy for banks, and close monitoring by the Ministry of Finance (one bank manager was dismissed for attempting to manipulate the recapitalisation programme).

The Polish programme appears to have worked reasonably well. At end-March 1994, banks reached conciliation agreements with debtors whose obligations constituted 82 per cent by value of the bad loans included in the scheme. Conciliation agreements accounted for 65 per cent of the loan restructurings by value and bankruptcy for 12 per cent, while 20 per cent regained creditworthiness. However, the savings bank and agriculture bank remain in poor financial condition and may require further recapitalisation.

While balance sheets of Polish banks have been strengthened, the task of restructuring the physical operations of the enterprises has not yet to begin in full.

The framework agreement between the Polish government and the EBRD on the Special Restructuring Programme aims to create an investment vehicle that will allow managers specialised in the turnaround of enterprises to take a lead in the restructuring.

*Slovenia*⁴³

In Slovenia, the approach to bank rehabilitation and enterprise restructuring combines both centralised and decentralised elements. A mass privatisation programme using vouchers has been initiated for enterprises that have relatively healthy finances. Responsibility for initiating their privatisation rests with the enterprises, but implementation plans must be approved by the Privatisation Agency. The state-owned Development Fund undertakes the restructuring and privatisation of the more troubled, larger enterprises, while the Bank Restructuring Agency (BRA) and Bank of Slovenia oversee the recapitalisation and privatisation of state banks.

The 1992 Law on Ownership Transformation of Enterprises provides for several privatisation methods, but a few general rules apply. The allocation of capital is subject to several constraints: 20 per cent is reserved for distribution among employees and former employees; 20 per cent is to be deposited with the state-owned Development Fund; and 20 per cent is to be transferred to two state funds (the Reimbursement Fund for Restitution and the Pension Fund). The remaining 40 per cent of shares are earmarked for sale to investors. The permitted sale methods are employee buy-outs, public tender, public auction and public issue. The legislation, however, provides for a strong incentive for employee buy-outs, allowing discounted payment over four years.

This privatisation scheme includes about 2,700 enterprises; by mid-1994, 215 have submitted privatisation plans. About 100 enterprises have been assigned to the Development Fund for restructuring. The Fund has sold 38 and proposed bankruptcy for another 12 enterprises.

To create an effective demand for the shares in the mass privatisation programme, every Slovene citizen has been given ownership accounts, the value of which is age-related. Special Investment Funds have also been set up to facilitate privatisation. The value in the ownership account can be used to buy shares in Special Investment Funds, to participate in employee buy-outs, and to purchase shares offered to the public.

The legal and regulatory framework for recapitalising banks laid the basis for the creation the BRA. This framework also allows the governor of the central bank to impose rehabilitation procedures on any bank with loan

⁴³ Korze (1994), Bank Rehabilitation Agency (1994), Voljc (1994) and Stiblar (1994).

losses in excess of 50 per cent of its capital and charges the BRA with responsibility for implementing these procedures.

In 1993, the BRA implemented rehabilitation procedures with two Slovene banks, in which the agency used its powers to take over the bank, suspend management and force the write-off of loan losses against capital. The agency recapitalised the banks by providing them with bonds, representing claims on the agency, in exchange for the bad loans in the banks' balance sheets. These bonds, denominated in Deutschmarks, have 8 per cent coupons and 30-year maturity (exposing the banks to considerable interest rate and foreign exchange risk). The agency provided the two banks with bonds amounting to DM 1.3 billion (6.3 per cent of GDP). Not all the banks' bad loans were transferred to the BRA, however, owing to fiscal constraints. The agency assumed those loans to debtors in the worst loan categories (these tended to be the larger enterprises). The BRA attempts to recover its assets in three ways: sale of claims at a discount, debt rescheduling and debt-equity swaps.

For those bad loans that have been retained by the Slovene banks, at least one institution has on its own initiative set up a work-out unit to manage these assets. This bank's strategy is to invest in those enterprises with operations complementary to that of the bank (factoring, leasing, trade finance) and to divest the others using debt-equity swaps.

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5. The framework of law in transition

A market economy presupposes the existence of certain basic economic freedoms. The legal framework underpinning these freedoms is being reconstructed, or constructed from scratch, in all the transition economies. This chapter gives a brief description of the progress made in building a legal framework, looking at six major areas: property, contract, security, bankruptcy, competition and company legislation. Passing legislation may be a step forward, but it is of limited relevance without effective implementation and enforcement. Predictably, progress on this front has been far slower, reflecting the need, among other things, for institutional reform in such areas as the courts and legal education and training.

This chapter should be read in conjunction with Table 5.1, which summarises recent developments in 25 countries.

5.1 Property law

The role of property law in market economies is to define the conditions of property ownership and the rights attached to it. Ownership has many dimensions including the right of disposal, control and access. Central to a market economy is the right of the owner of capital to the financial return, after taxation, generated by this capital. Property law may be seen as a crucial element of a market system. It facilitates title to property, the identification of assets or products available for economic transactions, and the agents that have to be considered in order to enter into such transactions.

The main characteristic of property law during the socialist period was the creation of a hierarchy among different types of property: “state” or “social” property (encompassing almost all urban industrial and commercial property), “cooperative” property (roughly coinciding with agricultural assets), property of trade unions and of other public organisations such as the Communist party, “personal” or “individual” property (usually restricted to one or two houses, and personal belongings) and, lastly, “private” property (which, where allowed, as in Hungary, Poland and the former German Democratic Republic, was defined as the private ownership of means of production, such as rental housing and assets of small, individually run shops and businesses). This hierarchy resulted in a largely unequal system of protection of ownership, in which “state” or “social” ownership enjoyed the greatest degree of protection, while private ownership rights were constantly threatened by the almost unlimited power of the state to expropriate the corresponding property or restrict its use.

One of the first initiatives of east European countries for the establishment of a legal environment capable of fostering market relations was the elimination of these distinctions. In particular, some central and south-eastern European countries such as Bulgaria, the Czech Republic, Hungary, Poland and the Slovak Republic have abandoned altogether the idea of differentiating between various forms of property. Whether embodied in national constitutions or in ad hoc laws, all countries of the region now grant individuals and legal entities the right to private ownership. They also guarantee that private ownership enjoys the same protection as public ownership. However, the rights covered by the term “ownership” often remain unclear. Sometimes the term is used in the laws to describe the entire set of rights that in Western countries are commonly attached to ownership (i.e. the right to use, alter, pledge and sell property, the right to receive any income generated by the property, and the right to prevent third parties from interfering with the property). Sometimes the term “ownership” is used to refer to just one or a few of those rights.

Furthermore, despite the assertion that all forms of property are now treated equally, rights attached to a particular type of property may still vary according to the nature of the agent owning it. For example, Russian property law, including the new Civil Code, which has inspired much other legislation in the Commonwealth of Independent States (CIS), does not grant certain legal entities exhaustive property rights. These entities include state-owned enterprises and institutions. While Russian property law recognises a particular form of limited property right by a legal entity consisting of the right to possess and make use of assets as though it were the owner, title to the property remains with the state or is heavily dependent on decisions taken by the owner. Such a fragmentation of property rights, combined with the lack of certainty as to which agents are allocated which property rights, can hamper private initiative at various levels. In the Russian example, the fragmentation of property rights among various persons and entities may restrict the establishment of joint ventures between foreign investors and CIS parties (whether they be private enterprises or state-owned enterprises) because some CIS parties cannot make in-kind contributions while title to the property remains with the state or with other owners. It also creates obstacles to the financing of enterprises. The right to create security over assets generally presupposes the right to dispose of them.

Table 5.1 Legal support for the market economy in each country in transition

Property Law		Contract Law
Albania	Law on the Sanctioning and Protection of Private Property (1991); Law on Land (1991).	Draft Civil Code approved July 1994 to come into force November 1994.
Armenia	Law on Ownership (1991); Land Code (1991).	Former Soviet Civil Code still applicable.
Azerbaijan	Law on Property (1991) recognises three types of ownership: state, collective and private. Land Code (1991): private ownership of land only allowed to Azerbaijani citizens.	Civil Code (1964) as amended. A new Civil Code is being drafted.
Belarus	Law on Private Property of Land (1993). Civil Code (1964) amended several times up to 1994. Law on Ownership (1990).	Civil Code (1964). Draft Commercial Code under preparation.
Bulgaria	Ownership Act (1990). Law on Ownership and Use of Agricultural Land (February 1991): foreigners prevented from owning land. Laws for the protection of intellectual and industrial property exist.	Law on Obligations and Contracts (1951, amended 1993): governs private non-business transactions. Commercial Code (1991, amended 1993-94): regulates commercial contracts.
Croatia	Former Yugoslav law adopted with amendments. Foreign companies and individuals granted the right to own property. May be subject to consent by the Ministry of Foreign Affairs.	Former Yugoslav Obligations Law (1978) as amended.
Czech Republic	The Civil Code of 1964 was substantially amended in 1991 and 1992. Act on Registration of Real Rights 1992. Land Act and other related laws (1990-91): foreigners may only own land through a 100% Czech-owned entity.	Civil Code for fundamental rules and Commercial Code (1991, amended 1993) for rules relating to commercial contracts (effective since January 1992).
Estonia	New Civil Code being prepared. Property Act (1990). Real Estate Law (1993).	New Civil Code being prepared. The first part in force since December 1993.
FYR Macedonia	Former Yugoslav law adopted.	Former Yugoslav Obligations Law adopted.
Georgia	Property Law adopted (1993).	Former Soviet Civil Code still applicable. The new Civil Code not yet adopted.
Hungary	Civil Code of 1959 as amended and several other ad hoc laws, e.g. Law XIV of 1991 eliminating the privileges attached to state property, or the Act On Arable Land of 1994 (foreigners prohibited from owning agricultural land unless allowed by another law).	Civil Code of 1959 as amended.
Kazakhstan	Land Code (1991). Law on Ownership (1990, amended 1993). Presidential edicts: (1) on Certain Questions Regarding the Regulation of Land Relations (1994); (2) on Further Improvements of Landholding Relations (1994). Decree no. 671 of the Council of Ministers, on the Activity in the Sphere of Protection of All Forms of Property (1993).	Civil Code (1963, amended 1990). Decree of the Supreme Soviet, on the Regulation of Civil Legal Relations in the Period of Conducting Economic Reform (1993).
Kyrgyzstan	Civil Code of 1964 still in force. Law on Ownership (1990). Constitution (1993): distinguishes state ownership from private ownership; ownership rights relating to private land are limited to the right to use the land and sell-buy it in restricted circumstances.	Civil Code of 1964 still in force. General part of the new Civil Code is being drafted.

Bankruptcy Law

Bankruptcy of State Enterprise Law (1992). Commercial Code is being drafted.

Draft Bankruptcy Law still in the process of examination.

A Bankruptcy Law has been passed by parliament but is not yet in force (and has not yet been published).

Bankruptcy Law (1991) amended in 1993 and 1994.

New Bankruptcy Law adopted in July 1994 as a chapter of the Commercial Code.

Bankruptcy Law came into force in July 1994 including special bankruptcy proceedings for banks.

Bankruptcy Act (1991, fully in force since April 1993). A debtor may apply for a three-month protective period.

Bankruptcy Law (1992): favourable to creditors in that it forces bankrupt enterprises into liquidation.

Former Yugoslav Bankruptcy Law of 1989 adopted.

Bankruptcy Law (1991). No significant effect yet.

Law on Bankruptcy (1991), was substantially amended in 1993. No more automatic bankruptcy for companies with 90-days overdue liabilities and no more required unanimity of consent of the creditors to decide for out-of-court restructuring.

Law and Decree on Bankruptcy (1992).

Insolvency Law (1993).

Anti-trust Law

Adoption of Law of Competition and Restriction on Monopolistic Activity expected in late 1994.

Law on Anti-monopoly Activity (1993): establishes a central body of executive power as a regulatory agency and authorises a special procedure for control of natural monopolies.

Creation of a State Anti-monopoly Committee (1991). Law On Combating Monopolistic Activity and Development of Competition (1992).

Protection of Competition Act (1991): regulates monopolies and unfair competition and establishes a special controlling body.

Draft Law on Competition and Monopoly being considered by parliament.

Law on Protection of Economic Competition (1991, amended in 1992 and 1993).

Competition Law adopted in June 1993.

Law on Monopoly and Competition in process.

Act on the Prohibition of Unfair Market Practices (1990). Sets up an anti-monopoly office, but this office is not empowered to order the break-up of large monopolistic firms.

Law on the Development of Competition and Restriction of Monopolistic Activity (1991). Anti-monopoly Law (1994). Defines "monopoly producers" as those with a domestic market share of at least 35% for the product(s) produced.

Anti-monopoly Law (1994). Defines "monopoly producers" as those with a domestic market share of at least 35% for the product(s) produced.

Company Law

Law on Commercial Companies (1992); Commercial Code is being drafted.

Law on Entrepreneurship and Enterprises (1992). Unclear distinction between the various business types.

Law on Enterprises (not yet published) has been passed by the parliament but is not yet in force. Law on Joint-Stock Companies currently being debated in parliament.

Law on Joint-Stock Companies, Companies with Limited Liability and Companies with Extended Liability (1992). Law on Enterprises (1990, amended 1993).

Commercial Law (1991): provides for joint-stock companies, limited liability companies and three types of partnerships. Rigid management imposed on limited liability companies.

Law on companies adopted and due to come into force in 1995.

Commercial Code provides business organisation types for medium to large-scale enterprises.

New Enterprise Law in preparation to replace the Enterprise Act and the Joint-Stock Company Decree of 1989, which were silent on many crucial points.

Former Yugoslav Company Law adopted (composed of several laws of 1988, 1989 and 1990). Unclear distinction between the various business entities provided for.

Law on Entrepreneurship and Enterprises in process.

Act VI of 1988 on Economic Associations: recognises four types of business entities (joint-stock company, limited liability company, limited partnership, general partnership).

Former Soviet Law applies: Law on Enterprises (1991) and Law on Economic and Joint-Stock Companies (1991, as amended 1993).

Law on Joint-Stock Societies (1991), Law on Enterprise (1991). The adoption of a comprehensive Company Law is envisaged.

Property Law

Latvia

Lithuania 1964 Civil Code still in force.

Moldova Law on Property (1991): establishes the right to own property and distinguishes three types of property (state, collective and private).

Poland Civil Code (1964, amended 1990). Law on Acquisition of Real Estate by Foreigners (1920) requires foreigners to obtain a permit from the Ministry of the Interior. Law on Land Management (1985) and Law on Expropriation of Real Property (1990, amended 1992) mainly affect state-owned property.

Romania Constitution (1991) recognises private property. Land Law (1991): prohibition of the ownership of land by foreigners, strict controls on the conversion of agricultural land to other uses.

Russian Federation General part of the new Civil Code approved in first reading by parliament in June 1994. Property Law (1990). Presidential edict (1993): grants citizens and juridical persons the right to own land. New Land Code under parliamentary discussion.

Slovak Republic Civil Code (1964 substantially amended 1991 and 1992). Land Act and several other laws (1990-91). Foreign ownership only allowed through a Slovak legal entity.

Slovenia Law on the Foundations of Property Relations (1980, amended 1990). The Constitution guarantees the protection of private property and prohibits foreigners from owning land.

Tajikistan Law on Property (1990, amended 1993): maintains a distinction between various types of property (state, collective and private).

Turkmenistan Private land ownership is now recognised by the law.

Ukraine Law on Ownership (1991, amended 1993). Law on Forms of Ownership of Land (1992). Land Code (1992). Decree no. 9 of the Cabinet of Ministers, on Supplemental Regulation of Leasing Relations (1992, partially repealed 1994). Decree of the Supreme Soviet, on Land Reform (1992, amended 1993). Law and Decree, on Pledge (1992). Law on the Lease of Assets of State Enterprises and Organisations (1992).

Uzbekistan Law on Property (1990, amended 1993). Private property is ill-protected. New legislative measures have been called for in the Presidential Decree on Measures for Further Deepening Economic Reforms, Protection of Private Property (1994).

Contract Law

Parts of the Latvian Civil Code of 1937 reintroduced by a law of July 1992.

1964 Civil Code still in force. Drafts of new Civil and Commercial Codes are being prepared.

Former Soviet Union Civil Code still applies.

Civil Code, amended in 1990.

Civil Code (1864, revised 1913 and 1920). Parts of the Commercial Code are still in force and regulate specific commercial transactions.

General part of the new Civil Code approved in first reading by the parliament in June 1994.

Revised Civil Code provides for general principles and Commercial Code regulates specific business contracts.

Yugoslav Law on Obligations (1978, amended 1985 and 1989).

Former Soviet Civil Code and Fundamental Principles of Civil Legislation (1991) still in force. General part of the new Civil Code in drafting process.

No contract law.

Civil Code (1963) still applies where not inconsistent with amending laws: On the Introduction of Changes to the Civil Code (1992 and 1993).

Former Soviet Civil Code and recent ad hoc laws.

Table 5.1: Legal support for the market economy in each country in transition

Bankruptcy Law	Anti-trust Law	Company Law
Bankruptcy Law (1992 and decrees of application of 1993).		Law on Entrepreneurial Activity (1990, amended 1993).
Bankruptcy Law of 1992, only put into practice at the end of 1993. No significant activity due to reluctance to bankrupt state-owned enterprises.	Legislation adopted in January 1992 but not yet put into practice.	The Company Law establishes two forms of joint-stock company (public corporation and closed corporation) and three forms of unlimited liability company (private enterprise, partnership and limited partnership). New Law on Stock Corporations passed July 1994.
Bankruptcy Law (1934, amended 1990): provides for reorganisation as well as liquidation; proceedings may be initiated by the debtor or the creditors. Law on the Procedure for Mutual Agreement (1934): only the debtor may initiate the procedure.	Anti-monopoly Act of 1990; Act on Counteracting Unfair Competition (1993) which also includes measures protecting intellectual property and the interests of consumers.	Commercial Code (1934, amended in 1991 to introduce the limited partnership form). The law does not provide for unlimited liability forms of businesses.
Bankruptcy Law in preparation; adoption will not take place before late 1994.	No anti-monopoly law adopted. General principles of competition may be found in the Law on the Restructuring of State Economic Units (1990) and the Law on Unfair Competition (1991), but these provisions are highly insufficient.	Company Law of 1990: authorises three types of partnerships, limited liability companies and joint-stock companies.
Bankruptcy law adopted in November 1992, came into force March 1993.	Law on Competition and Limitation of Monopolistic Activity in the Goods Market (1991). Other provisions may be found in laws dealing with the issuance of securities and the Stock Exchange.	Additional legislation on "stock associations" scheduled for 1994. Decree on Measures to Ensure Shareholders' Rights (1993). Law on Enterprises and Entrepreneurial activities (1990). Decree containing the Regulations on Stock Associations (1990): unsuitable for a market economy.
Bankruptcy Act (1991, fully in force since June 1993) provides for creditors or debtors to propose arbitration procedures or presentation of a bankruptcy petition; aims to give the debtor time to come to an arrangement with his creditors.	Law on Protection of Economic Competition (1991, amended in 1992 and 1993).	Commercial Code (1992): provides framework for types of business entities, including joint-stock companies.
Law on Compulsory Settlement, Bankruptcy and Liquidation adopted in December 1993: regulating the conditions for the execution and procedure of compulsory settlement and bankruptcy against debtors determined by this law.	Anti-monopoly Law (1993).	Law on Commercial Companies (1993) provides for four types of partnerships, limited liability company and joint-stock company.
Law on Bankruptcy (1992) has not yet been applied.	Draft of an Anti-monopoly Law has been submitted to parliament.	Law on Joint-Stock Companies (1992). Law on Enterprises (1993): firms are now granted the freedom to enter any commercial transactions.
Law on Bankruptcy (1992) has been rarely applied.	No anti-trust law despite the creation of an Anti-monopoly Commission".	Law on Enterprises.
Law and Decree on Bankruptcy (1992).	Law and Decree on the Limitation of Monopolistic Activities and the Prohibition of Unfair Competition in Entrepreneurial Activities (1992). Decree of the Cabinet of Ministers, on the Temporary Procedure for Determining the List of Enterprises that Occupy a Monopolistic Position (1993).	Law on Enterprises (1991) and Law on Business Companies and Partnerships (1991).
Law on Bankruptcy (1994): proceedings may be initiated by the debtor or creditors.	Law on Restrictions of Monopolistic Activities (1992); anti-monopoly regulations adopted by the government (1993). A special controlling body has been established which regulates prices practised by monopolistic firms, as well as mergers and acquisitions.	Law on Enterprises (1992).

Private ownership of land has been largely liberalised during the last few years. In 1994, a few countries (among them Azerbaijan, Tajikistan, Turkmenistan and Uzbekistan) still prohibit private ownership of land by their nationals and legal entities. In those countries, different forms of long-term or short-term leases are available. Various jurisdictions (including Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Ukraine) have also made an important move towards the development of markets for property by relaxing the rules concerning the transfer of land, buildings and leases. Under Russian law for example, various presidential decrees enacted in 1993 (whose legal validity is widely contested) granted private individuals and legal entities the right to sell and buy residential and agricultural land. However, only a few countries have abandoned the requirement of a governmental permit prior to sale (e.g. the Czech Republic, Hungary and the Slovak Republic). In some cases, the law may totally prohibit foreign nationals from owning real estate (as in Romania) or may grant local authorities preferential rights concerning land transactions. For example, Russian legislation provides for closed tender or auctions for land in cases where there are purchasers who have preferential purchase rights. Heavy restrictions are also imposed on the conversion of land to uses other than those for which it was originally intended.

The new property laws have introduced the broad principles necessary to establish markets (i.e. the right to private ownership and the right to transfer ownership). However, not all countries have implemented even these broad principles and in some cases the exact use of those rights is restricted. Another important issue is the general lack of reliable land registration systems. This makes it difficult to ascertain the identity of the actual owner of a particular piece of land, which in turn renders the validity of transactions over such property dubious. Efforts to introduce an adequate registration system are being made in Belarus, Bulgaria, the Czech Republic, Hungary, Kazakhstan, Poland, Romania, Russia, the Slovak Republic and Ukraine.

5.2 Contract and commercial law

In a market economy, the role of contract law is to provide a legal framework within which all contracts must be made, while still affording the parties to a contract freedom to define the terms of their relationship. This generally comprises the following elements:

- 1) The law sets the framework within which parties can freely contract. The law may impose provisions relating to the interpretation of a contract which supplement the terms explicitly agreed by the contracting parties.
- 2) The law imposes restrictions on the ability of a party in a strong bargaining position to exploit a party in a weaker position, and thereby protects traditionally vulnerable parties to contracts, such as consumers, tenants and employees.
- 3) The law provides a range of remedies for breach of contract, to provide a disincentive to parties not discharging their contractual obligations.
- 4) The law renders invalid contracts whose operation would lead to the committing of criminal offences.

In the context of a market economy, contract law should afford maximum freedom to economic agents to choose their contracting partners and exchange assets, products, services and rights. Contract laws under communism established different regimes for contracts between private parties (usually limited to non-commercial transactions and of limited scope given the minimal importance of private ownership) and contracts between state-owned enterprises. Private contracts were governed by the general principles of contract law contained either in the Civil Codes or in laws on contract, in countries where such Codes did not exist. Contracts between state-owned enterprises were regulated by separate statutes or by administrative orders and decrees. Disputes were resolved by state arbitration tribunals or, in the case of private contracts, by the courts. Another feature of socialist contract law was that, despite a theoretical recognition of freedom of contract, this freedom was constrained by the priorities imposed by central planning. State-owned enterprises were given little choice as to their contracting partners and the precise content of contracts was prescribed by law. Also, state enterprises would incur “pre-contractual” liability if they failed to conclude contracts designed to carry out state-controlled planning targets. Lastly, features of the centrally planned economy limited the range of available remedies in the event of a breach of contracts. The preferred remedy was specific performance (i.e. a ministerial order or arbitrage award¹ obliging the defaulting party to perform its contractual obligation). This was inadequate where the damaged party had suffered loss due to the delay in performance of the other party’s contractual obligations.

Since 1989, all countries of the region have reformed their contract laws to eliminate the distinction between private contracts and contracts among state enterprises. Some states have adopted new Civil Codes (e.g. Belarus in 1993) or greatly revised the pre-existing codes (e.g. Czech and Slovak Republics; 1964 code amended in 1991). In other states, new Civil Codes are currently being prepared (e.g. Albania, Estonia, Kazakhstan, Kyrgyzstan, Lithuania, Russia and Tajikistan). Irrespective of the parties involved,

¹ The “State Arbitrage” system was a feature of a centrally planned economy under which state-owned enterprises settled disputes that had arisen between them relating to performance of contractual obligations.

all transactions are now governed by the provisions of the Civil Codes or statutes which previously were applicable only to private contracts. Moreover, all laws that reflected socialist ideology (for example, voidability of contracts inconsistent with the “rules of socialist coexistence”) have been abrogated.

The present contract laws of the region appear on the whole to be consistent with the development of a market economy. Indeed, even though the statutes may not always be detailed and are, in some cases, quite old, they include adequate basic principles governing commercial transactions. These include provisions on the making and acceptance of offers so as to create binding obligations, as well as on causes of invalidity of contracts, rules relating to dealing in bad faith, and minimum terms without which the contract would be void. Some countries (including Belarus, Hungary, Poland, Romania, Russia and Ukraine) are parties to the 1980 Vienna Convention on the International Sale of Goods. Commerce can function with a relatively small body of contract law because most contractual terms are decided by the parties themselves, creating binding obligations. However, in the absence of a fully developed law of contract, greater effort is required of the parties to anticipate every possible development relating to the transaction and to “legislate” in advance to cover a range of contingencies.

The adoption or restoration of commercial law, covering various types of business transactions and defining standard terms, reduces uncertainty and helps to introduce uniformity, thereby facilitating the development of business. Standard terms seem to be particularly needed in countries where private business is not yet developed. The most advanced commercial code, regulating a wide range of contracts, is the 1991 Code used in both the Czech and Slovak Republics. Commercial codes are also in force in Bulgaria and Romania, but they cover only a limited number of transactions.

A crucial problem is the lack of adequate remedies, as, in all countries of the region, courts have very limited experience in commercial disputes and almost no experience in complex transactions. The remedies available for breach of contract generally do not provide for adequate compensation. There is also a lack of commercially trained judges. The consequent uncertainty over contractual enforcement leads to economic inefficiency at various levels. Economic agents are more inclined to deal with long-term associates and to avoid transactions with other parties with whom they are not closely connected. Firms will also be tempted to internalise more functions instead of contracting with external agents.

5.3 Security law

The taking of security is problematic under east European and CIS laws, since the laws on security do not provide adequate protection to creditors, creating obstacles to raising finance.

Taking security over land may be feasible, provided the ownership rights under the property law are clearly defined. For instance, some countries, such as the Czech Republic, Romania and the Slovak Republic, do not permit foreigners to own land or buildings, so that when a creditor wishes to obtain a mortgage, the sale can only be made to a domestic purchaser who may not be able to pay a price corresponding to what would be the property’s value in the absence of this restriction.

In the case of pledges of moveable assets, in many countries the creditor must take possession of the pledged property at the time security is taken due to the absence of official registries for pledges. The activity of the debtor enterprise is thereby hampered as it will often need all of its assets to carry out its trade. Possession may also be necessary for the protection of the creditor’s rights against third parties as there is no registration system for pledges. The laws on pledge in Estonia, Kazakhstan, Kyrgyzstan and Russia provide for pledge registers, but effective registers have not yet been established. In some cases the requirement of physical possession by the creditor may not apply when the creditor is a financial institution (e.g. in Bulgaria, Hungary and Poland). In this case, the pledge usually needs only to be recorded, but the register of pledges is maintained internally by the creditor bank and is not available for public inspection.

Provisions for taking security over intangible assets, such as contract debts, negotiable instruments (e.g. bills of exchange and promissory notes), securities (such as shares) or intellectual property rights are also underdeveloped. These are all of great practical importance to modern financing techniques.

In the case of all types of security interests, almost all laws of the region require court action in order to enforce the security, but the conditions of sale are rarely clear. Exceptions may exist for security taken by banks. Moreover, few countries adequately address the issue of fraudulent transfers of property resulting in the deprivation or limitation of creditors’ rights. Certain countries’ laws do address these concerns (e.g. the Czech Republic, Hungary, Poland, Russia, the Slovak Republic and Ukraine), but no jurisprudence has yet developed in this area. The EBRD has developed a Model Law on Secured Transactions as a first step towards addressing the problem of inadequate protection of security interests. Draft laws on secured transactions in Hungary and Poland have drawn on aspects

of the Model Law. Several countries are using it as a point of reference and are now working with the EBRD on efforts to establish workable secured transactions laws.

5.4 Bankruptcy law

Many Western bankruptcy proceedings place an insolvent enterprise under court supervision until the court decides whether the enterprise should be wound up through liquidation or allowed to carry on its business on a restructured basis. During the “observation” period, various steps are taken to identify the debtor’s assets and liabilities, to proceed with the orderly collection and realisation of those assets, to arrange for payment of secured creditors’ claims in an established order of priority and thereafter of debts owed to unsecured creditors, and to investigate the debtor’s conduct to find out whether there are grounds for criminal prosecution (e.g. if proper books have not been kept). Generally, western European laws emphasise the protection of creditors whereas the US model is more protective of the debtor enterprise.

Bankruptcy laws are intended to ensure, first, that insolvent firms do not survive; and, second, through bankruptcy reorganisation, they seek to prevent the premature termination of viable enterprises by discharging them of some liabilities and restructuring the business so that only the “healthy” components survive. The existence of strict bankruptcy laws can encourage the development of a private credit market. The threat of bankruptcy can also encourage efficient enterprise management. The possibility of bankruptcy proceedings, especially those involving state-owned enterprises, can be an important tool in the transformation from command to market economies.

During the socialist period, bankruptcy laws were almost non-existent as most commercial transactions were carried out between entities owned by the state. In such a context, there was no conflict of interests between creditors and debtors triggering bankruptcy proceedings. A state-owned enterprise unable to meet its liabilities would be granted loans or subsidies, could obtain debt reduction through “compulsory settlement” and, in the most serious situations, would be administratively reorganised or sometimes liquidated.

Several countries now have bankruptcy laws, but often these remain rudimentary. For instance, they may not define precisely the grounds for recourse to bankruptcy proceedings or amicable settlement or how creditors’ claims must be proved. The most developed laws in this field may be found in the Czech Republic, Hungary, Poland and the Slovak Republic. Hungary has the most complete set of rules. The Hungarian Law on Bankruptcy Procedures of 1991, as amended in 1993, indicates that a reorganisation of the debtor enterprise is to be preferred and that liquidation

is to apply only if the debtor cannot agree with a majority of the creditors on a reorganisation plan. Such a reorganisation may be undertaken as a result of bankruptcy proceedings or as part of an out-of-court settlement.

In some jurisdictions the law provides for liquidation and a court-supervised or amicable reorganisation plan. Furthermore, the Hungarian law envisages that the reorganisation plan should go further than just a financial scheme designed to settle the defaulting enterprise’s debts: it should also contain proposals for real restructuring (e.g. measures designed to increase the firm’s income) to make the enterprise more competitive in the longer run.

Under bankruptcy laws of the region there are difficulties in the ranking of creditors in the distribution of the proceeds of a liquidated enterprise. In some countries (e.g. Hungary, Kazakhstan and Poland), secured creditors’ claims are satisfied after workers’ claims, taxes, social insurance and insolvency expenses have been paid. When the same asset has been pledged as security to different creditors, the rules establishing priority between creditors are complex and difficult to apply in practice owing to the lack of reliable registration systems. This uncertainty may deter creditors from initiating bankruptcy proceedings and, more generally, renders the granting of all forms of credit (whether secured or unsecured) more risky. Some countries do give bank lenders a privileged status in bankruptcy proceedings. The Polish Financial Restructuring Law (1993), for instance, gives Polish bank creditors wide powers to establish arrangements with the debtor binding on all other creditors.

In general, bankruptcy laws in the region have rarely, if ever, been applied, and there is little court practice in this field. In some countries, protection from proceedings has been granted to state enterprises and soon to be privatised firms for a certain period, to facilitate the privatisation process (as in the Czech Republic). Most procedures are cumbersome and there are often no strict time limits imposed for each stage of the proceedings. This not only delays the outcome unnecessarily but may also result in a further decline in value of the debtor’s assets.

5.5 Competition law

Competition policies are required to deal with the consequences of a failure of the free market in which enterprises (or individuals) are able to escape market discipline and take advantage of inadequate competition (or prevent competition) to make excess profits or act inefficiently. Western competition laws are designed principally to prevent the creation of anti-competitive structures and anti-competitive behaviour, or to restore competition when it has collapsed, which may be the result of mergers, abusive conduct by dominant firms or anti-competitive agreements. East European and CIS competi-

tion laws often deal with these issues alongside unfair competition (i.e. deceptive trading practices such as misuse of trade secrets, imitation of products, misleading advertising, etc.) and sometimes even include other matters (e.g. antidumping under Slovene law, and protection of consumers and intellectual property under Polish law).

Competition laws have been enacted in most countries of the region. In some countries, including Armenia, Croatia, Georgia, Romania, Tajikistan and Turkmenistan, they are under consideration. The existing laws set up independent agencies charged with enforcing competition laws by imposing sanctions on offenders. Their authority usually includes the power to examine merger and acquisition proposals and to block their implementation if they are considered to be likely to affect competition adversely. In Bulgaria, the scope of the authorities' power is limited to the regulation of firms that are already monopolistic. In Hungary, such power is limited to the examination of large firms' merger proposals. Bearing in mind the particular purpose that competition law has to serve in a transitional context, namely to stimulate competition in an environment in which state-owned monopolies are undergoing privatisation, some laws have gone further. Competition enforcement agencies have been given a role in the privatisation process and the break up of existing monopolies. This is the case under Czech, Polish, Russian, and Slovak laws. In some cases, these agencies have been granted even broader powers. The Kazakh agency, for instance, is also given responsibility for the promotion of the private sector. The Russian agency is allowed to control prices of items produced by monopolistic enterprises.

Regarding anti-competitive behaviour, the laws of those countries that have competition laws ban horizontal and vertical restrictive practices and abuses of dominant positions, and introduce merger controls. The practices envisaged generally correspond to those found in Western and EC legislation. The severity of the prohibition on horizontal and vertical restraints differs from one country to another. Slovene law, for example, prohibits horizontal restraints (e.g. cartel agreements in restraint of trade) and vertical restraints (e.g. refusals to deal and "tied" sales). This applies irrespective of the actual effect on the market. Hungarian law establishes numerous exceptions to the prohibition on horizontal restrictive practices (e.g. they are allowed between parties that collectively represent less than 10 per cent of the market share, or, even more generally, if the advantages of the agreement outweigh its disadvantages for the economy). Hungarian law also forbids vertical restraints only if firms are in a dominant position. In Bulgaria and Poland, prohibitions of horizontal and vertical restraints are not strict: in most cases, wide discretionary powers are given to enforcement agencies to exempt such practices.

Such flexibility may be more appropriate during transition as it encourages defensive cooperation among private firms against existing state monopolies. At the same time, the nature of the discretionary powers of competition agencies create uncertainty as to which practices actually constitute illegal conduct, which in turn may slow down business initiatives. Moreover, there is still the familiar problem of the very limited application of competition laws and the general absence of effective enforcement.

5.6 Company law

In a market economy, company law provides a legal framework for enterprise and trade. This is done through the recognition of companies as legal persons in their own right, enabling them to acquire and own land, to enter contracts, and to sue and be sued in the courts. The significance of this is that the rights and obligations thereby acquired by a company are not directly those of the company's shareholders and directors, so that these individuals are personally protected from the consequences of their direction of the company's affairs. Hence, company law creates the possibility of limited liability.

Company laws are now in force in most east European and CIS countries or are in the process of being enacted. However, the majority are not yet adapted to a market economy. In the company laws of most CIS countries, detailed rules for the formation, capitalisation, registration, operation and management are provided only for joint-stock companies. The classifications adopted by many CIS countries are confusing in that some business types are defined in connection with the origin of the assets. For instance, Russian law (and the laws of most other CIS countries) envisages cooperatives, state enterprises and family firms as specific types of business without defining rules by which these may be organised. It is not clear whether these forms of business constitute limited or unlimited liability companies. Some other forms of business are defined in relation to their function.

6. Taxation and transition

6.1. Introduction

Taxation is fundamental to transition. In a command economy, planning dominates resource allocation and the role of taxation is largely nominal. It is simply the difference between output and what the government chooses to release to private households or firms. In a market economy, on the other hand, most goods and services are generated in the private sector, and if the government wishes to use resources it must finance their acquisition, primarily through taxation. The creation of an effective tax system is therefore a logical priority of the transition.

It is also an urgent priority. The old tax base lay mainly in the profits and turnover of state enterprises. The emergence of competition and the obsolescence of the existing enterprises at the outset of transition meant that profits quickly fell, as did output. As a result, revenue has fallen early in the transition process. The fall has been exacerbated by the breakdown of administrative arrangements for collection. Incentives for firms to report to authorities have also changed. The firms were previously well identified, large and had little incentive to evade. They had incentives to bias their reports of output upwards. As output and employment have moved outside the state sector, collection and compliance have become serious problems. Many private firms, emerging with the new opportunities, are initially small and not so easy for the authorities to track. Firms wish to conceal profits and turnover to keep down tax liabilities. Less centralised payments systems which emerge as a result of financial liberalisation during the transition make this evasion easier. Accounting practices are embryonic and unreliable. The authorities are themselves in a state of transition with changed powers, changed practices in administration and a new and changing system to implement. For all these reasons it is hardly surprising that, as is documented in this chapter, changes in the tax system are lagging behind changes in the economic system and that tax revenues have sharply declined.

A slow and irresolute response in constructing an effective tax system was a central ingredient in the inflation that hit many countries in transition. The inflationary tendencies were accentuated by the pressures on expenditures through, *inter alia*, the support of threatened enterprises, the acquisition of some responsibilities for social expenditures of firms, and a desire to invest in an infrastructure that can sustain and promote private sector development.

The task facing governments is to introduce a new tax system. The inherited system is not generally suitable for gradual reform. The new, market-oriented tax system should produce the necessary revenue in a way that *distorts as little as possible* the incentives to the entrepreneurial spirits which will be the driving force of the new economic system. Thus efficiency is a crucial criterion. If it is to function effectively, the tax system should be *simple* to administer for both the authorities and the taxpayers. It should be *stable*, admitting only a minimal number of changes to tax structure and rates. In revenue terms it should be *robust* to changing structures of the economy. For effective political discussion and decision-making it should also be *transparent* in its effects. It should also be *equitable*. Given growing political decentralisation in the region, the new tax system should be sensitive to the relationship it embodies between *different levels of government*. The design and implementation of a tax system that balances these stringent criteria is a daunting task.

A major purpose of this chapter is to set out the problems and developments of the tax system in transition, establishing its centrality, likely movements and policy challenges. An understanding of the role of tax reform in raising revenue and thereby *containing destabilising inflationary pressures* is crucial. Even more fundamental for the transition in the medium term is the tax regime faced by firms in taking their investment decisions. Tax systems that are confiscatory or haphazard can destroy the incentive to invest. Alternatively, or in addition, they can accentuate the practices of evasion and corruption which can become corrosive and systemic. Inflation exacerbates these problems both through the very high tax rates likely to emerge in a less-than-fully indexed tax system¹ and because of its capricious impact across different kinds of activity.

The challenges facing firms in a new environment are already considerable, and they can be greatly compounded by a tax system that is subject to rapid, numerous and radical changes in policy, and conflicts between different levels of tax authority. A second major purpose of this chapter is therefore to highlight the impact of tax policy on the circumstances of enterprises and, particularly, their investment decisions. The importance of the tax regime is reflected, among other things, in the adverse impact that haphazard and ill-conceived tax regimes can have on foreign direct investment (see Box 6.3). This is of particular interest to the EBRD, which is dedicated to encouraging the emergence of the private sectors in eastern Europe.

¹ See EBRD *Annual Economic Outlook* 1993, Chapter 3.

The chapter is structured as follows. Section 6.2 contrasts the functioning of Soviet-type and Western market-based tax systems and tracks the extent of the transition between these two forms in eastern Europe and the former Soviet Union between 1989 and 1993. Section 6.3 examines the important issue of taxation of different types of enterprises, placing particular emphasis on investment incentives and private sector development. Section 6.4 focuses on the impact of fiscal and political decentralisation, which is a growing trend in the region, and Section 6.5 concludes.

6.2. Taxation in transition

The challenge of tax reform in the region is to replace, speedily, implicit Soviet-type systems of revenue allocation with explicit market-based tax systems to ensure both that adequate revenue is raised and that the new tax environments are conducive to market functioning and private sector development. Charting the content and extent of the tax transition in eastern Europe and the former Soviet Union is the subject matter of this section. Section 6.2.1 describes the functioning of Soviet-type systems and places these systems in an international context. Section 6.2.2 traces developments in the tax system between 1988 and 1993 and examines current attributes of the tax systems. Section 6.2.3 brings together these different strands and offers some tentative directions for further reform.

6.2.1 Initial conditions and international context

The pre-reform revenue allocation system

In Soviet-type economies resource allocation was regulated by a central plan. This was a quantitative plan for the allocation of all inputs and outputs in the public sector. In principle, planners had the task of determining the optimal resource allocation for the economy, while balancing supplies and demands on both microeconomic and macroeconomic levels. Its counterpart was the financial plan consisting of the state budget, the credit plan, the cash plan and the foreign exchange plan. Given the administratively set prices and quantities, the financial plan was essentially an accounting exercise which had two main purposes: on the one hand, it had to reflect the consistency of the material plan to which it was subordinate and, on the other hand, it had to facilitate economic transactions.

The administration of the state budget in Soviet-type economies was also fundamentally different from Western-style tax administration: it represented the administration of the entire payment system. Virtually all payments were made through the state financial sector which consisted of the state monobank and various funds. Inter-enterprise transactions were effected through immediate debiting and crediting of largely earmarked accounts in the monobank.

The intermediation of savings and investments of enterprises was implemented mainly through the state budget, in particular through the turnover tax and the full transfer of the enterprises' residual income.

The fact that the vast majority of financial flows were channelled through state enterprises had several implications. The bulk of revenue could be raised using a limited number of taxes levied on state enterprises. Since these enterprises were few and highly monitored, both the administrative costs of collecting taxes and tax evasion were minimised. Moreover, taxes could be adjusted *ex post*, making statutory tax rates irrelevant. Since prices did not have an allocative function, the tax system, in principle, was non-distortionary. Explicit taxes were supplemented by wage controls, which acted as a tax on earnings, and by low interest rates, which acted as a tax on financial savings and as a subsidy to firms receiving credit.

As a consequence, large surpluses would accrue to the state enterprise sector. These surpluses were then captured by a mixture of turnover taxes on goods, profit taxes and payroll taxes. The revenues would be used to support loss-making enterprises, to finance investment and to provide pensions and other income support. Income support schemes included consumer subsidies to keep down the prices of consumer goods which, when combined with guaranteed employment and free or subsidised social services, constituted an effective social security system.

Turnover taxes, which were the main form of indirect taxation, formed the wedge between producer and consumer prices. Because these different prices were set independently, a large number of different rates of turnover tax were involved. These rates were frequently adjusted to reflect planning decisions to raise or lower producer or consumer prices. Because the state determined output, production costs and output prices, profit and profit taxes were concepts of little substance. Profit taxes were simply mechanisms by which the state extracted the financial surplus of enterprises. Since the state was the sole owner of enterprises there was no need to distinguish between dividends and taxes. All pricing and production decisions were made by the state, therefore different taxes had neutral effects on both efficiency and incentives. This meant that it made little difference which tax was chosen to raise a given quantum of revenue.

The government budget (i.e. the financial plan) not only played a very limited role in resource allocation but also for stabilisation. Only when production or external shocks occurred, or when there was a demand imbalance emanating from the household sector, did some stabilisation through the fiscal system become necessary (see Gregory

and Stuart, 1986). The budget was fully under the control of the government, hence fiscal balance could be ensured and fiscal deficits were on the whole very small (see Cheasty, 1992).

Tax composition: some international comparisons

Following international conventions² tax revenue can be broken down into three main categories: direct income and social security taxes, domestic indirect taxes, and foreign trade taxes. Table 6.1 (opposite) shows the composition of tax revenues in industrial, developing and transition economies, respectively. The same information has been used to produce Chart 6.1 (opposite). It shows that at this level of aggregation, and for the late 1980s (i.e. pre-transition), the tax composition of the industrial and transition economies appears similar. These sets of countries obtained roughly two-thirds of their tax revenue from income and social security taxes. The other third they obtained from domestic indirect taxes, leaving them with little dependence on foreign trade taxes. The closeness of the averages for industrial and transition economies is not surprising, given the high level of industrialisation in eastern Europe and the former Soviet Union and the fact that industrial enterprises represented the main source of taxation. In contrast, the developing economies have an average of roughly one-third of revenue from each of the categories, placing the average close to the centre of the triangle (see Table 6.1 and Chart 6.1). In these countries, where the industrial base is on the whole much less developed, there is much stronger dependence on “barrier” taxes (i.e. trade taxes and excises) and the taxation of domestic transactions (i.e. sales tax and VAT), and less dependence on direct (income and social security) taxes – see Burgess and Stern (1993).

Between 1989 and 1993, the tax structures of the transition economies shifted toward lessened dependence on income and other taxes levied on enterprises and greater dependence on foreign trade taxes. This latter trend was largely a short-term response to meet growing revenue demands and reflected the increasing inability of tax systems in eastern Europe and the former Soviet Union to raise adequate revenue by other less distortionary means. In this respect, the transition economies are moving towards developing country tax structure.³

The proximity between the 1989 transition and Western industrial averages in Chart 6.1 can be misleading, however, since it masks basic differences in the composition and functioning of these two types of tax system. The small shift between the 1989 and 1993

transition averages also underplays the extent of the tax transition, partly because the types of taxes included under each of the broad headings has changed a great deal. Fundamental tax reform has been undertaken by the majority of countries in transition. For example, in many countries cascading turnover taxes levied at a multitude of rates on numerous industrial products have been replaced by VAT systems, which are less distortionary for a market economy and extend beyond the production stage. The transition in taxation has, however, been a largely ad hoc process and progress has been patchy (see the transition indicators in Appendix 2.1). Examining Chart 6.1, it is likely that transition economies will move towards the centre of the triangle in their urgent search for sources of revenue in the short and medium term. Initially they are likely to make greater use of domestic indirect and trade taxes. Developments, such as the introduction of a comprehensive system of personal income taxes, are then likely to shift the average back toward the industrial economy average during the later stages of transition. As transition closes, different countries are likely to be left at different positions along the continuum between the developing and industrial country averages, depicted in Chart 6.1, depending on the level of development they will have achieved.⁴

6.2.2 Recent developments in fiscal reform

This subsection traces both the emergence of fiscal deficits in the region between 1989 and 1993 and the patterns of tax and expenditure change underlying this development. The picture varies greatly across the region.

Levels of taxation and expenditure

Total tax and expenditure levels as a percentage of GDP are presented in Table 6.2. Tax levels, in particular in 1989, are high by international standards (as would be expected in economies dominated by the state). The fall between 1989 and 1993 can be interpreted as an overall decline in the role of the state. One clear pattern emerging from Table 6.2 is that, while tax levels showed marked declines for nearly all countries, the decline in expenditure was less pronounced. Expenditure levels increased in almost half of the countries for which there are comparable data. The resilience of expenditure reflects in part the political difficulties associated with cutting such items as transfers to non-performing enterprises, public sector wage bills and procurement, price subsidies and social expenditures. This mismatch in the tax and expenditure movements during the tax transition has led to strongly rising fiscal deficits. In 16 out of the 23 countries for which there are comparable

² See for, example, the IMF *Government Finance Statistics Yearbooks*.

³ It must be recognised that this average conceals a great deal of variation within developing countries.

⁴ For example, we might expect that Turkmenistan would remain closer to the centre of the triangle, while the Czech Republic would end up lying closer to the industrial country average.

Box 6.1

Tax structure in industrial, developing and transition economies

Table 6.1 shows a decomposition of total tax revenue for three groups of economies: industrial countries, transition countries (EBRD countries of operations) and developing countries (using the IMF’s distinction between “industrial” and “developing” countries).

The different make-up of taxes in industrial, developing and transition economies shown in Table 6.1 may also be illustrated using a triangle diagram (Chart 6.1). The points A, B and C represent, respectively, 100 per cent of tax revenue from income and social security taxes, 100 per cent from foreign trade and other taxes, and 100 per cent from domestic indirect taxes. A point on the line BC corresponds to a zero level of income and social security taxes. From Chart 6.1 it can be seen that the averages for the transition and industrial economies lie together near to the AC axis and close to the A corner, whereas the developing economies have an average close to the centre

of gravity of the triangle (i.e. where one-third of revenue comes from each category). The dotted line, which corresponds to having 15 per cent of tax revenue from foreign trade and other taxes, clearly separates the two sets of averages. Virtually all transition and industrial economies lie to the left of the line (i.e. obtaining less than 15 per cent of their tax revenues from foreign trade and other taxes), while the bulk of developing economies lie to the right of it.

Table 6.1
Mean Tax Shares in industrial, developing and transition countries (in percent of total tax revenue)

Country group	Income and Social Security taxes	Domestic indirect taxes	Foreign trade and other taxes
Industrial countries 1987	67.6	29.3	3.1
Developing countries 1987	38.8	30.0	31.2
Transition countries 1989	58.3	38.4	3.3
Transition countries 1993	59.1	31.8	9.1

Sources: Burgess and Stern (1993) and Table 6.5.

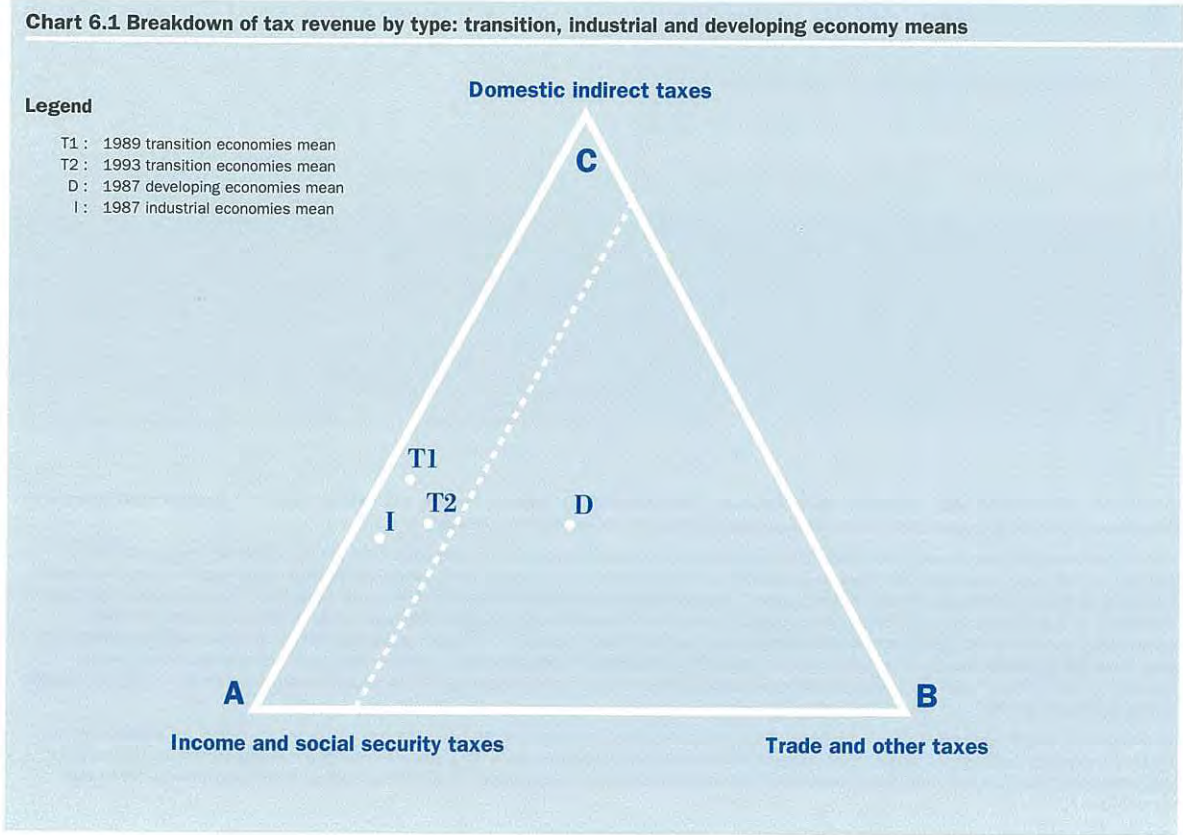


Table 6.2: Fiscal balances in countries in transition (in per cent of GDP) ¹

	Pre-reform/ Post-reform	Total revenue		Total expenditure		Fiscal balance	
		Pre-reform	Post-reform	Pre-reform	Post-reform	Pre-reform	Post-reform
Albania	1989/1993	51.3	28.0	56.8	44.1	-5.5	-16.1
Armenia	1991/1993	26.0	20.4	27.9	68.6	-1.9	-48.2
Azerbaijan	1991/1993	35.6	38.4	40.7	52.0	-5.1	-13.6
Belarus	1991/1993	49.1	47.5	45.5	56.9	3.6	-9.4
Bulgaria ²	1989/1993	60.0	30.6	61.4	45.7	-1.4	-15.1
Croatia	1991/1993	34.2	33.8	39.0	34.8	-4.8	-1.0
Czech Republic ^{3, 4}	1989/1993	62.1	49.0	64.5	48.5	-2.4	0.5
Estonia	1991/1993	36.4	32.5	31.8	33.9	4.6	-1.4
FYR Macedonia	1991/1993	36.8	34.3	40.4	45.0	-3.6	-10.7
Georgia	1991/1993	29.9	12.5	33.0	46.3	-3.1	-33.8
Hungary ⁵	1989/1993	48.5	47.5	49.3	54.5	-0.8	-7.0
Kazakhstan	1989/1993	35.4	22.4	35.4	23.5	0.0	-1.1
Kyrgyzstan	1989/1992	38.0	12.7	35.9	26.2	2.1	-13.5
Latvia	1991/1993	37.4	33.5	31.0	32.5	6.4	1.0
Lithuania	1989/1993	50.0	25.1	53.8	29.7	-3.8	-4.6
Moldova	1993		17.1		25.9		-8.8
Poland	1989/1992	41.4	44.0	48.8	50.7	-7.4	-6.7
Romania	1989/1993	51.1	30.9	42.7	31.0	8.4	-0.1
Russia ⁶	1989/1993	41.0	33.8	49.5	41.8	-8.5	-8.0
Slovak Republic ³	1989/1993	62.1	48.0	64.5	55.5	-2.4	-7.5
Slovenia	1993		49.8		49.4		0.4
Tajikistan	1989	41.1		38.6		2.5	
Turkmenistan	1989/1992	30.1	45.0	32.0	31.0	-1.9	14.0
Ukraine	1991/1993	38.3	42.3	51.9	55.6	-13.6	-13.3
Uzbekistan	1989/1992	35.0	33.5	35.9	46.5	-0.9	-13.0
Mean		41.2	33.9	43.0	42.9	-1.8	-9.0

Source: IMF, World Bank, and information provided by national authorities.

¹ For general government, including extrabudgetary funds. Blanks denote figures not available. Countries have different categorisations of expenditure. The translation of the "national" categories into the ones appearing in the table was done by EBRD staff using their best judgement, and an ambition of being consistent throughout, but there are certain uncertainties associated with the translation. As far as possible, expenditure figures are stated on commitment basis rather than on cash basis.

² Expenditure figure for 1993 is adjusted for unmet commitments and London Club interest deferrals.

³ Pre-reform figures for Czech and Slovak are 1989 figures for Czechoslovakia.

⁴ 1993 figure for Czech Republic excludes revenues from privatisation.

⁵ Consolidated state budget.

⁶ Pre-reform figures for Russia are 1989 USSR figures. Figures for 1993 include estimated surpluses on extra-budgetary accounts.

data the fiscal position worsened, in many cases markedly (see Table 6.2). Given the difficulties associated with borrowing and money/inflationary finance in the transition economies, an implication of these difficulties is that macroeconomic stability is contingent on profound and permanent fiscal corrections being made in the short and medium run (see Aspe, 1993, and McKinnon, 1993).⁵

The fiscal stance and off-budget expenditures

The measurement of the fiscal stance in transition economies is in itself an important step in designing macroeconomic policies, which may be severely complicated by inflation.^{6,7} In eastern Europe and the former Soviet Union considerable resource flows such as bank credits and transfers to enterprises are kept outside the budget, which therefore understates the fiscal deficit. Unified budgeting is required for appropriate assessment of tax requirements and expenditure liabilities. The large number of extrabudgetary items and differences in budget accounting practices also greatly weakens the validity of cross-country comparisons in eastern Europe.⁸ The Russian case is particularly illustrative in this regard. Box 6.2 shows the effect of inclusion of various extrabudgetary funds on the size of the fiscal deficit.

⁵ Development of the financial sector in eastern Europe has to some extent expanded the means of financing fiscal deficits. However, in the former Soviet Union lack of adequate tax income to finance deficits leads directly to money finance with strong inflationary consequences.

⁶ First, inflation tends to erode the information content of the price system and thus delays transition. Second, inflation can lead to inordinately high statutory tax liabilities for enterprises, thus encouraging evasion and leading to a discrediting of the tax system. Third, institutions that stabilise the system through indexation and the imposition of penalties for the late payment of taxes are largely undeveloped in eastern Europe and the former Soviet Union. As a result, enterprises are encouraged to delay tax payments, which can lead to a significant erosion of real revenue. Fourth, price distortions caused by inflation will tend to be more pronounced if some price and interest rate controls remain in place, as is the case in a number of transition economies. Fifth, in an inflationary environment firm-level accounting information becomes misleading and this complicates calculations of value and creditworthiness. This factor is likely to act as a significant deterrent to both investment and entry, since information on potential returns will be blurred. Taken together, these factors imply that inflation is highly damaging to private sector development.

⁷ With a constant ratio of debt to GDP, interest payments in GDP tend to increase with inflation to the extent that holders of government debt are compensated for inflation. This in turn is reflected in a higher level of expenditure within GDP (and hence a larger deficit) despite the fact that there has been no real increase in government liabilities. As a result, measured deficits tend to be higher in inflationary as opposed to non-inflationary periods, even though the real deficits may be identical.

⁸ This should be kept firmly in mind when interpreting Tables 6.2, 6.5 and 6.6 in this chapter.

Box 6.2

The fiscal implications of extrabudgetary funds in the Russian Federation, 1992-94.

As sufficient data are available only for 1992, that year is used to illustrate the quantitative and qualitative impact of these resource flows on the official budget balance. There are four major sources of non-budgetary resource flows in the Russian Federation:

- (i) *Off-budget operations of the federal government.* Amounting to Rb 864 billion or 5½ per cent of GDP in 1992, these expenditures were concentrated in investment, military conversion and working capital indexation. Since there were no corresponding revenues, their off-budget nature reduced the officially recorded deficit and allowed the government to obtain additional credit lines from the Central Bank of Russia (CBR) above the credit ceiling imposed by the Supreme Soviet (IMF 1993a).⁹
- (ii) *Import subsidies.* The government subsidised 45 per cent of all imports in 1992 by purchasing goods at world market prices and selling them domestically to importers at rouble prices below those implied by market exchange rates (which embodied a very low real value of the rouble). The average subsidy rate was 94 per cent. While some subsidies were included in the budget, the majority (11.9 per cent of GDP) was kept off-budget “(mostly in the form of counterpart funds)”. The total import subsidy in 1992 was 13.7 per cent of GDP (IMF 1993a: Table 13).¹⁰
- (iii) *CBR credits.* Given disagreement about the course of economic reform between the government and the CBR, and given the incomplete extrication of other republics from the rouble zone in 1992-93, the CBR extended substantial credits to commercial banks and other republics of the former Soviet Union. These amounted to 18.3 per cent of GDP for enterprises, and 8.5 per cent of GDP for other republics.¹¹ Since they constituted pure monetary expansion, their inflationary impact was considerable – particularly in 1992.¹² However, it could be argued that only the “subsidy component” of these expenditures represent “fiscal outlays” (with the rest being portfolio operations). This component may arise from debt forgiveness by the central bank or from interest rates being below market-clearing levels. The latter factor was particularly

important in Russia in 1992 when inflation was far higher than interest rates.

- (iv) *Extra-budgetary funds.* While there are over 20 extra-budgetary funds at the federal level, and an unknown number at the local level, the principal funds are earmarked for social purposes (Pension Fund, Social Insurance Fund, Employment Fund, etc.) and for investment purposes (Road Fund, R&D Fund, Fuel and Energy Fund, Metallurgy Fund, etc.). Some data on these funds are summarised in Table 6.3.

As is shown in Table 6.4, when these four off-budget items are taken into account, assessment of the fiscal balance changes dramatically. With proper accounting for these funds the size of the fiscal deficit in Russia rises from 9 per cent of GDP to 32 per cent of GDP. These numbers are computed on a cash basis, which implies that they understate the underlying deficit to the extent some government operations and interest payments were financed through non-payment (i.e. accumulation of arrears).

CBR credits and import subsidies were much reduced in 1993. As a result, the large gap seen in 1992 between the consolidated budget figures for the state and local governments on the one side and the “overall fiscal balance” (as defined in Table 6.4) on the other shrank in 1993. Mainly on account of the reduction in import subsidies, the difference between the consolidated deficit and the “enlarged” deficit (again using the definitions in Table 6.4) dropped to 2 percentage points in 1993 and the “enlarged” deficit fell from almost 19 per cent of GDP in 1992 to 8 per cent of GDP in 1993 (see also the detailed country tables in Appendix 10.1).

In terms of fiscal accounting, the continued existence of extrabudgetary funds still obscures the transparency of the public finances. The magnitude of off-budgetary resource flows leads to biased evaluations of the relative size of the public sector: in 1993 (Q1-Q3), for example, the revenue of all federal extrabudgetary funds amounted to 107 per cent of federal budget revenues, and 55 per cent of consolidated budget revenues (Dubinin 1994). Whereas consolidated revenues were only 31 per cent of GDP, the

⁹ In Table 6.4, these expenditures are included in the “consolidated budget of the state and local governments”.

¹⁰ With the appreciation of the rouble in 1993, the need for this policy was much reduced, so that the total subsidy in 1993 was only 2.3% of GDP (Delpla and Wyplosz 1994: Table 2). In early 1994 the policy was completely abandoned.

¹¹ While there are no data to estimate the repayment of these loans, it appears as if the commercial banks did service them in 1992, when real interest rates were highly negative, but less so since then. In 1992, the implicit interest rate subsidy was still very significant, even if repayment is assumed: assuming full repayment within one year, Delpla and Wyplosz (1994: Table 2) still estimate total subsidies to central banks as 9.3% of GDP, and to former republics as 3.7% of GDP.

¹² While credits to other republics of the former Soviet Union were scaled down in 1993 with the consolidation of the rouble zone (totalling Rb 2,158 bn or 1.3% of GDP), credits to commercial banks were still considerable, amounting to Rb 7,454 bn or 4.6% of GDP. (Fedorov and Kazmin 1994: Table 2.1).

Table 6.3 Principal federal extrabudgetary funds in the Russian Federation

Figures in Rb trillion (% of GDP)	1992	1993	Revenue sources	Expenditure functions	Characteristics
Pension Fund					
revenues	1.78 (9.9%)	10.7 (6.6%)	31.6 percentage points of 38% payroll tax (39% since January 1993)	Pensions	Reporting to Duma, not to government; interest-bearing investments prohibited; arrears of federal government Rb 50 bn in 1992
expenditures	1.30 (7.2%)	10.4 (6.4%)			
balance	0.48 (2.7%)	0.3 (0.2%)			
Social Insurance Fund		Q1-Q3	5.4 percentage points of the payroll tax	Maternity and sickness benefits, sanatoria visits, children allowances	Legacy of Soviet era; administration of benefits by enterprises; managed by the Independent Federation of Trade Unions
revenues	0.29 (1.6%)	1.3 (0.8%)			
expenditures	0.23 (1.3%)				
balance	0.06 (0.3%)				
Employment Fund		Q1-Q3	1 percentage point of the payroll tax in 1992, 2 since 1993	Unemployment benefits, job retraining, job placement services	Only 20% of revenue is transferred to federal employment fund (remainder in local funds), hence little scope for redistribution to depressed areas
revenues	0.06 (0.33%)	0.52 (0.3%)			
expenditures	0.05 (0.28%)				
balance	0.01 (0.06%)				
Fund for Social Support of the Population			No permanent source of financing; initial endowment from Communist Party bank deposits	Targeted social assistance (programmes for orphans, assistance to pensioners, free meals)	Large share of resources devoted to commercial activities to generate further revenue; 45% of expenditures are of a social nature
revenues	0.011 (0.06%)				
expenditures	0.009 (0.05%)				
balance	0.002 (0.01%)				
(Federal) Road Fund			Five different taxes, <i>inter alia</i> , vehicle excise tax and vehicle registration fee	Maintenance and construction of general purpose roads	Federal fund collecting 76% of aggregate revenues of all road funds in 1992
revenues	0.13 (0.72%)				
expenditures	0.11 (0.61%)				
balance	0.02 (0.11%)				
Fund for financing of R&D in different industries			na	Financing of R&D	
revenues	0.11 (0.61%)				
expenditures	0.05 (0.28%)				
balance	0.06 (0.33%)				
All known federal funds			na	Financing of R&D	
revenues	3.25 (18.1%)	27.8 (17.1%)			
expenditures	2.41 (13.2%)	23.0 (14.2%)			
balance	0.88 (4.9%) ¹³	4.8 (2.9%)			

Sources: IMF (1993a); Ministry of Finance; *Russian Economic Trends* (1994), Dubinin (1994); Tepluklin (1994).

inclusion of off-budgetary revenues raises the proportion of public revenues in GDP to the 48 per cent.

The problems of measuring revenue occur also at lower levels of government in Russia. The World Bank has estimated the size of local extrabudgetary revenues at 10 per cent of local budgetary expenditures (Wallich, 1992:54).¹⁴

In order to address some of these concerns, the government has recently decided to include all funds except the social ones into the budget as of Q2 of 1994, albeit "with the

preservation of their specificity" (Dubinin 1994). Similar consolidation of extra-budgetary and budgetary resources has been recommended to local governments. In the long run, the social funds are also to be brought into the budget in order to "raise the efficiency of the governing of state funds" (*ibid.*). Evidently, the off-budget resource flows are gradually being eliminated. This process is an important part of the transition. It allows a clearer appreciation of both the government's and the fiscal stance. The result should be an improvement in the functioning of the real economy, of democracy and of macroeconomic control.

¹³ This figure was based on information provided by the Russian Ministry of Finance. IMF estimates put the balance of extrabudgetary funds in 1992 at 2.5 per cent of GDP – a figure also quoted by Delpla and Wyplosz (1994) for the table which is reproduced as Table 6.4 above. One likely source of the discrepancy between the 4.9 per cent quoted by the Ministry and the 2.5 per cent quoted by Delpla and Wyplosz is that the latter refers to only a subset of all extrabudgetary funds in Russia (namely the subset for which there are separate entries in Table 6.3 above). For comparison: in Ukraine in 1992, the surplus of the three principal social extrabudgetary funds was 4 per cent of GDP, which compares with an expanded overall deficit of 60 per cent of GDP of the federal government (IMF 1993b).

¹⁴ Local extrabudgetary funds were introduced by the Law on the Rights of Local Self-Government and include a wide variety of revenue sources (e.g. voluntary contributions and donations (a potential channel for enterprise "contributions"), local loans, and fines and penalties for non-payment of taxes). Local governments do not have to disclose these to the centre, and can retain 100% of the revenue.

Table 6.4 Budgetary balances of the Russian Federation, (in per cent of GDP) 1992¹

Consolidated budget (cash basis) of the state and local governments, including off-budget expenditures on investment, military conversion and working capital indexation	
Total revenues	29.0
Total expenditures (incl. off-budget operations of the federal government)	38.4
Consolidated budget balance (cash basis)	-9.4
Extrabudgetary funds	2.5
"Adjusted" balance (cash basis)	-11.9
Import subsidies (off-budget)	11.9
"Enlarged" balance (cash basis)	-18.8
Rough estimate of interest subsidy on CBR credits to enterprises	-9.3
to other republics	-3.7
"Overall" balance (cash basis)	-31.8

¹ The source of this table is Delpla and Wyplosz (1994). Note that we have updated the estimate of consolidated expenditures from the figure of 37.8 per cent of GDP quoted by Delpla and Wyplosz to the more recent official estimate of 38.4 per cent of GDP. It should also be noted that Table 2 in Delpla and Wyplosz (1994) provides a more nuanced interpretation of the fiscal impact of CBR credits than the one included in Table 6.4.

Structure of taxation

An examination of changes in tax composition is helpful in understanding the causes of the overall fall in revenue shown in Table 6.2. Table 6.5 presents tax breakdowns by type of tax, for the EBRD's countries of operations, as a percentage of GDP. As can be seen from Table 6.5, the fall in total revenue is more pronounced than the fall in tax revenue. This is in part because much of the difference between total revenue and tax revenue was accounted for by profit transfers from state enterprises that fell off sharply during the 1989-93 period as output declined, monopoly rents were eroded, and enterprises were allowed to retain a share of profits as an incentive to restructure and innovate. Correspondingly, within tax revenue the decline of the state industrial base, and the inability of existing tax systems to extend beyond this base, account for the decline in the corporate tax contribution to revenue. Individual income taxes and social security taxes, which are both in essence payroll taxes, have remained more buoyant, largely because employment has declined less than output and because there has been strong upward pressure on wages. There has, however, been little success either in developing personal income taxes capable of reaching those outside formal sector employment or in extending social security systems beyond this sector. In the long term, the extension of income tax to new private sector activity, particularly in the formal sector, offers considerable scope for increased revenue. Systems should preferably be simple, with few rates or allowances.¹⁵

Within domestic indirect taxes, while the shift from turnover taxes¹⁶ to VAT systems is attractive on efficiency grounds, there has been a loss in revenue. Building the revenue potential of these systems requires extending them to cover emergent bases and the full set of transactions between production and consumption (see Tait, 1992). In Table 6.5 only the foreign trade taxes have increased their share within GDP. Foreign trade taxes are relatively easy to administer, but they are distortionary regarding both trade and competition. They should therefore be considered mainly as a transitional measure to generate revenue and to give industrial enterprises the opportunity to restructure production. Whether use of taxes of this type (common in developing countries, see Box 6.1) can be restricted to a transitional role is an open question. The answer depends on how quickly other less distortionary components of the tax system can be reformed and strengthened and whether the vested interests created behind trade barriers can be controlled.

Structure of expenditure

As was noted above, aggregate expenditure levels as a proportion of GDP have shown only a moderate decrease between 1989 and 1993 (see Table 6.6). The declining share of investment expenditure signals a shift from capital to current expenditure in the region. Explicit subsidies (on energy, housing, food and enterprises) have also fallen as a

¹⁵ The reconstruction of functioning personal income tax systems forms a major part of tax reform; greater emphasis is given in this chapter to corporate tax issues.

¹⁶ These taxes represented the wedge between government fixed retail prices and production costs. The use of turnover taxes to compensate for the perceived differences in the profitability of different products contributed to a proliferation in the number of implicit turnover tax rates (see Tait, 1992). For example, pre-transition, there were over 3,000 turnover tax rates in Hungary.

Table 6.5 Tax structure in countries in transition (In per cent of GDP) ¹

	Pre-reform/ Post-reform	Total revenue		Tax revenue		Income taxes				Domestic taxes on goods and services		International trade taxes		Social security taxes		Other tax and non-tax revenue	
		Pre	Post	Pre	Post	Corporate taxes		Individual taxes		Pre	Post	Pre	Post	Pre	Post	Pre	Post
						Pre	Post	Pre	Post								
Albania	1989/1993	51.3	28.0	44.2	20.0	11.1	3.5	0.0	0.6	22.6	8.2	0.0	2.8	4.9	2.5	12.7	10.4
Armenia	1991/1993	26.0	20.4	15.8	13.1		4.6		1.6		6.3					26.0	7.9
Azerbaijan	1991/1993	35.6	38.4	34.7	38.4	5.7	8.0	2.3	2.2	0.0	11.4	0.0	0.8	7.7	9.0	19.9	7.0
Belarus	1991/1993	49.1	47.5	35.7	37.1	11.0			12.1	15.7	16.4			9.0	7.0	13.4	12.0
Bulgaria	1989/1993	60.0	30.6	49.4	18.8	23.3	4.6	4.1		11.1	6.2			9.6	8.0	11.9	11.8
Croatia	1991/1993	34.2	33.8	33.0	31.2	4.0	0.5	4.8	4.7	8.4	14.6	1.2	2.9	17.6	11.4	-1.8	-0.3
Czech Republic ²	1989/1993	62.1	49.0	53.1	43.9	10.9	7.7	6.9	3.2	17.8	11.6	1.8	1.6	12.6	15.4	12.1	9.5
Estonia	1991/1993	36.4	32.5	33.8	31.0	7.5	4.0	6.5	7.0	9.9	9.2	2.0	0.5	7.8	9.7	2.7	2.1
FYR Macedonia	1991/1993	36.8	34.3	17.2	15.9	0.8	0.9	5.5	5.5	8.6	6.8	2.1	2.2	18.6	15.9	1.2	3.0
Georgia	1991/1993	29.9	12.5	22.3	2.6	7.2	1.0	3.4	0.3	11.3	1.2	0.0	0.1			8.0	9.9
Hungary ³	1989/1993	48.5	47.5	48.5	47.5	7.7	1.8	0.0	6.3	17.3	14.3	2.8	2.6	18.7	17.6	2.0	4.9
Kazakhstan	1989/1993	35.4	22.4	25.0	20.6	10.5	6.0	0.0	0.0	10.6	6.6	0.0	2.1	3.7	0.0	10.6	7.7
Kyrgyzstan	1989/1992	38.0	12.7	28.0	11.2	3.6	3.9	4.2	1.3	15.1	5.2	5.1	1.0			10.0	1.3
Latvia	1991/1993	37.4	33.5	31.6	29.5	7.3	7.3	14.2	14.1	10.1	8.1	0.0	1.3			5.8	2.7
Lithuania	1989/1993	50.0	25.1	40.6	23.3	10.7	4.7	4.9	4.6	18.0	7.2	0.8	0.5	6.6	5.6	9.0	2.5
Moldova	1993		17.1		15.3		4.6		1.6		7.4		0.9		0.0		2.6
Poland	1989/1992	41.4	44.0	26.5	23.9	11.4	5.9	3.4	6.3	8.9	9.0	0.0	2.3	6.7	3.0	11.0	17.5
Romania	1993	51.1	30.9	33.2	29.7	6.3	3.5		6.0	18.9	7.4	0.0	1.4	6.8	8.5	19.1	4.1
Russia ⁴	1989/1993	41.0	33.8	38.5	28.5	12.2	10.4	4.4	2.7	11.8	7.9	6.3	3.4	3.5	5.3	2.8	4.1
Slovak Republic ²	1989/1993	62.1	48.0	53.1	27.2	10.9	6.5	6.9	4.3	17.8	14.0	1.8	1.4	12.6	12.7	12.1	9.1
Slovenia	1993		49.8		46.4		0.5		7.2		11.7		3.8		23.2		3.4
Tajikistan	1989	41.1		28.9		5.7		4.3		15.7		0.2		3.0		12.2	
Turkmenistan	1989/1992	30.1	45.0	18.1	36.1	1.4	4.2	4.9	1.0	10.6	6.1	0.0	24.9	2.6	0.0	10.6	8.8
Ukraine	1991/1993	38.3	42.3	26.2	32.4	9.6	9.3	3.2	1.9	9.4	12.7	0.0		12.2	10.0	3.9	8.4
Uzbekistan	1989/1992	35.0	33.5	26.8	31.5	4.2	6.5	4.9	2.1	12.4	10.8		1.6	2.9	1.0	10.6	11.5
Mean		41.2	33.9	32.4	27.3	8.3	4.8	3.8	4.2	12.8	9.2	1.3	2.9	8.8	8.3	9.5	6.7

Source : IMF, World Bank, and information provided by national authorities.

¹ For general government, including extrabudgetary funds. Blank denotes figures not available. Countries have different categorisations of revenue and expenditure. The translation of the "national" categories into the ones appearing in the table was done by EBRD staff using their best judgement and an ambition of being consistent throughout, but there are uncertainties associated with the translation. Total revenue figures include social funds, extrabudgetary revenue and grants, wherever they are available.

² Pre-reform figures for Czech and Slovak Republics are 1989 figures for Czechoslovakia.

³ Consolidated state budget.

⁴ Pre-reform figures for Russia are 1989 USSR figures.

result of efforts to decontrol prices (Table 6.6).¹⁷ Social outlays, which comprise social security and social service expenditures, have remained more buoyant. This presumably reflects, in part, the desire to protect living standards (and maintain a consensus for reform) as unemployment rises and wage rises lag behind cost of living increases. It also reflects, in part, the state taking on responsibilities for providing social services that were formerly provided by state enterprises (e.g. health, education).¹⁸ Public procurement and public sector wage payments have also remained relatively buoyant. The growing size of the residual (other) expenditure category is partly accounted for by the increasing magnitude of domestic and foreign interest payments.

Content of fiscal reform

Table 6.6 reflects the fiscal tension in transition economies. On the one hand the government wants to build a social consensus for reform by maintaining spending to protect living standards and to provide key services and infra-

structure. This makes expenditure difficult to cut. However, given the narrowness of existing tax bases, spending levels of 40 per cent or so of GDP imply levels of taxation that may damage the incentive to invest and hence limit growth (see Kornai, 1992). Growth and the incentive to invest may be further damaged if the inability to finance fiscal deficits leads to inflation. Two important strategies to deal with this fundamental problem of transition exist. First, total expenditure can be reduced by focusing spending on key areas (such as infrastructure, regulation, public services and social services) and by diminishing the state's role in areas such as industrial subsidies, general administration and defence. Second, in the interest of both efficiency and lowering rates, the tax base can be broadened. This can strengthen the incentive to invest and also improve revenue potential by encouraging growth and by including emergent bases (e.g. SMEs, services) which take up an increasing share of GDP. In short, fiscal reform should move hand-in-hand with the changing role of the state during transition.

¹⁷ It should be kept in mind that subsidies to enterprises are largely not explicitly accounted for in the government budget (see Box 6.2).

¹⁸ The state also *de facto* financed these services under the previous regime. The difference is that the services previously provided by enterprises are now explicitly accounted for as government expenditures.

Table 6.6 Expenditure structure in countries in transition (in per cent of GDP) ¹

	Pre-reform/ Post-reform	Total expenditure		Investment		Goods & services/ wages & salaries		Subsidies		Social outlays		Other	
		Pre	Post	Pre	Post	Pre	Post	Pre	Post	Pre	Post	Pre	Post
Albania	1989/1993	56.8	44.1	29.3	7.1	10.0	13.8	8.7	2.2	7.7	13.0	1.1	8.0
Armenia	1991/1993	27.9	68.6		7.7		7.5		8.4		7.0	27.9	38.0
Azerbaijan	1991/1993	40.7	52.0	3.0	3.0			0.0	4.4	26.4	24.4	11.3	20.2
Belarus	1991/1993	45.5	56.9			0.8	5.8		10.5	19.0	9.8		30.8
Bulgaria	1989/1993	61.4	45.7	3.0	1.5	19.0	11.7	15.5	3.9	10.4	12.9	13.5	15.7
Croatia	1991/1993	39.0	34.8	1.3	2.4	21.0	20.2	2.9	2.8	13.7	8.6	0.1	0.8
Czech Republic ²	1989/1993	64.5	48.5	8.9	3.6	14.9	26.0	16.6		13.2	14.6	10.9	4.3
Estonia	1991/1993	31.8	33.9	3.4	2.0	15.5	19.5	2.5	1.3	10.4	8.8	0.0	2.3
FYR Macedonia	1991/1993	40.4	45.0	0.6	3.9	10.2	12.0	6.8	4.8	22.2	21.2	0.6	3.1
Georgia	1991/1993	33.0	46.3			13.9	5.8		33.3	12.0	1.9	7.1	5.3
Hungary ³	1989/1993	49.3	54.5	2.2	0.9	14.9	20.2	10.7	3.1	15.8	22.5	5.7	7.8
Kazakhstan	1989/1993	35.4	23.5	0.0	1.4	20.7	6.0			13.9	7.5	0.8	8.6
Kyrgyzstan	1989/1992	35.9	26.2	5.2	1.1	16.4	9.9			14.3	5.3	0.0	9.9
Latvia	1991/1993	31.0	32.5	3.0	1.1	10.2	12.1	0.0	0.2	11.4	13.0	6.4	6.1
Lithuania	1989/1993	53.8	29.7	4.9	2.6	4.6	6.7	17.2	1.4	20.5	14.4	6.6	4.6
Moldova	1993		25.9		2.7		1.3		2.9		9.5		9.5
Poland	1989/1992	48.8	50.7	3.3	1.5	7.6	10.7	12.9	3.3	2.4	6.3	22.6	28.9
Romania	1989/1993	42.7	31.0	17.6	3.9	9.8	11.4	0.4	5.5	9.5	8.9	5.4	1.3
Russia ⁴	1989/1993	49.5	41.8	7.2	3.0	4.5	6.0	8.5	12.0	14.8	13.1	14.5	7.7
Slovak Republic ²	1989/1993	64.5	55.5	8.9	0.1	14.9	4.7	16.6	4.8	13.2	17.0	10.9	28.9
Slovenia	1993		49.4		2.2		7.5		4.1		30.5		5.1
Tajikistan	1989	38.6				17.1				19.4		2.1	
Turkmenistan	1989/1992	32.0	31.0	8.0	6.6	4.4	3.4	3.0	9.6	15.1	8.4	1.5	3.0
Ukraine	1991/1993	51.9	55.6			4.4	8.3			27.9	29.3	19.6	18.0
Uzbekistan	1989/1992	35.9	46.5			9.5		14.0		14.8		2.4	
Mean		43.0	42.9	6.1	2.9	11.2	10.5	8.5	6.2	14.9	13.4	7.2	11.6

Source: IMF, World Bank, and information provided by national authorities.

¹ For general government, including extrabudgetary funds. Blanks denote figures not available. Countries have different categorisations of expenditure. The translation of the "national" categories into the ones appearing in the table was done by EBRD staff using their best judgement and an ambition of being consistent throughout, but there are uncertainties associated with the translation. As far as possible, expenditure figures are stated on commitment basis rather than on cash basis.

² Pre-reform figures for Czech and Slovak Republics are 1989 figures for Czechoslovakia.

³ Consolidated state budget.

⁴ Pre-reform figures for Russia are 1989 USSR figures.

In Appendix 2.1, the transition indicators, information was presented on the types of fiscal reform measures introduced in each of the EBRD's countries of operations. Some reform has occurred in most of these countries. On the tax side, corporate income taxes with simple rate structures are replacing profit taxes and transfers, systems of personal income taxation systems are being developed, VAT systems have been introduced to replace multiple turnover and sales taxes, and customs duties have increased in importance. On the expenditure side, some subsidies are being phased out as part of efforts to decontrol prices. However, the fact that two pillars of the pre-transition social security system, low prices and guaranteed employment, are crumbling has meant that the state is having to take on new responsibilities, in particular for unemployment insurance and social service provision.¹⁹ Growing revenue pressures associated with these developments, and the limitations imposed by the structure and capabilities of the inherited systems have meant that fiscal reform has been a largely ad hoc process. As is evident

from Appendix 2.1, there have been frequent changes and additions to the system. A multitude of tax rates still apply, and there is little integration of different taxes. Furthermore, there is little consistency in the incidence of taxation across different types of enterprises, with a bias towards granting tax concessions to foreign firms at the expense of domestic firms (see Chapter 9). As a result, in the majority of countries revenues are unstable and the tax environment uncertain for the taxpayer.

6.2.3 Directions for reform

Drawing on the quantitative and qualitative evidence on the content and extent of the tax transition, this section concludes by offering tentative guiding principles for fiscal reform in eastern Europe and the former Soviet Union.

(i) Efficiency

The tax burden should be spread in a consistent manner across different types of taxpayers, whether these be individuals or firms. Differential tax treatment of enter-

¹⁹ Problems associated with breaking off social services from enterprises are likely to be much more severe in the former Soviet Union, where there is a much stronger tradition of enterprise social provisioning.

prises greatly constrains the efficiency and revenue potential of tax systems. Because tax administrations in transition economies are incapable of reaching emergent domestic enterprises, these are often left outside the tax net. Broadening the tax base will make revenue more robust to the rapidly changing economic conditions that typify eastern Europe and the former Soviet Union. Large “tax breaks” for foreign companies can distort investment decisions, limit competition, discriminate against domestic companies and reduce the medium-term revenue potential of tax systems. Generally, in pursuit of efficiency, long-term growth of revenue and the limitation of evasion, the goal should be wider bases and lower rates.

Efficiency also implies that the focus of indirect taxation should be final consumption. This means that intermediate goods should not be taxed unless there are special distribution reasons or there is difficulty in taxing final goods. The widespread introduction of VAT systems is promising in this respect. For economic efficiency, tariffs should be rebated on intermediate goods and linked to other taxes on final goods. Tariffs should be used for protection only when the case for supporting a particular domestic industry (and penalising its users) is strong and where other means of stimulating the industry are less satisfactory. Tariffs act as a production subsidy financed by a consumer tax on the same goods. There is no presumption that such a tax is the best fiscal means of aiding an industry through a learning period (assuming such aid is really justified). In transition economies with few effective taxes, tariffs may have a role as transitional revenue generators. Tariffs should be reduced as domestic tax systems capable of taxing both domestic and imported final goods in a consistent manner can be built up (i.e. VAT systems). For further discussion see Chapter 8.

(ii) Simplicity and transparency

Pre-reform tax systems in eastern Europe and the former Soviet Union were characterised by complex rate structures on a range of different taxes. Complexity and progressivity in rate structures are administratively costly and may not be implementable under the new market conditions. By improving stability and simplicity, the transparency of tax systems in the region will be greatly improved. Increasing transparency is essential both to improve administration and compliance and to enable coherent political discussion and analysis of the tax system. The move towards transparency should be associated with reducing the amount of discretion allowed to the tax collector and taxpayer respectively in assessing and paying taxes. This is because allowing discretion in taxation widens the scope for corruption. Improving transparency and reducing discretion can therefore be potent means of reducing corruption.

(iii) Stability

A government should seek a set of taxes capable of raising adequate revenue, rather than resorting to ad hoc introductions as revenue demands emerge, and should avoid frequent changes to these tax rules and rates. Once introduced, tax rules should be enforced with as few exemptions and concessions as possible. Uncertainty reduces both compliance and investment incentives.

(iv) Coherence

Coherence between tax systems for different levels of government is a crucial ingredient for a successful federal system or for any decentralisation of government. Lack of this coherence can be a source of instability and opacity in the tax system.

(v) Equity

In market economies, the main vehicles for income redistribution lie on the expenditure side of the budget. Well functioning schemes for income support reduce the force of arguments for progressivity in taxation. Strong progressivity in taxation of incomes is also administratively costly to implement in a market economy. However, lower taxation of goods disproportionately consumed by the worse off or lower taxation of their incomes may remain as useful tools for supplementary income support, particularly while new social protection schemes are being developed.

For many countries in eastern Europe and the former Soviet Union, tax reform is seen mainly in terms of converging towards the types of tax system that operate in OECD nations. It should be kept in mind that the operation of these tax systems falls well short of the principles presented above, and governments in many market economies are themselves struggling with tax reform.

Without strong and persistent efforts to reform taxes in these directions evasion can become systemic within society – as is the case in many developing economies. Tax compliance is intimately linked with respect for law and property, which is crucial for private sector development. Failure to enforce compliance can both slow the transition and reduce social cohesion. Compliance with taxation carries distinct advantages regarding the conduct of business (e.g. maintenance of proper company accounts, licensing, trade assistance, legal framework rights and access to credit). Non-compliance should carry severe penalties. Strengthening tax administration lies at the core of fiscal reform.

6.3 Enterprises and taxation

Enterprise profits were at the centre of pre-reform tax systems (see Section 6.2.1). The output collapse, the shift of production out of the state sector, growing autonomy of

enterprises, and the need for profit retention as an incentive for enterprises to restructure have all meant that the contribution of profit taxes has declined. The new corporate income taxes that replace the old profit taxes will play a smaller role in the overall tax system and will have to satisfy very different criteria from the old profit taxes.

The new tax rules for enterprises should be simple, easy to administer, stable and robust to inflation. Enterprises should be able to make decisions with a proper understanding of likely returns to investment. Riskiness associated with lack of clarity in, and frequent shifts of, the tax environment (often arising from inflation and taxes emanating from different and uncoordinated levels of government) can constitute a major deterrent to investment. Inflation greatly complicates the measurement of taxable income in transition economies as interest payment deductions are often based on nominal rather than real interest rates, depreciation allowances are based on historic as opposed to replacement costs of capital, and deductions for inputs are based on historic costs uncorrected for the inflation that occurred since these goods were purchased. Bringing enterprise real and taxable income more closely into line is a priority in the design of corporate income taxes (see Gordon, 1994).

Corporate income taxes should also be similar across different activities and firms, be integrated with other parts of the tax system, and offer a minimum of concessions. Foreign firms, privatised firms and SMEs should be included in the corporate tax net and treated in a similar and consistent manner. Neutrality can then be preserved in the sense that the tax system should not give arbitrary or inefficient incentives or disincentives to certain industries or enterprise structures.²⁰ Concessions should be restricted, not only on efficiency grounds but also to protect revenue and to limit political manipulation. Many countries have eroded their corporate tax base through the introduction of a series of ad hoc (and often ineffective and distorting) concessions, tax holidays and the like. In such environments substantial energy is expended by enterprises in an attempt to “fix” the system to their benefit. Once introduced these concessions are difficult to remove. The culture of the “special sweetener” is not one that is conducive to a competitive market economy. Overall, the objective of corporate tax reform must be to extend the base as widely as possible to allow moderate rates to be levied.

Enterprise tax reforms in the region fall well short of the benchmark described above. In many countries state-

owned enterprises that have not been privatised obtain credit from the government through directed credits and the accumulation of tax arrears. Profit tax rates for domestic companies (state, privatised firms and new start-ups) are generally in the range 25-45 per cent for domestic enterprises. In practice, the bulk of taxation is still raised from large state and privatised enterprises. Banks are generally subject to higher rates of taxes than other domestic enterprises. Some “priority” industries are exempt from taxes, and regional incentives are offered in some countries. Small businesses are generally subject to tax rules similar to those applying to larger enterprises, alleviated in some cases by specific administrative concessions and tax allowances. The tax breaks offered to foreign firms are considerable. Most countries encourage foreign investment through reduced tax rates and/or tax holidays for 2-5 years (see Chapter 9).

Some issues in the design of corporate income taxes for the main types of enterprises in transition economies are discussed below.

6.3.1 Taxation of state-owned enterprises

Budget hardening and fiscal balance

State enterprises in pre-reform transition economies were unlike capitalist firms in many ways: they were very large, they produced a large fraction of total output, there was no profit motive, financing was independent of performance, they faced no competition and were unresponsive to market demand, jobs for their employees were guaranteed and compensation fixed, and they provided a range of social services and other in-kind benefits to workers.²¹ With the onset of transition these firms have only slowly updated and adjusted their production structure to meet market demands. The solvency of many of these firms is questionable. However, they continue to receive many explicit²² and implicit²³ subsidies and directed credits which enable them to survive (see Box 6.2).²⁴ A hardening of the budgets of these enterprises is a crucial element in forcing them to restructure and face market conditions. The fiscal drains and disincentives for economic change embodied in these subsidies suggest that the subsidies constitute a more pressing issue than the rate of taxation for such enterprises.

Given limited alternatives, the state enterprise tax base also needs to be protected in the transition phase. The volatility or depressed state of profits, upward pressure on wages caused by the removal of in-kind benefits, and a shift of priority from profits to wages for worker-controlled firms,

²⁰ Western experience increasingly queries the economic utility of regional or industry-specific tax policies.

²¹ For a review of these issues see Carlin and Mayer (1992), Aghion, Blanchard and Burgess (1994), and Carlin, Reenen and Wolfe (1994).

²² Explicit subsidies amounted to as much as 25 per cent of GDP in 1992 in Russia. See Fan and Schaffer, 1994. Thus even though taxation of these enterprises may be high their net contribution to the budget may be negative.

²³ For example, via lower energy prices.

²⁴ As price controls are removed during transition, enterprises use this soft money to bid for key producer and consumer goods and this leads to inflation.

suggest that a combination of corporate income and payroll taxes may be more effective mechanisms for taxing these enterprises. Preventing state enterprises from keeping accounts outside the state financial system can also slow the erosion of revenue from this base. There are thus strong fiscal reasons for tax administrations to retain tight control over state enterprise financing, at least during the early stages of transition, both to protect tax revenue accruing from this base and to control the fiscal deterioration and inflationary pressures caused by open-ended enterprise spending.

Credit subsidies, the central bank and industrial policy

In some countries subsidised credit programmes have been operated through the central bank. This can readily lead to a lack of transparency in the financial system, confusion, manipulation, and a loss of fiscal and monetary control. For example, Box 6.2 showed how the inclusion of credit subsidies from the central bank to state enterprises radically worsened assessment of the fiscal balance of the Russian Federation in 1992. If priority programmes for different sectors or activities are to be introduced, they are probably better operated in an explicit way through the budget, so these costs appear directly in the fiscal system. If operated through the central bank it is all too easy for the expenditure to flow directly into a loosening of monetary policy. While these problems arise particularly in relation to state-owned enterprises, they can permeate the whole system. It is a good principle of policy to “separate development banking and central banking”.

“Social unbundling”

An important difference between socialist enterprises and capitalist firms is that the former often provide a range of social services.²⁵ Of particular importance are housing, medical services and childcare. Such provisions are not only costly burdens on firms, but limit flexibility in employment and thus both restructuring and growth elsewhere. Because in-kind services represent a large share of real income of workers, their removal (without replacement) is strongly opposed by coalitions within state enterprises.²⁶ The freeing of enterprises from these responsibilities will assist the transition process but will involve some increase in expenditure responsibilities, and thus taxation, by central and local government.²⁷ This is a crucial respect in which the role of the state is changed, and in some respects increased, by the transition. Enterprises, and particularly local governments, are developing ways for “unbundling” responsibilities from enterprises, but it remains a major organisational and fiscal

challenge. Some activities, such as housing, may be best shifted to private markets, whereas others, such as medical services and childcare, are likely to entail major involvement of central or local governments.

6.3.2 Taxation of domestic private enterprises

Linking corporate taxes, personal taxes and the VAT

The long-term viability of tax systems in eastern Europe and the former Soviet Union is contingent on the inclusion of private sector activity in the tax base. Corporate income taxes have to be extended to include new start-ups and privatised enterprises. Where personal incomes are not easily manifested, taxation at the corporate level provides one method of taxing personal incomes. Corporate incomes themselves may be difficult to track for taxation purposes. The VAT system, which most transition economies have in place, may be used as an instrument to limit tax evasion by small firms and the self-employed. The VAT system can also generate important information for corporate and personal income taxation.

Small and medium-sized enterprises

Most new firms start small, and SMEs are crucial for development in the region. Because of the high level of uncertainty, investors in eastern Europe and the former Soviet Union have an incentive to wait to see which projects (or types of projects) succeed before committing their funds. Other potential entrants also play a similar waiting game. New firms therefore may be viewed as experiments which help both investors and later entrants to learn how to function effectively in the new market environment. These demonstration effects are important for private sector development and growth.

It is only recently that small private businesses have been allowed to develop freely. Small businesses are, at least on paper, subject to the same set of corporate taxes as other enterprises with some concessions in certain countries. In practice, however, the administrative difficulties associated with tracking SMEs means that evasion is rife and their tax contribution small. Improving the accounting conventions of SMEs, including them in VAT systems, simplifying assessment for corporate income tax purposes, and improving administration can strengthen incentives for SMEs to comply with tax laws.

6.3.3 Taxation of foreign enterprises

Governments have the difficult task of creating and maintaining the conditions for high levels of investment, both domestic and foreign, while at the same time keeping the budgetary cost of investment incentives low. Box 6.3

²⁵ This tradition is particularly strong in the former Soviet Union, whereas in eastern Europe social service provision by central and local government is more common.

²⁶ In a similar vein, if enterprise restructuring requires a degree of labour shedding then fiscal incentives in the form of tapered compensation, retraining or an adequate safety net may be necessary to reduce resistance to restructuring.

²⁷ Shifting expenditure responsibility from enterprises to local government without granting them the necessary revenue sources (may) lead to conflict between different levels of government (see Section 6.4.2).

Box 6.3**Taxation and the discouragement of foreign direct investment**

Haphazard, convoluted, volatile or confiscatory tax regimes can severely discourage foreign direct investment (FDI). Discouragement of FDI often results despite countries' desire to capture external benefits through the use of selective tax reliefs to attract FDI: in some cases, these very reliefs can add to complexity, further distort resource allocation and be a deterrent to investment, domestic and foreign.

Tax-associated deterrents to FDI are likely to come from several sources. First, frequent changes in tax legislation (altering tax rates, the tax base or introducing new taxes) add to the complexity and costs of assessing the return of an investment and add to the fears of retrospective and possibly expropriating legislative change at a subsequent date. Second, these frequent changes, often made to tax systems which were already complex and problematic, can aggravate an uneven and distortive tax environment, with investment (domestic and foreign) strongly encouraged in some areas and discouraged in others. Third, FDIs are discouraged by variable and arbitrary application and enforcement of the rules, often compounded by a lack of clarity as to the legitimate enforcing authority. The problems can be especially severe where different levels of government compete for revenue. Fourth, the entanglement of the fiscal regime with direct legislative controls (and frequent changes in them), can have the effect of increasing the tax burden, for example through licensing systems, export quotas and foreign exchange controls. Fifth, the near absence of effective legal redress in many countries, through a functioning court or arbitration system in the event of disputes, can also be a major deterrent.

These problems (which very often also apply to domestic investment) are made worse by the difficulties experienced in many countries where macroeconomic stability has yet to become firmly entrenched. Sudden demands for extra revenue to cover burgeoning fiscal deficits encourage frequent "emergency" revenue measures. Inflation itself also makes accurate tax assessment difficult, by distorting measures of depreciation, interest payment deductions and much else.

The incidence and severity of these problems varies enormously across the region (and they are not unique to the region). In some cases, tax regimes are probably not a serious impediment to FDI. This is likely to be the case where, as for example in the Czech Republic, a combination of macroeconomic stabilisation and general legislative and fiscal reform is creating a degree of stability and

transparency in the business environment. None the less, significant disincentives may remain. For example, in the Czech Republic, tax law prohibits the deduction of interest from the taxable income of a company in respect of loans provided to that company by shareholders owning more than 25 per cent of the share capital (to the extent that the total loans provided by such shareholders exceed some specified multiples of the company's capital in the relevant tax period). There is uncertainty about how particular provisions relating to the deductibility of interest on loans granted by shareholders will be applied by the tax authorities, in particular how and at what moment the capital will be measured. The treatment of bad debt provisioning is probably also a deterrent. In the Czech Republic, in practice bad debt provisions are not tax deductible (except for banks) as Czech legislation requires specific steps in the bankruptcy procedure to be completed for each individual bad debt case before allowing the tax deductibility of provisions.

In other cases, inadequate fiscal reform is probably a serious deterrent to FDI. For example, in Russia the climate for oil and gas investment has been influenced over the past two years by a combination of fiscal and regulatory action. These have included restrictive licensing legislation which has blocked the export of oil by foreign direct investors which had previously been guaranteed 100 per cent export rights by the Russian government. All sellers have been obliged to operate through "government licensed exporters" who have given "quotas" for the amount of oil that could be exported. The effect of such licensing arrangements on natural resource projects is to impose an implicit tax by forcing the sale of goods at lower prices in the domestic market. A range of tariffs and fees have been introduced over the past two years. These have included transport tariffs and port fees charged at higher than Western rates.

Frequent changes to the tax and regulatory regime for foreign investment in Russia, both the incidence and the rate, has had the effect of reducing the amounts invested and is a reflection of the extent to which failure to achieve a reasonable level of stability and transparency in the tax system can reduce economic activity. This problem is compounded by different levels of government (central regional and local) vying for the perceived "surplus" from economies activities.

briefly discusses the discouraging effects which poor design and frequent alterations to the tax system can have on foreign direct investment.

Governments may seek to attract foreign investment with tax breaks and holidays, but these have adverse effects on efficiency. In Chapter 9 the tax treatment of domestic and foreign firms is compared, and it is shown that tax holidays for foreign firms are widespread in eastern Europe and the former Soviet Union. Domestic firms, many facing significant restructuring costs, are thus placed at a competitive disadvantage *vis-à-vis* foreign firms. Foreign firms may dissolve after the tax holiday ends, deliberately choose projects with short gestation periods, or manipulate prices between the project eligible for a holiday and other activities. Transfer pricing may imply that the bulk of value added generated by the activities of these firms is exported. Moreover, countries or regions may compete for investment using these measures with a resulting equilibrium which may leave all regions in fiscal difficulties. There is also now considerable evidence on FDI motivation which suggests that tax incentives have little effect on the decision to invest.²⁸ Tax breaks, moreover, represent a drain on revenue, and are also difficult to withdraw once in place. Non-budgetary incentives such as an adequate legal system, infrastructure, education and political stability may be more effective means of attracting FDI than tax breaks.

6.4 Fiscal decentralisation

6.4.1 General considerations

Parallel to the economic decentralisation associated with privatisation and the abandonment of central planning, there has also been a major political decentralisation in most of the formerly planned economies. In some cases countries were split up completely (Czechoslovakia, Yugoslavia and the Soviet Union), in other cases considerable fiscal authority has been given to lower levels of government (Hungary, Poland, Russia). The break-ups have been associated with significant costs due to trade disruption and less coordinated monetary, fiscal, trade, defence and environmental policies (see Bolton and Roland, 1994, and Prud'homme, 1994). Political decentralisation has thus forced the countries of the region to attempt to construct a workable system of public finances that allows a federal or decentralised governmental structure to function. Basic to such a structure is the allocation of fund-raising and expenditure decisions. It is the right to make and execute these decisions which lies at the heart of the distribution of powers. The challenge is to institute a system of inter-governmental fiscal relations that is consistent with the emerging political order.

The allocation of fiscal authority between levels of government has to take account of these various economic and political tensions and has been structured in many different ways in different countries. Powers are jealously guarded and very often controversial. There is no settled answer in economic or political theory as to the optimal allocation of fiscal authority. Any design must take careful account of the incentives embodied in it. It should be transparent in the sense that the responsibilities of each level of government and the associated funding sources are clear. It should also be simple, to limit administrative, compliance and legal costs. Where possible the level of government that makes a particular expenditure should be responsible for raising the associated revenues (see Hewitt and Mihaljek, 1992). There are always dangers of loss of aggregate fiscal control if lower tiers have only limited incentives to balance their budgets. Maintaining lower level governments on hard budgets should be viewed as a precondition for allowing extensive fiscal decentralisation. Otherwise the incentive to collect taxes may be eroded and local politicians may choose to sacrifice fiscal tightness for the popularity generated by generous spending programmes, thus generating deficits which ultimately need to be funded by the centre. This has been among the concerns of those trying to design monetary union in the EU and has been a major challenge for the public finances in India (see also Section 6.4.2 on the Russian experience).

There are arguments for the centralisation of important areas of expenditure, including defence, foreign affairs, law and order, and higher education. Macroeconomic stabilisation and inter-regional distribution are activities that should naturally be placed with the centre. Central government also has the advantage of being able to provide and enforce a consistent set of tax guidelines, and this is of particular importance for VAT and income taxes.

Providing some fiscal autonomy at the local level, however, has some important economic advantages and, in this context, growing political separatism and fiscal decentralisation reinforce one another. Lower levels of government may have informational advantages regarding the collection of taxes, and because they are more accountable they have a stronger incentive to satisfy the particular expenditure needs of the local population. It may be very difficult for the central government to fulfil a similar function, because it is costly to transfer large amounts of information to the centre and because local representatives may have an incentive to report biased or manipulated information in order to benefit more from the centre's policies.

²⁸ See Chapter 9 on FDI.

Clearly, for the countries of the region fiscal decentralisation will constitute a major challenge over the coming years, and in many countries both taxation powers and expenditure liabilities will have to be shared across different levels of government. This will be done in different ways in different countries. There is, however, little doubt that conflicts between various levels of government have greatly complicated both budgetary decision-making and the investment environment for firms. Some of these issues are illustrated by an examination of the Russian experience.

6.4.2. The Russian experience

The disintegration of the USSR

A potent element in the disintegration of the USSR was the withholding by constituent republics of revenue from the federal budget. The vulnerability to this withholding lay in the structure of the federal budgets, which relied on transfers to the centre of the locally collected federal share of tax revenue by regional tax administrations. In his attempt to salvage the union, Gorbachev initiated a tax reform ("On the Fundamentals of Economic Relations between the USSR and Union and Autonomous Republics", April 1990) which shifted significant fiscal power to the regions and increased their economic autonomy. To a certain extent, however, this granting of *de jure* rights merely acknowledged that republics had already *de facto* claimed those powers for themselves. Ultimately the Union broke apart at the end of 1991 due to near-complete withholding of revenue by the constituent republics. This trend of local and regional assertiveness (*mestnichestvo*) against excessive central control and dependence has been inherited by the Russian Federation and is a common feature in much of the CIS and elsewhere.

Expenditure assignments at the federal level in the USSR included defence, science, justice, internal security and foreign trade activities. At the sub-national level, responsibilities included social insurance, culture, education, health, pensions and other transfers. Other expenditures such as investment and subsidies were split across levels.

Russian developments

Since the dissolution of the USSR, intergovernmental fiscal relations have fallen into a formal vacuum. While the old structures, personae and processes are still in place, there is a natural tendency to eschew comprehensive reform and proceed with incremental changes to the previous system.

According to the 1991 Law on the Basic Principles of Taxation, Russia abandoned the Soviet system of discretionary tax sharing, and legislated a system of restrictive tax assignment. In this system sub-national governments²⁹ were assigned the revenue from certain taxes (personal income tax 100 per cent, corporate income tax 100 per cent, excises 50 per cent) without the right to affect the base or rate of those taxes, in effect making it a system of revenue assignment, as local tax autonomy is very limited.³⁰ However, government policy has been in a state of flux, with current legislation and policy documents shifting between tax assignment and tax sharing. Moreover, in practice fiscal relationships between federal and regional governments are not ruled by the new framework of revenue assignment, but are superseded by sharing arrangements contained in the budget laws, thereby effectively preserving many of the adverse features of Soviet tax sharing.

Furthermore, the system of tax sharing in Russia is neither transparent nor simple in the sense that actual sharing does not correspond to the statutory rules. Table 6.7 illustrates this by contrasting actual and statutory federal and local shares of taxation for 1992. This inconsistency works both to the advantage and disadvantage of the federal government, as it concedes some VAT revenue in return for profit tax and excise tax revenues.

The budgetary independence that was supposed to be part of the new framework³¹ is hence very limited, as regions still negotiate their individual budgets with the Ministry of Finance. This means that the regions are not on hard budgets and have only weak incentives to raise local revenue and to allocate resources efficiently.

The regions' newly legislated ability to borrow has been suspended by budget laws, in an attempt to force regions to maintain fiscal balance. Given adverse fiscal developments at the federal level in 1992, the federal government has sought to "off-load" some expenditure on to regional governments by arbitrarily changing their expenditure assignment without providing clear sources of corresponding revenue (as transfer shares were fixed by budget laws). Thus, social expenditures equivalent to 6 per cent of GDP were transferred to the regions (Bird and Wallich, 1993). The central government thus provided a clear signal to the regions that, notwithstanding *de jure* affirmations to the contrary, the federal government is still powerful enough to interfere in local budgets and to extract potential surpluses.

²⁹ The Russian Federation has two tiers of subnational governments: at the regional level, there are 49 regions (oblast), 7 provinces (kraj), 10 autonomous regions (okrug), and 20 autonomous republics, while at the local level there are innumerable cities and districts (raion).

³⁰ See Table 6.7 for the revenue assignment according to the Law on the Basic Principles of Taxation (adopted 27 December 1991), and the actual shares of revenue in 1992.

³¹ The "Law on Budgetary Rights of Local Self-Governments" (1993), the "Law on the Basic Principles of Taxation" (1991), and the "Law on Local Self-Government" provide for independence in making budgets and prohibit interference by other levels of government in local budgets, including the extraction of budget surpluses or the assignment of unfunded expenditures (mandates).

Table 6.7 Statutory and actual federal and local shares of 1992 tax revenue in Russia

	Basic principles of taxation law statutory shares		1992 actual shares	
	Federal	Local	Federal	Local
	share of total revenue from individual sources, in per cent		share of total revenue from individual revenue sources, in per cent	
Revenues total			55.9	44.1
VAT	100	0	75.1	24.9
Trade taxes	100	0	98.3	1.7
Personal income tax	0	100	0	100
Profits tax	0	100	41.2	58.8
Excise taxes	0	100		
of which vodka	50	50	47.5	52.5
Natural resource taxes	40 (20)	60 (80)	0	100
Land tax	0	100	24.0	76.0
Property taxes	0	100	0	100
Geological exploration fee	-	-	100	0
Subventions to state governments	-	-	0	100

Sources: Goskomstat; Ministry of Finance

However, various regions that resent this interference have adopted special regimes, unilaterally altering their fiscal relations with the centre, or are threatening to do so. Moreover, regions have increasingly shifted resources into opaque off-budgetary funds in order to shield revenue from federal appropriation (see Box 6.2). Several regions have negotiated “single-channel agreements”, whereby all revenue is retained by the regions, which then forward a fixed fraction to the centre (see Table 6.8). The most significant withholders are Bashkortostan (Rb 51.2 billion in 1992), Tatarstan (Rb 43.2 billion), Karelia (Rb 4.1 billion), Udmurt (Rb 3.1 billion) and Sakha-Yakutia (Rb 1.4 billion). Another 20 (of the 88) regions have set unilateral sharing rates (see Table 6.8).

Stabilisation implications

While some observers have pointed to fiscal federalism as a latent roadblock to economic reform,³² by most accounts inter-governmental fiscal relations have to date not played a major role in the failure of stabilisation to materialise.³³ However, the development of tax revenues in late 1993 and early 1994 indicates that this may be changing, as Table 6.9 illustrates. Various withholding mechanisms exercised by the regions are contributing to a clearly discernable downward trend in the share of total revenues accruing to the federal government. The expenditure share has stayed broadly stable resulting in a destabilising shortfall.

In sum, the present system is affected by serious inconsistencies and perverse incentives:

Lack of transparency – The allocation of expenditure responsibilities and tax powers across different levels of government is unclear. There is an incentive for local government to extract central revenues by overspending and for central governments to decentralise expenditure responsibilities but retain tax powers. These incentives and the high level of discretion in the system have led to conflicts between the centre and regions which threaten the integrity of the federation. Enterprises can be caught in this “cross-fire” with serious damage to incentives to invest.

Lack of regional incentives – The Ministry of Finance is intimately involved in local budget formation. Since federal decisions on some regional expenditure items (e.g. public sector wages, utility rates) have to be funded from regional budgets, it is difficult to maintain fiscal prudence at the local level. It is essential that power over expenditure decisions lies with the governing authority responsible for funding them.

6.5 Concluding remarks

Under former regimes governments could control resources directly but in a market economy they have to raise resources from the private sector. Tax reform is therefore a requirement of transition. Tax reform is urgent since the old tax system will yield sharply declining

³² See Sachs (1994a, 1994b), as well as the output from various technical assistance missions of the World Bank (Wallich 1992, Bird and Wallich 1993, Wallich (ed.) 1994, Martinez-Vazquez 1994).

³³ The accounts by Sachs (1994a, 1994b), while pointing to the destabilising potential of fiscal federalism as threatening Russia, do not ascribe significant importance to it in accounting for the failure of stabilisation in 1992-93. While Wallich (1992, ch.2) discusses potential destabilising effects, no major channels are quantified. DIW et al. (1993:45) ascribe federal deficits to regional tax withholding without providing any empirical evidence.

Table 6.8 Withholding of revenue by region in Russia

	1992	1993
Total withholdings	Rb 103 bn 0.57% of GDP 3.4% of federal revenue	Rb 1,039 bn 0.64% of GDP 5.7% of federal revenue
Total arrears to federal budget	na	approx. 1.5% of GDP (average 1-9/93)
Principal withholding regions	Bashkortostan, Tatarstan, Karelia, Udmurt	<i>inter alia:</i> Bashkortostan, Tatarstan

Sources: For 1992: Ministry of Finance (1993) and IMF (1993a); for 1993: Nagel (1994), Sineinikov (1993).

Table 6.9 Share of the central Russian government budget in total (central and local) revenue and expenditure (%)¹

	Revenue	Expenditure
1992	63.5	61.4
1993	41.1	59.5
1993 Q1	51.0	67.6
Q2	46.7	48.6
Q3	53.3	66.0
Q4	21.5	56.6
1994 Q1	41.0	59.6

Source: Russian Economic Trends 1994(1), forthcoming, Table 5.

¹ Expenditure excludes net transfers from the central government to local authorities.

revenues as its bases in profits and turnover in the large state enterprises erode and its collection methods deteriorate or collapse. Political pressures, however, imply that expenditures are difficult to cut. Taken together these developments have led to rising deficits in the region which have greatly contributed to the emergence of inflation. The failure to match revenue and expenditure has also encouraged the growth of ad hoc and often confiscatory tax regimes, reducing the incentive to invest and thus constraining private sector development and growth.

Emerging tax systems in the region should take into account many often conflicting considerations. These include revenue, economic efficiency, incentives, stability, simplicity and transparency for authorities and tax payers, equity, robustness to change in the economic system, and the harmonious involvement of different levels of government. Meeting these challenges will require fundamental reform in both the system itself and in tax administration. Base broadening and rate lowering should play a central role.

For the transition, and a bank investing in it, it is vital that the tax system which is created allows entrepreneurship, investment and rational decision-making to develop. To generate adequate revenue the tax system needs to be extended to cover emergent bases and in particular different types of enterprises. This extension must be

achieved in a manner that limits as little as possible the entrepreneurial spirits which will be the driving force of the new economic system. Maintaining stability in the tax system and consistency across different taxpayers are vital in this respect.

The above considerations can help to limit evasion, which threatens to become systemic in many transition societies. Tax compliance is intimately linked with respect for law and property, and is basic to the smooth functioning of the financial system. Growing tax evasion also threatens social cohesion and the consensus for reform. Tax administrations in eastern Europe and the former Soviet Union also have to meet the challenge of growing political and fiscal devolution through the appropriate allocation of tax and expenditure responsibilities across different levels of governments.

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International issues

Chapter 7 Openness to trade and foreign investment in transition

Chapter 8 Trade policy reform

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8.2 Trade policy reform

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9.1 A summary of developments

9.2 The legislative environment for FDI

Table: Legal environment for foreign investment in each country in transition

9.3 Investor motivations

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7. Openness to trade and foreign investment in transition

This chapter describes the role that trade and foreign direct investment (FDI) may play within the transition, and the implications this carries for policy. Subsequent chapters then comment on the extent to which the institutional and policy framework has promoted this role or its deficiencies have hampered it. The focus is not on a description of patterns of trade and FDI, which has been provided in greater depth by other publications.¹

Many countries worldwide have embraced an outward-oriented approach to economic development, particularly since the early 1980s. The evidence on global integration is impressive. While world incomes grew in real terms by one-third from 1982 to 1992, the volume of world trade rose twice as fast, by 65 per cent, further augmenting a process of trade expansion which had been especially rapid in the 1950s and 1960s. FDI, once it had recovered from the 1981-82 recession, grew even more rapidly at almost 30 per cent per year for the remainder of the decade. The number of countries that have participated significantly in these developments has expanded well beyond the OECD area. One Latin American and six Asian developing countries were among the world's top 20 exporters in 1992. Developments regarding FDI have been similar, though more recent. In the period 1986-89, 90 per cent of FDI flows still took place within the OECD area; but FDI into developing countries had risen to approximately US\$ 56 billion, or over a third of the total, by 1993.

Overcoming protectionist pressures which emerged from time to time, the broadening of the world economy during the 1980s was fuelled by the progressive reduction and elimination of barriers to trade, to investment and to financial services – no doubt in an interplay with technological developments. A major contribution of the 1980s and early 1990s is the worldwide convergence on these policies. Underpinning liberalisation there has been a remarkable shift in attitudes. Where market integration had been seen as a threat to a nation's control over its development path, the stress is now on greater individual freedom and competition, and the dynamism and efficiency that derives from them. Similarly, in many developing countries foreign capital had earlier been viewed with suspicion, which led to a preference for sovereign debt as a means of complementing domestic savings. The conviction has now taken hold – and has been translated into more welcoming policies – that foreign

investment provides potential benefits that go well beyond its financial contribution, and that the debt crisis has demonstrated that borrowing carries risks.

Wrapped in the cocoon of central planning, the CMEA (Council for Mutual Economic Assistance) area hardly participated in this process of worldwide economic integration. Joining the world economy along the liberal guidelines of the 1980s has become one of the principal features of the transition process. The “late entry” carried a cost in terms of a profound need for adjustment and in the destruction of existing commercial links – sometimes perhaps more comprehensively than warranted by economic fundamentals. Nevertheless, there is a widespread understanding that progressive integration into the world economy is both a component of economic transition and a crucial factor in bringing it about.

Liberal trade and FDI are carriers of economic benefits that are supportive of growth and may be of particular relevance for the dynamics of transition. They contribute to both macroeconomic demand and supply. As microeconomic phenomena, they can constitute “packages” that transfer goods and knowledge and cause, potentially, a host of behavioural and institutional adjustments. Principal benefits associated with trade and FDI are described and illustrated in Box 7.1. While the macroeconomic contributions have doubtless played a role in recent developments in eastern Europe and the former Soviet Union, the effects at the micro-level are particularly interesting. As argued in Chapter 1, institution-building and behavioural change are at the heart of the process of transition and are often embodied in FDI. Many potential benefits are not captured by the profit and loss statements of the investing or trading enterprises and thus represent, from an economic viewpoint, positive externalities.

Externalities are a recognised form of market failure; crudely speaking, an externality may be defined by effects arising from the activity of an economic agent (household or firm) which do not accrue to that agent. “Positive” externalities represent benefits to others and “negative” externalities costs. Generally policy should be designed to encourage activities that generate positive and discourage those that generate negative externalities. Since the social benefits of building institutions and acquiring new technologies and management methods are likely to be much higher than the private benefits, private enterprise

¹ See UNECE (1994) and EBRD (1993) for a thorough description of patterns of trade; UNCTAD-PTNC (1994) forthcoming, and Meyer (1994) for a detailed discussion of recent FDI patterns.

may be expected to underinvest in these activities. Many governments in eastern Europe and the former Soviet Union have consequently resorted to special incentives as a means of attracting FDI. On the other hand, the enhanced competition resulting from open trade is sometimes viewed as a drawback since, ostensibly, it does not allow infant or currently ailing industries to realise their long-run potential. The market failure here is said to derive from the existence of learning effects together with deficient capital markets which cannot finance the learning period. Some cases of reversal of the initial import liberalisation in the region – discussed in Section 8.3 – appear to reflect this rationale.

Should governments attempt to “steer” trade and FDI so as to maximise its benefits? The case for and against these policies is taken up again below in their respective context, but some general points can be made here. Some of the effects of trade and FDI derive from the volume of activity: their aggregate demand and supply effects, probably the impact on institution-building, etc. These do not tend to cause much controversy. However, depending on the sector and form of activity, FDI and trade are unevenly endowed with some of the other potential benefits (or perceived drawbacks). The answer by governments – not at all limited to the transition economies – has been to design selective and often highly discretionary policies to promote or restrict trade and FDI. While perhaps justifiable in theory, there is reason for caution since in practice market failure tends to be at least evenly matched by government failure, not only in eastern Europe and the former Soviet Union but worldwide. Three sources of government failure are of particular relevance here:

- **Low administrative capacity:** Markets may need to be strengthened in the transition economies, but so do governments. Policies that selectively support or discourage economic activities are hard to design, and even harder to implement if costly mistakes and distorting side-effects are to be avoided. Where various administrative layers are involved, and bureaucrats are still imbued with the *dirigisme* of previous times, managerial problems and corruption may be hard to avoid.
- **Information deficiencies:** Some market failures are caused by imperfect information. As should be expected, this is true in particular regarding transactions that lie in the future. But there is often no

reason to assume that civil servants – whose financial incentives are rarely linked to the outcome of their decisions – should be better prepared for the task of predicting future demand for processes and products, or generally the development of the competitiveness of a particular industrial sector, than private enterprise managers would be.

- **Political economy constraints:** Government might be able but not willing to intervene “correctly”. The distributive effect of discretionary government interventions turns them into a focus for lobbying activities. Governments have to be strong, or democratic processes well balanced, to prevent unwarranted biases. Or else they have to be weak, in the sense of having their hands tied in international treaties or by other means, which in turn limits their discretionary powers.

There are, of course, circumstances in which government intervention to overcome market failure is warranted, even necessary, and in which experience has proven it to be effective. But these tend generally to be cases in which intervention does not target individual companies or industries, but rather establishes rules of the game (such as in the financial and insurance sectors to overcome information failure and the risk of financial sector collapse) or augments the economy’s general receptiveness to change and ability to amplify spillovers and externalities (such as in promoting general education and research).²

The position taken here is that, in the area of foreign trade and FDI, it is generally unwise for governments in eastern Europe and the former Soviet Union to attempt to “pick winners”. The policy regime should allow a country’s comparative advantage to determine patterns of investment and trade, while strengthening its ability to *acquire* comparative advantage through learning effects and spillovers from trade and FDI. As a general rule, selective interventions into the market mechanism should be avoided, predictability increased so as to reduce uncertainty³ – itself a cause of distortions – and policies designed to augment human capital and build appropriate institutions.

Part of this debate could become obsolete in the future, since governments – especially in central Europe – may gradually give up degrees of freedom in industrial policy. While the traditional discussion of policies towards trade

² In some cases in East Asia, a lowering of factor costs (capital) through government intervention, as well as persuasion to coordinate expectations of industry around particular development paths, have been successfully employed in economic policy; however, success can be ascribed in the first instance to a low incidence of government failure, a condition less likely to be met in the transition economies.

³ There can be trade-offs between uncertainty and other distortions, namely when liberalisation is perceived to be politically unsustainable; a credible commitment to step-wise liberalisation less subject to pressure for reversals may then be the best course of action. This issue is taken up again in Section 8.3 in the context of foreign trade policies.

and FDI has focused on border measures which have been termed “shallow integration”; new developments within the world trading system point to a progressive move towards “deep integration”, in particular within regional trading blocks.⁴ Deep integration refers to the harmonisation of national legislation, taxes and industrial policies that affect international competitiveness and the movement of capital and labour as well as of goods and services. The most advanced example of this phenomenon is the creation of the European Union’s single market. NAFTA’s provisions regarding labour and environmental legislation have also been well publicised. At the multilateral level, the results of the Uruguay Round extend international rule-making to trade in services and intellectual property and trade-related investment measures.⁵

In the context of the transition economies, the trade provisions of the Europe Agreements concluded between six eastern European countries and the EU already constrain government discretion significantly in the area of trade policy. In addition, however, they contain far-reaching provisions (and assistance) for a rapid harmonisation of competition policy and legislation, subsidisation policies and other elements of the “*acquis communautaire*” as a basis for subsequent membership. Some degree of “deep integration” in the same areas might also be forced upon other countries of the region to reduce their vulnerability to contingent protection measures in the EU, their largest export market.⁶ The analysis of trade policy is taken further in Chapter 8 and FDI is discussed in greater detail in Chapter 9.

Box 7.1

Potential benefits of foreign trade and investment Macroeconomic level

Aggregate demand: Both trade and FDI may enable the greater utilisation of production capacity by dampening a fall or boosting an increase in aggregate demand. This effect has been in evidence in eastern Europe and the Baltic states (but not in the CIS), whose exports to the West expanded significantly, while the early transition was characterised by macroeconomic austerity and a sudden loss of traditional export markets in the former CMEA area.⁷ Beyond this cushioning function, exports have been successfully used by East Asian economies, and more recently by countries such as Chile and Costa Rica, to provide a dynamic source of economic growth and to enable the realisation of economies of scale.

Aggregate supply: A dynamic tradables sector can increase the level of resources available for growth by raising an economy’s external debt-carrying capacity and by attracting FDI, i.e. hard currency earnings can be leveraged. FDI itself directly adds to available savings.⁸ At the same time, trade and FDI facilitate the modernisation of production facilities through the import of capital equipment.

Microeconomic level

Relative prices and competition: Through relatively free international trade – including a high degree of currency convertibility – a country can “import” a set of relative prices that makes economic sense and inject a degree of competition into an economy dominated by monopolies. For small economies in particular, this makes foreign trade an effective complement to privatisation. This impact on production incentives and market structure was consciously used by governments, in particular in central-eastern Europe and the Baltic states, as a driving force behind their “big bang” policies of market-based restructuring. Irrespective of its other merits, which have been widely discussed,⁹ the fact that this policy is relatively easy to administer has proven to be an advantage given that not only markets, but also bureaucracies face a difficult task of adjustment. FDI can play an important complementary role in this process – especially in the non-tradable sectors – by overcoming barriers to market entry facing new local firms, which may encounter credit or management limitations. As described in UNCTAD-PTNC’s *World Investment Report 1994*, the benefits in terms of price decreases, quality of output and higher productivity can be profound, particularly in service sectors that had been neglected under

⁴ See Lawrence (1991).

⁵ As well as agriculture and textiles which had been excluded previously: GATT began in 1947 as a negotiating forum for industrial tariffs.

⁶ Market access conditions on Western markets are discussed in Section 8.4.

⁷ See Section 8.1 for information on recent trade flows in the region.

⁸ See Section 9.1 for information on FDI flows by country. Domestic savings, household savings in particular, have suffered during the early economic transition. The savings rate out of disposable income, even in a country as advanced in the transition as Estonia, is less than 4 per cent. This has been attributed to the fall in purchasing power that many households have experienced, and to improved consumption choices – the transition from a regime of forced savings (for lack of buying options) to one of market-based, decentralised savings decisions.

⁹ See Balcerowicz (1993) for a spirited defence of the “big bang” approach.

central planning. Thus advertising agencies have reportedly been induced to offer lower prices and better services by the entry of Western companies such as Young & Rubicam, McCann-Erickson and others.¹⁰ Similarly Ceska Pojistovna, the former monopoly provider of insurance in the Czech Republic, has lost 20 per cent of its market share as a result of market entry by foreign providers.¹¹ On the other hand, FDI has also had competition-reducing effects in cases in which multinational enterprises have demanded protection from imports as a prior condition for investing and governments have been willing to oblige.

Institutions: Markets rely on appropriate legal and financial systems as well as supportive administrations to reduce transaction costs. The exposure to market-based transactions and the demands of trading partners and foreign investors can give impetus to the transformation of the inadequate institutional frameworks inherited from central planning so as to ensure better conformity with the requirements of the market. Foreign investment laws have often been the first steps in the development of a transparent and predictable legal basis for contractual relationships, providing a core around which other basic laws evolve. This has been the case, for instance, in the Baltic states, Bulgaria, Romania and the Russian Federation.¹² The ability of the local financial system to conduct market-based transactions has been strengthened, in some cases through direct investments by Western commercial banks and in others through the learning effects (and the income) that derived from short-term foreign trade finance.¹³ Lastly, investor surveys provide evidence of a gradual conversion of government and local administrations towards more “market-friendly” modes of interaction in repeated contacts,¹⁴ while trade agreements – notably the Europe Agreements – have severely curtailed administrative discretion in foreign trade.¹⁵

Knowledge and technology transfer: FDI has sometimes been credited with the ability to diffuse Western technology, know-how, management and marketing skills (and channels) as well as with the capacity to demonstrate standards of quality, safety and environmental acceptability prevailing on international markets. The switch during market-oriented transition from a sellers’ to a buyers’

market forces changes in business culture and demands an array of new skills, in particular for success on export markets. Many of these skills are best promoted by constant exposure and learning-by-doing. From the perspective of the host country, foreign investment enterprises would ideally serve as incubators for these skills and the acquisition of technology, i.e. a certain degree of personnel rotation – while less appreciated by the investing enterprise – may be beneficial for the process of transition. Experiences with technology transfer by foreign investment enterprises in developing countries have been rather mixed, given the interest that multinational enterprises tend to have in maintaining control over proprietary technology. Nevertheless, there have been positive examples. In the case of Renault’s investment in Slovenia, for instance, a series of technology transfer contracts were signed between Renault’s major European component suppliers and Slovene companies to help them upgrade the quality of their products.¹⁶ Among other examples, training programmes for the local labour force feature prominently in Fiat’s investment in Poland.¹⁷

Privatisation: The different components of the FDI “package”, in particular the capital contribution and the ability to turn around uncompetitive enterprises, have been targeted by privatisation programmes in various countries. This strategy has been successful in Hungary, where, in 1990, 95 per cent of the revenues of the state property agency came from foreign investors, with the share declining to around 40 per cent in the first half of 1993.¹⁸ However, massive participation of FDI in the privatisation of state assets has also proved controversial where the dearth of domestic investible funds was viewed as giving an unfair advantage to foreigners, and transactions have been perceived to take place at fire-sale prices or to be linked to corruption. The perception of a sell-out has at times been reinforced by the job-losses during the initial restructuring, and by the closing of whole lines of production as part of multinational enterprises’ strategies of regional consolidation of their value chains. For instance, General Electric closed the production of vacuum equipment, electronic components, floppy disks and magnetic tape at its Hungarian affiliate, Tungsram, some of which were apparently considered profitable operations by that affiliate.¹⁹

¹⁰ UNCTAD-PTNC (1994 forthcoming), p.110.

¹¹ UNCTAD-PTNC (1994 forthcoming), p.110; the Report cites the case of Poland.

¹² See also Section 9.2 on legal frameworks for FDI and Chapter 5 on the evolution of legal systems in the countries in transition. International financial institutions that promote foreign investment in the region have also assisted the process of institutional reform; thus, apart from project-related assistance, the EBRD has elaborated a model law for secured transactions which has been used in Hungary and Poland and is being discussed in other countries.

¹³ The limitations of financial institutions in the countries in transition in the area of trade finance are discussed in Section 8.5.

¹⁴ See Genco, Taurelli and Viezzoli (1993).

¹⁵ However, the Europe Agreements have stopped short of eliminating administrative interference to the extent that multiple non-tariff barriers to market access remain that make it necessary, e.g., to assign licences to exporters.

¹⁶ UNCTAD-PTNC (1994 forthcoming), p.103.

¹⁷ They are also a regular feature of other EBRD-supported projects in the region; more general information is hard to obtain.

¹⁸ Lane (1994). In Poland, 45 per cent of total FDI between 1988 and 1992 was linked to the privatisation process. Even in the Czech Republic, which has applied preferential conditions for citizens in the privatisation process, 87 per cent of FDI during the same period was related to privatisation.

¹⁹ UNCTAD-PTNC (1994 forthcoming), p.106.

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8. Trade policy reform

This chapter analyses the evolution of trade policy in eastern Europe and the former Soviet Union and briefly reviews access conditions to Western markets. There has been a remarkable degree of liberalisation (in both East and West), but many discretionary interventions remain and there have been some setbacks in the reform process. The chapter goes on to discuss deficiencies in trade finance which were partly responsible for the disruption of pre-existing commercial links.

8.1 A summary of developments

The evolution of cross-border trade in eastern Europe and the former Soviet Union has been one of the more drastic reflections of systemic change in the region. Trade flows are captured in Tables 8.1 and 8.2.¹ Developments, set out more fully in the EBRD's *Annual Economic Outlook* 1993,² have been far from uniform:

- Trade among the former CMEA partners and among the republics of the former Soviet Union shrank by half or more between 1989 and 1993.
- At the same time, the fast-reformers in eastern Europe and the Baltic states achieved a rapid reorientation of trade flows towards the Western market economies, according to OECD statistics, while the Western trade of the other transition economies stagnated. The European Union market has clearly dominated as a destination for these “new” exports (Chart 8.1).
- Apart from the geographical distribution of trade, its product composition has also changed, since capital goods and other so-called “soft” goods (i.e. manufactured goods of a quality that could not hold its own in hard currency trade) have been the principal victims of the intra-regional trade collapse.
- Although deliveries from the region have grown dynamically in recent years, total extra-regional merchandise exports from eastern Europe and the former Soviet Union in 1993 did not surpass those of the Republic of Korea alone.

A multitude of factors explain these developments, many of which are quite specific to the individual economies and will not be taken up here. Nevertheless, it is clear that the nature and depth of reforms as well as various transitory

impediments to international trade can explain overall trends and some of the variation across countries. Above all, the opening of trade and exchange regimes – to be discussed more fully in the following – was a forceful and often consciously used means of disrupting the economic coordination mechanisms of central planning. Other, less welcome, causes of trade destruction are discussed in Section 8.5 below.

8.2 Trade policy reform

As reported in the transition indicators (Appendix 2.1), reform programmes have gone far in dismantling explicit quantitative restrictions on imports and exports and in introducing liberal tariff regimes. As a result of liberalisation, the international competitiveness of enterprises producing tradable goods has become important in determining the pattern of cross-border trade. Some of the former intra-regional trade had no economic justification in a market environment, while trade with OECD and other countries had been artificially suppressed under central planning. By applying competitive pressure, liberalisation reshaped these trade flows. To a large – though hard to quantify – extent, the disappearance of some commercial transactions and the surge of new ones thus testifies to the more appropriate use of the region's resources.

Trade regimes in eastern Europe and the former Soviet Union are described in Table 8.3. Direct controls on imports – the mainstay of the previous import regimes – have generally been abolished. In eastern Europe, explicit restrictions of any importance remain only in some of the more advanced transition economies – the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. Even in these countries, quotas appear to be limited to products that also carry the label of “sensitive” in the West and tend to be severely restricted there. However, the table does not include restrictions as a result of contingent protection measures, which are discussed below for Hungary. In all other countries of the region, including those of the CIS in which this can be established with some confidence, explicit quantitative restrictions on imports have been eliminated even in agricultural trade, though some licensing appears to have been maintained. It should be noted, however, that over 70 per cent of intra-CIS trade in 1992–93 was conducted on the basis of bilateral agreements on strategic supplies at regulated prices, which often diverged widely

¹ Information on trade flows can differ substantially between national sources and the “mirror” statistics of the trading partners. This is best documented by Bulgaria, for which OECD statistics (Table 8.2) show substantial success in raising exports to the West, while a decline was registered in national sources. Large inconsistencies in statistics are also evident when one compares trade between eastern Europe and the countries in the former Soviet Union as reported independently by these two sets of countries (compare the upper and lower parts of Table 8.1).

² See UNECE (1994) for a more recent and complete discussion of developments in foreign trade.

Table 8.1 Foreign trade performance of countries in transition
(based on data reported by these countries)

Eastern Europe ¹	<i>Growth in US dollar values (in per cent)</i>					<i>Value (in US\$ billion)</i>	
	1989	1990	1991	1992	1993²	1988	1992
Exports (total) to:	-3.2	-2.8	-6.9	-4.8	-2.1	63.9	53.3
Eastern Europe ³	-8.4	-25.6	-20.1	-9.7 ⁴	-13.1 ⁴	6.1	3.0
Former Soviet Union ³	-9.3	-16.1	-25.1	-31.7 ⁴	16.0 ⁴	13.9	5.4
Developed market economies	6.5	9.9	6.6	0.4	-2.2	27.9	34.9
Developing countries	-12.5	-12.6	-11.8	8.1	9.0	8.4	6.1
Imports (total) from:	-2.2	4.6	-4.1	1.1	14.4	61.1	60.6
Eastern Europe ³	-8.9	-17.3	-25.8	-4.4 ³	-10.5 ⁴	5.2	2.8
Former Soviet Union ³	-12.5	-10.8	-9.3	-6.5 ³	1.3 ⁴	13.3	8.8
Developed market economies	4.8	19.1	7.8	9.2	20.7	27.0	39.6
Developing countries	5.5	6.7	-9.2	-22.1	18.4	7.28	5.8

Former Soviet Union /Russian Federation ⁵	<i>Growth in US dollar values (in per cent)</i>					<i>Value (in US\$ billion)</i>	
	1989	1990	1991	1992	1993	1988	1992
Exports (total) to:	0.4	-5.2	-24.6	-25.2	1.4	79.6	42.4
Transition economies ⁶	-8.7	-24.3	-35.0	-25.8	-12.6	39.0	13.0
Eastern Europe ³	-11.1	-26.9	-40.8	-32.7	-7.9	30.1	7.8
Developed market economies	7.8	-12.6	-16.2	-20.3	4.6	30.4	24.6
Developing countries	2.0	-9.5	-29.0	-44.0	23.1	13.1	4.8
Imports (total) from:	12	-0.1	-35.9	-21.3	-27.1	65.5	37.0
Transition economies ⁶	-4.5	-10.6	-43.4	-42.8	-14.7	31.8	8.8
Eastern Europe ³	-5.7	-12.1	-51.6	-49.7	-46.1	27.3	5.5
Developed market economies	21.1	5.6	-31.0	-13.0	-36.9	30.1	23.1
Developing countries	26.0	3.8	-35.8	-2.6	-4.5	6.4	5.2

Source: UNECE "Economic Survey of Europe", various issues; IMF.

¹ Eastern Europe includes Albania, Bulgaria, the Czech and Slovak Republics, Hungary, Poland, Romania, former Yugoslavia and the German Democratic Republic through 1990. Data exclude "new" foreign trade (i.e. trade among the successor states of the CSFR and Yugoslavia).

² From Jan-Sept 1992 to Jan-Sept 1993.

³ Definitionally the value of exports (imports) from eastern Europe to the former Soviet Union is the same as imports (exports) into the former Soviet Union from eastern Europe (except for CIF/FOB – valuation differences). The fact that there are inconsistencies in Table 8.1 in this respect is due to measurement and reporting errors.

⁴ Data excludes former Yugoslavia and Albania.

⁵ Before 1991 Soviet Union, thereafter Russian Federation.

⁶ In this context the concept "transition economies" comprises east European countries (including former Yugoslavia), the former Soviet Union, the Asian centrally planned economies (including China) and Cuba.

**Table 8.2 Foreign trade between countries in transition the OECD area
(based on data reported by OECD countries)**

Exports to OECD countries	Growth in US dollar values (in per cent)				Value (in US\$ billion)	
	1990	1991	1992	1993	1989	1993
Eastern Europe-6	23	15	19	2	19.0	32.3
Bulgaria	26	27	28	78	0.8	2.9
Former Czechoslovakia	20	35	40	1	4.1	9.3
Hungary	29	17	9	-10	4.4	6.6
Poland	48	11	13	-2	6.0	10.9
Romania	-25	-15	4	7	3.7	2.6
Former Soviet Union	24	2	-2	11	25.1	34.2
Baltics	na	na	na	52	na	2.4
Newly Independent States	na	na	na	9	na	31.8
Former Yugoslavia	27	-7	-19	-21	9.6	7.3
Imports from OECD countries	Growth in US dollar values (in per cent)				Value (in US\$ billion)	
	1990	1991	1992	1993	1989	1993
Eastern Europe-6	23	34	27	7	18.0	40.1
Bulgaria	-34	6	13	6	2.4	2.0
Former Czechoslovakia	35	29	72	2	3.6	11.0
Hungary	18	22	18	9	4.6	8.5
Poland	26	63	8	9	6.1	15.0
Romania	106	-5	38	11	1.2	3.5
Former Soviet Union	-3	5	-6	8	28.1	29.0
Baltics	na	na	na	52	na	2.1
Newly Independent States	na	na	na	6	na	27.0
Former Yugoslavia	45	-24	-18	-1	9.6	8.6

Note: 1993 data do not include trade with Belgium/Luxembourg, Denmark and Ireland.

Source: Monthly statistics of Foreign Trade (Series A), OECD.

from world prices. Given the continuing predominance of state enterprises in some of these countries – see Chapter 3 – as well as restrictions on currency convertibility, the import regime is not always transparent or well described by tariffs or explicit quotas.

It is striking that, within very few years of the beginning of the economic transition, import regimes have become highly liberal by international standards in most countries of the region. Estonia and, it appears, Ukraine have almost no import tariffs at present. In fact, out of the 16 countries where average tariffs have been established or can be inferred from the table, in 10 countries it is lower than the current OECD average of 6.3 per cent.³ It is less than twice the OECD average in most of the remaining six countries, with the exception apparently of Moldova.⁴ This latter group includes some of the larger countries of the region, notably Russia, Poland and Romania. In addition, there is in most countries a relatively limited variance of duties across products.

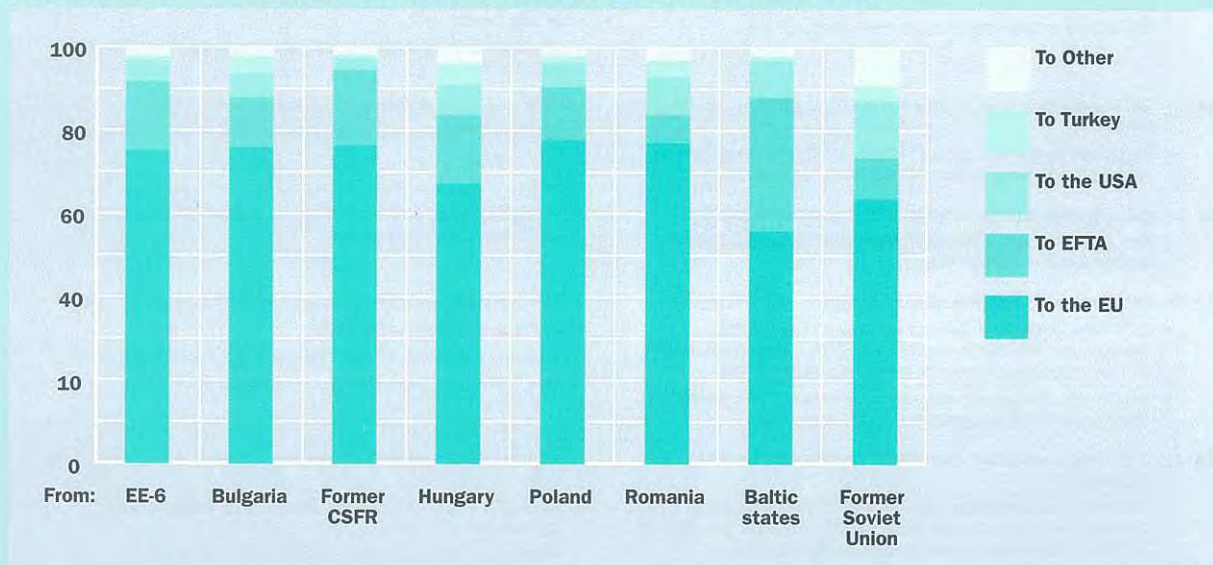
On the export side, the situation differs considerably among countries but tends to be much more restrictive. In eastern Europe, certain restrictions in the form of duties, quotas or licences remain in place in Bulgaria, Latvia, Lithuania, Romania and Slovenia. Some degree of intervention is also reported for Albania, the Czech Republic and the Slovak Republic. It is noteworthy that export restrictions (or rather the “management” of exports) have been introduced in some cases because of market access restrictions in the West – the table mentions Bulgaria, the Czech Republic and the Slovak Republic, though other countries exporting textiles and food are likely to have similar regimes.

In the countries of the CIS, highly restrictive export regimes continue to be the rule, with Kyrgyzstan the only notable exception. Export duties or currency surrender requirements at below-market exchange rates cover many product groups, while quotas are applied to raw materials, foodstuffs and other strategic exports. In some cases

³ For industrial products only; the average tariff is to be reduced to 3.9 per cent under the Uruguay Round agreement by January 1995. The corresponding current value for developing countries is 6.8 per cent (source: GATT). By way of contrast, average import tariffs of large Latin American countries in the heyday of the import substitution philosophy in the 1960s could range up to 150 per cent.

⁴ There are, however, severe limitations on the accuracy of such data for many countries of the former Soviet Union.

Chart 8.1 Distribution of exports by OECD destinations in 1993
(in per cent of total exports, from each identified origin, to the OECD area)



Note: 1993 data do not include trade with Belgium/Luxembourg, Denmark and Ireland.

Sources: Monthly statistics of Foreign Trade (Series A), OECD.

obstacles to exports might be regarded as defensive measures to counter arbitrage resulting from the subsidisation of raw materials, undervalued exchange rates, and the widespread practice of illegally acquiring state enterprise property for sale abroad. Other reasons have included dumping accusations by Western companies (in the aluminium industry). Generally, however, export curbs are inimical to the development of rational trade patterns and they foster bureaucratic control. Their elimination is likely to hinge on the general progress of reforms.

8.3 Setbacks in the liberalisation process

The initial sweeping liberalisation has in some countries given way to a partial reconsideration of tariff regimes and quotas, resulting in the – still limited – reintroduction of both broad and selective forms of import protection. One of the main features of existing trade laws on the import side is the considerable amount of discretion they leave to the authorities. No country of the region except

for the Czech Republic and the Slovak Republic is fully subject to GATT disciplines, and several governments have made use of that discretion.

Various countries, most notably Poland, Bulgaria and Russia, have raised average MFN⁵ tariff levels, passing through frequent suspensions and reintroductions of import surcharges and the enactment of new general tariff schedules. The trend appears to be towards higher rates on competing imports of final goods, while imported inputs remain much less affected. This conforms with worldwide patterns of protection, which is enjoyed particularly at the final stages of assembly. A further pattern that emerges is the discriminatory favouring of large foreign investments by protective barriers, often as a result of intense lobbying and as a precondition for the investment to take place (see Section 9.4). Quotas have also reappeared, again most notably as part of packages to attract foreign investors. Lastly, well founded or not and modelled on current Western practice, in certain instances – particularly in

⁵ MFN (most-favoured-nation) status, a GATT principle, ensures that a particular exporting country will not be treated worse than others (this does not apply, however, within free trade agreements or to preferences for developing countries – the GSP). MFN does not have to be granted by or to non-signatories of the GATT; however, its application tends to be broader than the GATT membership. Tariff rates are generally substantially lower with MFN than without it.

Table 8.3 Foreign trade agreements and trade regimes of each country in transition
Eastern Europe and the Baltic states

Major trade agreements

Relations with GATT, EU, EFTA, other OECD, intra-regional
(Agreements are described in Box 8.1)

Albania	- GATT observer status, working party on accession (1992). - EC Trade and Cooperation agreement (Sept. 1993).	- EFTA Declaration on Cooperation Dec. 1992, Free Trade Agreement in negotiation. - All other OECD countries except Japan have granted MFN and/or GSP status.
Bulgaria	- GATT working party on accession (1986), expected to be concluded in 1994. - EU Europe Agreement signed* March 1993, Interim Agreement covering trade components entered into force Jan. 1994.	- EFTA Free Trade Agreement in force since July 1993. - All other OECD countries have granted MFN and/or GSP status.
Croatia	- GATT observer status, working party on accession (1993). - Terms of EC Cooperation Agreements with Yugoslavia (1980) applied to Croatia as of 1991.	MFN/GSP status granted by Japan in 1993.¹ Information on other OECD countries not available.
Czech Republic	- GATT original contracting party as successor to CSFR (1948). - EU Europe Agreement signed* with CSFR in Dec. 1991, renegotiated with Czech Republic Oct. 1993. Interim Agreement covering trade components in force since March 1992. - EFTA Free Trade Agreement in force since July 1992, protocol on succession of CSFR agreement signed April 1993.	- All other OECD countries have granted MFN and/or GSP status. - CEFTA in force since May 1993. - Customs Union with Slovak Republic in force since Jan. 1993. - Free Trade Agreement with Slovenia signed Dec. 1993.
Estonia	- GATT observer status (June 1992), working party on accession (March 1994). - EC Trade and Cooperation Agreement in force since March 1993. - EU Free Trade Agreement signed July 1994 to enter into force by Jan. 1995. Exploratory talks on Association Agreement. - EFTA Declaration on Co-operation Dec. 1991; bilateral Free Trade Agreements in force with Finland (Dec. 92), Norway (Aug. 93), Sweden (July 92) and Switzerland (Apr. 93).	- All other OECD countries except Japan¹ have granted MFN and/or GSP. - Baltic FTA in force since April 1994, but agricultural trade unresolved. - Free Trade Agreement with Slovenia signed May 1994. N.B. MFN agreement with Russia not yet implemented.
FYR Macedonia	- GATT observer status. - Terms of EC Cooperation agreements with Yugoslavia in 1980 applied as of 1991.	Japan has granted MFN/GSP status since April 1993.¹ Information on other OECD countries not available.
Hungary	- GATT contracting party (1973); working party on re-negotiation of accession terms formed. - EU Europe Agreement in force (i.e. fully ratified) since Feb. 1994, Interim Agreements covering trade component in force since March 1992.	- EFTA Free Trade agreement in force since Oct. 1993. - All other OECD countries have granted MFN and/or GSP status. - CEFTA in force since March 1993. - Free Trade Agreement with Slovenia in force since July 1994 (tariffs phased out by 2001).
Latvia	- GATT observer status (Oct. 1992), working party on accession (1993). - EC Trade and Cooperation Agreement in force since Feb. 1993. EU Free Trade Agreement signed in June 1994 to enter into force by Jan. 1995. Exploratory talks on Association Agreement. - EFTA Declaration on Co-operation Dec. 1991, bilateral Free Trade Agreements in force with Finland (May 93), Norway (Aug. 93), Sweden (July 92) and Switzerland (Apr. 93).	- All other OECD countries except Japan¹ have granted MFN and/or GSP. - Baltic FTA in force since April 1994, but agricultural trade unresolved. N.B. MFN agreement with Russia not yet implemented.
Lithuania	- GATT observer status (Oct. 1992); working party on accession (1993). - EC Trade and Cooperation Agreement in force since Feb. 1993. EU Free Trade Agreement signed in June 1994 to enter into force by Jan. 1995. Exploratory talks on Association Agreement. - EFTA Declaration on Co-operation Dec. 1991, bilateral Free Trade Agreements in force with Finland (Jan. 93), Norway (Aug. 93), Sweden (Aug. 92) and Switzerland (Apr. 93).	- All other OECD countries except Japan¹ have granted MFN and/or GSP status. - Baltic FTA in force since April 1994, but agricultural trade unresolved. N.B. MFN agreement with Russia not yet implemented.
Poland	- GATT contracting party (1967), working party on re-negotiation of accession terms. - EU Europe Agreement in force (i.e. fully ratified) since Feb. 1994. Interim Agreements covering trade components in force since March 1992.	- EFTA Free Trade Agreement in force since Sept. 1994 (applied since Nov. 1993). - All other OECD countries have granted MFN/GSP status. - CEFTA in force since March 1993.
Romania	- GATT contracting party (1971), working party on re-negotiation of accession terms. - EU Europe Agreement signed* Feb. 1993. Interim Agreement covering trade components in force since May 1993.	- EFTA Free Trade Agreement in force since May 1993. - All other OECD countries have granted MFN and/or GSP status.
Slovak Republic	- GATT original contracting party as successor to CSFR (1948). - EU Europe Agreement with CSFR signed* Dec. 1991, renegotiated for Slovakia October 1993, Interim Agreement covering trade components in force since March 1992. - EFTA Free Trade Agreement entered into force July 1992 for CSFR, protocol on succession of that treaty signed April 1993.	- All other OECD countries have granted MFN and/or GSP status. - CEFTA in force since March 1993. - Customs Union with Czech Republic since Jan. 1993. - Free trade agreement with Slovenia signed Dec. 1993 (virtually free trade planned for 1996).
Slovenia	- GATT working party on accession (1992). - EC Trade and Co-operation Agreement (April 1993), EC Commission expected to receive mandate for negotiation of Association Agreement soon. - EFTA negotiations on Free Trade Agreement.	- Japan has granted MFN/GSP status since April 1993; no information available on other OECD countries. - Free Trade Agreements signed with Czech Republic (Dec. 1993), Slovak Republic (Dec. 1993), Hungary (April 1994) (tariffs to be phased out by 2001) and Estonia (May 1994).

¹ Japan was to offer MFN status upon the acceptance of previous agreements. In practice Japan has granted MFN/GSP status to countries if they are deemed to have succeeded the trade agreement from the previous entity such as Yugoslavia and the USSR. However, some countries are not deemed to have succeeded these agreements and thus MFN/GSP status is not applied in practice.

Trade regime

Tariff and non-tariff import barriers**

Four rates of import tariffs from 0-30% ad valorem, excluding temporary surcharge of 5%. No quantitative restrictions.
Average tariff from 13% (1989) to 11% (1991) to 16% (1992). 22% average tariff on industrial goods reported in 1994. Minimum prices for tyres and steel pipes. Restrictive import licences for a limited number of products. Some tariff quotas on processed foods and agricultural products.
10% import tax introduced in autumn 1993 as part of macroeconomic stabilisation programme. No quantitative restrictions.
Average weighted tariff 5.7% in 1993 (based on 1990 CSFR imports). Quantitative import restrictions on some agricultural products, textiles, clothing, steel and coal; licences for oil, gas and weapons.
Only 14% of imports are subject to duties (10% duty for furs, sea and road vehicles), average weighted tariff 1.4% (1993). Licences for alcohol and tobacco. No quantitative restrictions. Import subsidies abolished beginning of 1992.
Average tariff of 4.7% in 1993. Quotas on only 4% of imports (mostly agriculture, imposed seasonally). Over 90% of imports free of licensing requirements.
About 10% of imports subject to quota or licensing restrictions, with number increasing in 1994. Average unweighted tariff changed from 13% (1989) to 11% (1991) to 16% (1992); further increase in 1994 (on imports by individuals).
Basic tariff 15% (as of March 1994), but many exceptions at 0.5% (raw materials, food products); some high agricultural tariffs. Import licensing and quotas for military products and tobacco. No import subsidies.
Import tariffs 5-15%; higher for food products, alcohol, tobacco and about a dozen manufactured goods (carrying tariffs up to 25%). No quotas since Oct. 1993 except for health and safety reasons.
Average weighted tariff 11% on industrial products and 18% on agricultural goods (1993) (after a 9.4% overall average in 1991). Most quantitative restrictions eliminated in 1990. Quotas on wheat, cars, alcohol, cigars, cigarettes, engine oil and petrol.
Most licensing requirements eliminated in May 1992. Weighted average tariff 11.7% (1993), maximum rate 40%. Restrictions only for arms, drugs and items affecting national health. 30% anti-dumping duty on alcohol, vehicles, TVs and video recorders imposed between May-Oct. 1993.
A 10% surcharge on imports established in March 1994 was removed in August. Average weighted tariff in 1993 was 5.7% (based on 1990 CSFR imports). Quantitative import restrictions on some agricultural products, textiles, clothing, steel and coal; import licences for oil, gas and weapons.
Generally tariff free. Where tariffs are applied, rates range up to maximum 25%. Customs formality tax of 1%. Some quotas on agricultural and textile products (98% of products free of quotas).

Export quotas and other export barriers

Only eight product groups subject to export licences. Temporary export tax on six unprocessed natural-resource-based products (introduced March 1993).
Export taxes on 30 items, mainly foodstuffs, have replaced most export quotas. Export quotas on six primary commodities. Occasional export bans on agricultural products. Registration and licensing restrictions still operative.
High degree of liberalisation, most exports tariff free.
20% of exports required licensing in 1992. Export tax of 100% applies only to antiques and art works. Export licensing for livestock and plants, some natural resources, and products such as textiles and steel which are subject to quotas in other countries.
Minimal export barriers. 100% export tax on antiques and art works. Quotas removed except for export ban on gravel and specialised clay. Most licensing requirements removed Oct. 1991. No export subsidies.
Export quotas removed in Jan. 1994. Over 90% of exports free of licensing requirements.
Exports of fuels, wheat and industrial raw materials subject to licences (a little less than 25% of total exports). 80% of the agricultural budget in 1993 devoted to export subsidies. In 1992, these amounted to an estimated 13% of export value.
Export taxes on raw materials, precious metals and antiques. Few quantitative restrictions, mostly for health and national security reasons. No export subsidies.
Some export taxes on raw materials and foodstuffs. No export subsidies. Some quantitative restrictions. Export licensing system abolished in July 1993.
Minimal export restrictions. Most export subsidies were eliminated in 1990.
Export quotas on raw materials for conservation reasons and drugs for price support reasons. Occasional export bans on food, fruits and wood products. Reduced export licensing requirements since June 1993.
Export licensing for livestock and plants, some natural resources, and products such as textiles and steel which are subject to quotas in other countries.
Temporary export duties of 10-25% on raw materials. Permit for export of "susceptible goods".

Exchange regime***

Restrictions on current account, heavy controls on capital account. Floating rate.
Few restrictions on current account, heavy controls on capital account. Floating rate.
Few restrictions on current account, some controls on capital account. Floating rate with CB intervention.
Current account convertibility for enterprises, some capital controls. Peg to DEM/USD. Special clearing account with Slovak Republic.
Full current account, virtual capital account convertibility. Currency board with rate fixed to DEM.
Few restrictions on current account (tourism), controls on capital account. Floating rate.
Current account convertibility (except tourism). Some restrictions remain on capital account. Peg to USD/ECU basket.
Full current and capital account convertibility. Informal peg to SDR.
Full current and (virtually) capital account convertibility. Currency board, with rate fixed to USD.
Largely current account convertibility, limits on residents' capital account transactions. Pre-announced crawling peg regime.
Virtual current account convertibility (except tourism), but capital controls. Floating exchange rate.
Current account convertibility for enterprises, some capital controls. Peg to DEM/USD. Special clearing account with Czech Republic.
Full current account convertibility, some restrictions on capital account. Floating exchange rate.

* Signed but not yet in force.
** Average tariff rates are from a variety of different sources using divergent methodologies and should be viewed as indicative only.
*** Treatment of profit and capital repatriation by foreign investors is described in Table 9.3.

Commonwealth of Independent States

Major trade agreements

Relations with GATT, EU, EFTA, other OECD, intra-regional (Agreements are described in Box 8.1)

Armenia	• GATT observer status (July 1992). • EC Trade and Cooperation Agreement signed Dec. 1989 with USSR, still in force.	• Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis. • Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
Azerbaijan	• GATT observer status (1993). • EC Trade and Cooperation Agreement (Dec. 1989) with USSR still in force, but not signed by Azerbaijan. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.	• Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries. • Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).
Belarus	• GATT observer status, working party for accession (1993). • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. Negotiating an EU Partnership and Cooperation Agreement. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.	• Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries. • Union treaty with Russia (Jan. 1994), aiming for economic union. • Free trade agreement with Ukraine
Georgia	• GATT no official status. • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force.	• Other OECD countries, except Japan¹ and the US, have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis. • Economic Union signed with CIS countries (Sept. 1993). Bilateral barter and inter-governmental agreements in place with CIS countries.
Kazakhstan	• GATT observer status (Oct. 1992). • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. EU Partnership and Cooperation Agreement initialed May 1994. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.	• Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries. • Single Economic Space with Kyrgyzstan and Uzbekistan in force since Jan. 1994. • Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).
Kyrgyzstan	• GATT observer status (1993). • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. EU Partnership and cooperation Agreement initialed May 1994. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.	• Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries. • Single Economic Space with Kazakhstan and Uzbekistan in force since Jan. 1994. • Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).
Moldova	• GATT observer status; working party on accession (1993). • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. Negotiating an EU Partnership and Cooperation Agreement. • Other OECD countries have granted MFN and/or GSP status, some	- on an exceptional, temporary or de facto basis. • Economic Union with CIS countries signed Sept. 1993. Bilateral inter-governmental barter agreements in place with CIS countries. • Free Trade Agreements with Czech Republic, Hungary, Poland, Romania, Slovak Republic, Ukraine.
Russia	• GATT observer status (1990); working party on accession (June 1993), memorandum on trade policies presented in Feb. 1994. • EU Partnership and Cooperation Agreement signed June 1994; free trade talks only in 1998. • All other OECD countries have granted MFN and/or GSP status.	• Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries. • Union Treaty with Belarus aimed at establishing economic union (signed Jan. 1994)
Tajikistan	• GATT observer status. • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.	• Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries. • Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).
Turkmenistan	• GATT observer status (July 1992). • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis. The US has not granted MFN/GSP, but a bilateral trade agreement was signed in 1992.	• Economic Union with CIS countries signed Dec. 1993. Bilateral barter and inter-governmental agreements with CIS countries. • Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).
Ukraine	• GATT observer status (July 1992), working party on accession (1993). • EU Partnership and Cooperation Agreement signed June 1994. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.	• Economic Union with CIS countries (Sept. 1993) not signed by Ukraine, but associate statue since April 1994. Bilateral barter and state order agreements in place with CIS countries. • Free Trade Agreements with Belarus and Moldova.
Uzbekistan	• GATT observer status (June 1994). • EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force, but not signed by Uzbekistan. • Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis. • Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements with CIS countries and some former CMEA partners.	• Single Economic Space with Kazakhstan and Kyrgyzstan in force since Jan. 1994. • Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

¹Japan was to offer MFN status upon the acceptance of previous agreements. In practice Japan has granted MFN/GSP status to countries if they are deemed to have succeeded the trade agreement from the previous entity such as Yugoslavia and the USSR. However, some countries are not deemed to have succeeded these agreements and thus MFN/GSP status is not applied in practice.

Table 8.3 Foreign trade agreements and trade regimes of each country in transition

Trade regime

Tariff and non-tariff import barriers**

Most goods tariff-free, except raw materials, equipment and some consumer-goods. Maximum duty 20%. 10% general import tariff for non FSU countries. No quantitative restriction except for health, national security or environmental reasons.

Tariffs on imports from non-FSU countries eliminated Aug. 1992. As of 1993, licences only required for military supplies. Import duties may be rendered ineffective by limited border controls.

Import tariffs 10-20%, higher rates for a few products introduced in Oct. 1993, but FSU countries exempt. Import subsidies abolished in Aug. 1993. Few quantitative or licensing restrictions, mostly for health and national security.

2% uniform duty on all imports except food items. Import licences generally not required. No significant import quotas.

Trade system streamlined in May 1994. Import tariffs from 0-50%, generally 5%. Rates vary between individuals and enterprises as well as between goods. FSU countries exempt. Importers have to be licensed. Few quantitative restrictions, mostly for health and national security.

Substantial liberalisation of import restrictions in early 1994. No specific tariffs.

New import tariff schedule adopted Nov. 1993 which reduces average tariff to about 30%, few commodities at maximum rate of 100%. Few licences, mainly for health, national security, environment reasons.

Relatively free of quotas and licensing requirements. Weighted average tariff raised to 14% in July 1994. Excise duties of 10-400% on some products. Import subsidies phased out by early 1994 (1992: 17.5% of GDP).

Command system continues to dominate production and trade. Duties 5-100% in rouble terms, lower if paid in hard currency at official exchange rate.

Centralised state trading continues to be prevalent. 1981 USSR customs code still in force. Imports from FSU countries exempt of duties.

Foreign trade recentralised late 1993, leaving most transactions (both within and outside CIS) subject to bilateral agreements and state order system. Few tariff rates since Jan. 1993, ranging from 0-10%, with a limited number of goods (incl. textiles, cars) facing tariffs up to 50%. No significant quotas.

Up to 40% duties on imports from non-FSU countries in 1993; all suspended in early 1994 until mid-1995. Few quantitative restrictions except for health and national security reasons. Import subsidies on commodities acquired through barter.

Export quotas and other export barriers

No significant export taxes. Export licences for nine product groups. No quantitative restrictions.

Strategic exports, mostly raw materials, sold through bilateral state trading agreements at fixed prices. Extensive export quotas, licences and taxes.

Export taxes of 2-30% since April 1992. 10% surcharge on convertible currency exports and barter outside the FSU since Jan. 1993. Quota and licensing system for 11 product categories, mainly energy, raw materials, and foodstuffs. Quantitative restrictions substantially reduced early 1994.

8% tax on non-FSU exports. Significant licensing requirements.

Exporters outside state-order system have to be licensed. Export taxes on many products, avg[?]. 18% in 1992, but substantially cut in 1994. Restrictions on 29 products to non-FSU and 59 products to the FSU (mostly strategic commodities) in 1993. Plans to liberalise (auction off quotas) at end-1994. No export subsidies.

Export licensing requirements have been eliminated. No export quotas, taxes or subsidies since December 1993, with the exception of nine groups of goods (incl. grains and live animals), which are subject to export taxes of 30%. State-order system has been replaced by voluntary supply contracts.

Soviet era export taxes abolished Nov. 1993. 5% surcharge on certain exports to the FSU. Licensing requirements for 77 export categories. Export quotas on leather, energy products and cereals. No export subsidies.

Wide range of tariff and non-tariff restrictions. Export of strategic goods, mainly raw materials, only by registered exporters. Introduction of 'commodity passports' in 1994 to limit capital flight. Quotas on most energy and raw material products (2/3 of total exports in 1993). Scope of quota and licensing systems reduced in early 1994, but scrapping postponed to 1995.

Centralised state trading still prevalent.

State-trading prevalent. Quantitative restrictions for main exports (natural gas, oil and cotton) and subsidised goods. Export taxes of 10-50%. Licensing requirements for non-FSU exports, but liberal rules for obtaining licences.

Foreign trade recentralised late 1993, leaving most transactions (both within and outside CIS) subject to bilateral agreements and state order system (explicit exports quotas and licences for virtually all products since March 1994). Export duties within state orders largely eliminated. No export subsidies.

Export taxes on 65 product groups from 5-50%. Licensing arrangements reduced to 26 strategic products in early 1994. FSU trade on hard currency basis since May 1994. No export subsidies.

Exchange regime, other aspects***

Restrictions on current and capital account convertibility. 50% export surrender requirement at official rate. Floating rate.

Restrictions on current and capital account convertibility. Export surrender requirement at official exchange rate, set on basis of commercial bank rates. Strategic exports valued at domestic prices, creating multiple implicit exchange rates.

Interim currency, with restrictions on current and capital account convertibility. Floating rate with heavy CB intervention. New rouble zone planned with Russia and Tajikistan.

Interim currency, heavily restricted convertibility. Rate floating within these parameters. 32% export surrender requirement at official rate implemented in June 1993. 20% customs duty on barter arrangements.

Current account convertibility for enterprises, restrictions on capital account. Floating rate, but intervention. 50% surrender requirement to inter-bank market. Small trading amounts (\$1,000 for exports and \$10,000 for imports) exempt from all tariffs.

Current account convertibility for enterprises, restrictions on capital account. Floating rate, but intervention.

Largely current account convertibility, some capital restrictions. 35% export surrender requirement, but market-based floating rate. Barter trade disallowed with convertible currency countries.

Largely current account convertibility (capital restrictions), floating rate. 50% export surrender requirement to inter-bank market. New rouble zone planned with Belarus and Tajikistan.

Rouble remains official currency. 30% export surrender requirement. New rouble zone planned with Russia and Belarus.

Current account convertibility with various restrictions. Capital controls. 50% export surrender requirement at official rate. Multiple exchange rates for different transactions.

Interim currency with heavy restrictions on convertibility. Floating with intervention. 50% export surrender requirement at official exchange rate (effectively a 30% tax). Multiple exchange rates are to be gradually united. Much of foreign trade "underground".

Interim currency with convertibility restrictions, managed float. State foreign trade monopoly lifted in March 1994. 30% export surrender requirement at rate set by the central bank.

* Signed but not yet in force.

** Average tariff rates are from a variety of different sources using divergent methodologies and should be viewed as indicative only.

*** Treatment of profit and capital repatriation by foreign investors is described in Table 9.3.

Box 8.1**Glossary of principal trade agreements***Europe Agreements*

Europe Agreements (EAs) aim to further the integration of east European countries into the EU by lowering barriers to trade, establishing a framework for political dialogue, harmonising legislation, cooperating on science and technology, and providing for technical cooperation. EAs have been concluded with Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic. The most important aspect of the agreements is the establishment of free trade in industrial goods over 10 years asymmetrically – with the EC reducing protectionist measures faster. Remaining trade barriers applied by the Community on industrial imports will be abolished by January 1995,⁶ except for textiles (1997). Further concessions on trade in agricultural products are applied on a reciprocal basis. The EAs include standstill clauses prohibiting the introduction of new trade restrictions, safeguard clauses, anti-dumping provisions, and definition of originating products (rules of origin). The east European countries are, however, allowed to derogate exceptionally from the standstill clause in order to protect, under strict conditions, infant industries and sectors under restructuring. Harmonisation of legal and institutional provisions governing competition and state subsidies is emerging as a key element of the EAs in the wake of the elimination of import tariffs and quotas (as a means of pre-empting other forms of non-tariff protection). Association Councils (ministerial level) monitor the implementation of the treaty provisions. The prospect of eventual EU membership of the EA countries (without specification of dates) has been made explicit following the Copenhagen Summit of the European Council.

EC and Baltic States: Free Trade Agreement

The Free Trade Agreements between the EC (and member states) and the three Baltic states were signed in July 1994. All three agreements are expected to enter into force on 1 January 1995. The goal is free trade, but the timetable for the lifting of trade restrictions is not the same for the three countries: whereas free trade will be immediately and mutually established with Estonia for all industrial products (including textiles, and ECSC and Euratom products), the opening of markets will be asymmetrical and gradual in the cases of Lithuania and Latvia, which will benefit from transition periods of six and four years respectively for industrial products (whereas the EU will

open its market immediately for most products while maintaining duties on some sensitive products for two to four years). Trade in textiles will be ruled by specific provisions. Other provisions cover cumulation of rules of origin, payments, competition rules, monopolies, customs cooperation, and approximation of laws on trade and customs matters, etc.

Partnership and cooperation agreement between the EC and CIS countries

Partnership and Cooperation Agreements (PCAs) constitute a new form of agreement, announced by the EU in October 1992, to be negotiated with former Soviet states that are not on track for EU membership. PCAs have been signed with Ukraine and Russia, and initialed with Kyrgyzstan and Kazakhstan. The agreement essentially contains provisions concerning the following: political dialogue; improved market access on the basis of mutual most-favoured nation (MFN) treatment; improvements on quantitative restrictions, safeguards and anti-dumping procedures; asymmetric market opening measures such as the inclusion of imports from the CIS countries into the Generalised System of Preferences (GSP); the right of establishment for companies; capital transfer; intellectual property; economic cooperation and institutional framework. Specific agreements on nuclear products have been requested with each partner, depending on the situation.

EFTA Free Trade Agreements

EFTA's free trade agreements (covering the same transition countries as the Europe Agreements, plus the Baltic states) aim at abolishing all customs duties, quantitative restrictions and measures having equivalent effect in trade between the partners. These measures are asymmetric in the sense that the EFTA countries will abolish all customs duties upon entry into force except for some sensitive products, while the partner countries will abolish their customs duties over a transitional period. The agreements also set up provisions in areas such as intellectual property, public procurement, competition and state aid. Evolutionary clauses on investments and services are included in most agreements. A separate evolutionary clause provides for the development of relations in areas related to trade not covered by the agreements.

⁶ 1996 in the case of Bulgaria and Romania.

Central European Free Trade Agreement (CEFTA)

This agreement was signed by the then Czech and Slovak Federal Republic, Hungary and Poland on 21 December 1992 and entered into force on 1 March 1993. Symmetric trade liberalisation covers all industrial and agricultural products. All trade barriers applied to industrial products are to be dismantled gradually but at the latest by 1 January 2001. Individual articles of the CEFTA follow the EFTA model, whereas their rubrics (industrial, agricultural and general provisions) follow the EC association agreement model. Industrial products: for “List A” products, the customs duties are eliminated at the time of entry into force of the agreement; for “List B” products, customs duties will be eliminated by 1 January 1997; for “List C”, which contains sensitive products such as metallurgic, vehicle manufacturing, textile and apparel products, by 1 January 2001. Agricultural concessions include a 20 per cent customs duty reduction over two years and 50 per cent reduction over five years, both up to the limit of quantitative quotas, as well as a customs duty reduction of 50 per cent over five years, without quantity limits. Other provisions concern: rules of origin, internal taxation, state monopolies, state aid, government procurement, intellectual property and dumping. Exceptions similar to GATT rules are provided. The implementation of the Agreement is supervised and administered by a Joint Committee.

Baltic Free Trade Agreement

The treaty to establish a free trade area encompassing Lithuania, Latvia and Estonia was signed in September 1993, and came into force in April 1994. The three countries agreed to eliminate most barriers to trade in industrial goods falling within Chapters 25 to 97 of the Harmonised Commodity Description and Coding System. Extension to trade in agricultural goods is expected at a later date. The Agreement is by its substance similar to those which the three countries had concluded with EFTA countries. At least for an initial period, some restrictions on exports of raw materials will be maintained by all three countries (in Latvia and Lithuania through export tariffs, in Estonia through quotas). Other provisions concern rules of origin (cumulation of rules of origin which will enable the transit of goods to the Scandinavian countries without tariffs), customs cooperation, competition and state monopolies.

CIS – Economic Union

A Union agreement was signed on 24 September 1993, by all CIS countries except Ukraine (which has associate status). The treaty aims at establishing free movement of goods, services, capital and labour; coordinated financial and credit, budgetary, tax, pricing, foreign trade, customs and monetary policies; harmonised economic legislation; a common statistical base; and coordination of social policies. The Union intends to create a customs and monetary union in an unspecified future. The Council of Heads of States and the Council of Heads of Governments make decisions by consensus. Separate agreements will determine the procedures for the setting up, functioning and financing of institutions of the Economic Union. Disputes are settled through the Economic Court of the CIS, unless the contracting parties have agreed otherwise. Steps towards the creation of a set of common institutions and of a payments union were taken at the Moscow Summit of September 1994, but the substance of the Treaty still awaits implementation.

Single Economic Space (Central Asia)

The treaty (between Kazakhstan, Uzbekistan and Kyrgyzstan) entered into force in February 1994 and will be implemented over an unspecified period. It envisages the establishment of an economic space where goods, services, capital and labour move freely (as of July 1994, customs duties had already been eliminated and a payments clearing system was being established). It also aims at the harmonisation of policies on credit, prices and taxes. Mutual convertibility of national currencies is to be achieved. The treaties contain a clause on non-discrimination on the grounds of nationality in employment.

Economic Cooperation Organisation (ECO)

ECO, which had been dormant for 27 years, was reactivated in June 1990 by its member states: Turkey, Iran and Pakistan. In November 1992, Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan, Tajikistan and Azerbaijan were admitted, together with Afghanistan. A 10 per cent preferential decrease of tariffs among members was agreed to in March 1992, and the articles of a regional investment and development bank were initialed in November 1992. In January 1993 ECO agreed on further tariff reductions and devised measures to attract foreign investment. In 1994 the creation of a customs union was proposed.

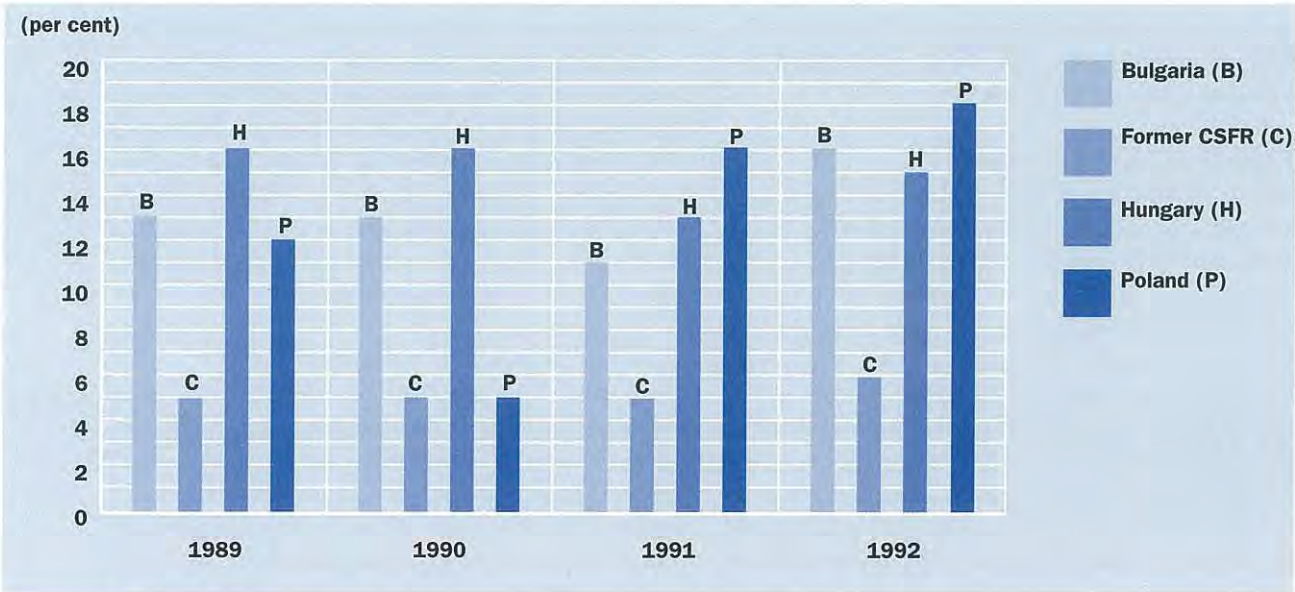
Hungary – recourse has been taken to anti-dumping measures and countervailing duties, predominantly against imports from former CMEA trading partners (see Chart 8.2 and Box 8.2).

The renewed recourse to active tariff and quota policies should be seen in the context of macroeconomic policies and of the impact on domestic production of the initially radical reforms. Whereas foreign competition was at first welcomed to introduce world market relative prices, limit monopoly pricing, and provide for the backlog of consumer demand, industrial policy considerations are beginning to assume more importance in the trade policies of transition economies. Generally speaking, restrictive trade intervention raises domestic prices and thus the revenue available for wages and profits in import-competing sectors. This comes first of all at the expense of consumers and of the users of imported inputs into production. While this may be sufficiently well known, other implications are not. Three issues should be separated: the average level of protection, the discriminatory granting of higher or lower rates, and the frequency and discretionary nature of modifications.

Increases in the average level of import duties – in the form of temporary surcharges or as a result of compre-

hensive revisions of tariff schedules – have been justified by governments on two counts: by a general lack of competitiveness of domestic industry that squeezes production – with social consequences – and by the need for increased fiscal revenues.⁷ The first argument implies, in effect, that the prevailing exchange rate overvalues the domestic currency. This may be one of the root causes of the recent adverse developments in exports and continuing rise in imports of Hungary and Poland. Their real effective exchange rates appreciated by 31 per cent and 77 per cent, respectively, between 1990 and 1993.⁸ Import barriers are not an appropriate instrument to deal with this problem. Subject to conditions on factor markets, they tend to raise the production cost of exports (which cannot increase in price correspondingly since they are “unprotected” on their markets). A combination of cautious monetary and aggregate demand management and a responsive exchange rate policy avoids this bias and should be the preferred approach. However, the second argument may justify the temporary recourse to tariffs if this is required to improve macroeconomic stability until less distorting fiscal instruments can be brought into play.

Chart 8.2 Average tariff levels
(in per cent, unweighted)



Source: Koteva and Ferreira (1993).

⁷ See Chapter 6 on the fiscal role of trade taxes. A further argument has been that the countries' initial opening up has not led to a comparable response by trading partners.

⁸ Source: Institute of International Finance, *Monthly Economic Review(s)*, August 1994 (Hungary and Poland). The real effective exchange rate is the trade-weighted relative price of a basket of domestic and foreign goods.

Box 8.2

Cases of trade policy reversals

Increases in nominal tariffs mirrored the extent of the initial liberalisation. The Polish and Russian cases are particularly revealing in this respect. After liberalisation and tariff suspensions in 1990, Poland's average tariff fell from 18.3 to 5.5 per cent. In the first half of 1991, however, after the zloty had appreciated significantly against other currencies, the government raised the average tariff to 16 per cent (weighted average 9.4 per cent). In autumn 1991, further tariff revisions took place, and early in 1992 all tariff suspensions were ended. As a result, average weighted tariffs rose to 11 per cent on industrial goods and 18 per cent on agricultural goods according to some estimates.⁹

Russia launched trade policy reform in 1991 with the scrapping of most non-tariff barriers.¹⁰ A presidential decree in January 1992 then abolished the USSR's import tariff schedule, which was not replaced until July by a new schedule – in force for only two months – with a prevailing tariff rate of 5 per cent. Beginning in September 1992, general tariff rates were raised to 15 per cent in a regime that survived until April of the following year. This regime was, however, highly inconsistent at least until February 1993, since imports remained free from the 28 per cent value added tax as well as from excise taxes – effectively discriminating against local goods. Even after February and until November 1993, the basis on which the value added tax was assessed was lower for imports than for local goods.¹¹ It was not until March 1994 that excise taxes began to be fully assessed on imports. The April 1993 tariff revision actually decreased the average tariff by two percentage points to 13 per cent, while substantially increasing the variability of tariff rates. However, the main purpose of the revision seems to have been to raise revenues, and there does not appear to have been a clear pattern of higher protection. In contrast, the most recent revision of the import tariff schedule, which came in force in July 1994, has had an

explicit protective orientation. The average tariff rate increased to 15.5 per cent (14.1 per cent if weighted), with a maximum rate of 100 per cent. It appears that the major increases occurred in those sectors with the strongest lobbying power, with a clear hierarchy of defence, micro-electronic, aerospace, motor vehicle and agricultural producers.¹² The Russian government has, however, assured that it will announce in October 1994 a gradual reduction in import tariffs according to a pre-set three-year to five-year timetable.¹³

In Hungary, which had implemented more moderate tariff decreases in the early transition, recourse was more often taken to non-tariff measures. In almost all cases, the main targets were exports from former CMEA partners. Steps undertaken in the period 1992 to mid-1993 were as follows. The Hungarian Cement Industry Association requested and received (in March 1993) the imposition of quotas for various categories of cement on imports from the Czech Republic, Slovak Republic, Romania, and all countries of the former Soviet Union. In October 1992, the Iron and Steel Industry Association initiated a market protection procedure; quotas were introduced on imports from the Czech and Slovak Republics, Romania, the Ukraine and the Russian Federation in July 1993, for a one-year period. At the request of a foreign-owned producer, import quotas on paper products became effective for one year from November 1992, excluding imports from EFTA and the EU because of the prevailing trade agreements. The Hungarian Chemical Industry Association managed to obtain import quotas on various base chemicals from the CIS countries, the Czech Republic, Slovak Republic and Romania beginning in January 1993; a measure later extended to Austria. A preliminary examination was carried out regarding imports of refrigerator compressors, but resolved in negotiations. Lastly, market protection procedures were initiated in March 1993, against imports of PVC powder from outside the EU.

⁹ Sources are GATT (1992), and Inotai and Sass (1994). These sources might not be fully comparable.

¹⁰ The following is based on Drebenstov (1994).

¹¹ The customs value – pre-tax – was the basis for imports, while retail prices – including the tax – were the basis for domestically produced goods.

¹² V. Drebenstov, (1994), p.10.

¹³ Note that Russian borders, in particular with the CIS area – which has not followed Russia in its tariff policy – remain highly permeable. The effective implementation of tariffs is therefore very constrained.

The discriminatory granting of higher or lower rates of protection to particular sectors does not respond primarily to macroeconomic disequilibria, even though the tendency to make recourse to it may be reinforced by an overvalued exchange rate or sluggish domestic demand. The public justification tends to combine the

need to mitigate the social implications of sudden adjustment (caused by the production effect of superior competition) with the venerable rationale of the “infant industry” argument: the initial liberalisation is said to have put undue pressure on certain activities that could be viable in the longer term, once equipment has been

modernised, management has progressed on the learning curve, and other adjustments to market-based exchanges have taken place in the economy as a whole. While the argument may have a conceptual justification, attempts to “pick winners” through discretionary intervention have in many cases ended in costly failure even in less well established economic environments and with more experienced administrations. The difficulty for bureaucrats of predicting the competitiveness of a sector several years into the future is accompanied by political economy problems. The existence of discriminatory protection in some sectors signals to economic agents that financial rents are subject to negotiation, and that political positioning and effective lobbying can substitute for economic adjustment. In the extreme, the “soft budget constraint” may be simply replaced by the “rent-seeking society” as the primary enemy of market-oriented adjustment.

A better case could be made for the non-discretionary protection of “senile industries” if radical liberalisation makes excessive demands on the economies’ ability to adjust. A possible strategy would have been: first, to convert all the inherited barriers to trade into explicit equivalent tariffs; second, immediately to reduce exceptionally high rates; and third, phase down the remaining tariffs over say, 10 years to a level characteristic of relatively open trading members of the OECD. Such a process would enable industries with no long-term future to contract slowly as others grow and, as long as the scheduled tariff reduction were credible, would not distort the allocation of resources. Labour retained in the short run would otherwise have been unemployed in many cases, while investment will only be made in industries enjoying temporary protection if, like replacing failed light bulbs, it has a very quick payback relative to the expected viable life of the enterprise.

The discretion and frequency of trade interventions is the third issue of relevance here. Trade restrictions have been subject to frequent changes and have tended to be responsive to circumstances, including balance of payments developments, social pressure, and lobbying efforts by industry groups and foreign investors. This generates two problems: it reinforces the political economy drawbacks mentioned above by signalling even more forcefully the opportunities to capture trade policy for commercial purposes and it raises the general level of uncertainty in the economy. The latter is particularly damaging to investment, since the inability to predict government policy in the trade – and other – fields increases risk. An important corollary is that there can be a trade-off between uncertainty and the drawbacks of

temporary protection: where quick liberalisation appears *ex ante* unsustainable for political or other reasons, proceeding more slowly but in some predictable and committed fashion may carry less economic cost and be more conducive to investment in long-term viable sectors. Government credibility is weakened (uncertainty therefore increased) when protective policies that are specifically announced as “temporary” fail to be so. A useful means of reducing discretion and increasing the domestic credibility of liberalisation is to anchor trade policy in international commitments. The GATT provides one such anchor, but regional trade agreements such as the Europe Agreements may at times be more demanding and therefore useful in stabilising expectations.

8.4 Access to Western markets

For an outward-oriented reform strategy to be successful, exports have to enjoy access to their major markets. Through the example it provides – trade policies are the foreign emissaries of the market economy – the openness of Western import regimes can also be politically and psychologically significant in helping governments in the region hold the course on liberalisation. Anything other than liberal trade exposes Western governments to charges of hypocrisy, and stifles their own growth potential as well as that of the transition economies.

The conclusion of the Uruguay Round is a promising sign; however, most countries of the region are not yet members of the GATT¹⁴ and therefore do not enjoy automatic MFN status. As a result, they have to rely on less predictable and sometimes more selective concessions for access to OECD markets. Additionally, there is a threat of increasing recourse to more subtle forms of protection, such as anti-dumping (including for ostensibly social and environmental reasons), countervailing duties and safeguard action, as exporters of the transition economies gain market share in the West. While their use may sometimes be justified, these measures are pernicious in that they punish success. The mere threat of limited market access may generate sufficient uncertainty so as to reduce investment in competitive sectors. This can stifle the necessary reallocation of resources away from the industries excessively promoted under central planning.

The response by Western governments to the challenges of the import growth from eastern Europe and the former Soviet Union has not been without its merits. As reported in Table 8.3 (and Box 8.2) most OECD countries have granted trade concessions to the transition economies. Of particular importance have been the swift promotion of six central and south-eastern European countries¹⁵ to the top of the trade preferences pyramid¹⁶ of the European Union in the Europe

¹⁴ Whereas the CSFR joined in 1948 as a founding member, Hungary and Poland joined later on special terms reflecting their status as state trading economies. They are presently renegotiating their terms of accession, while most other countries in transition have initiated negotiations on accession.

¹⁵ Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic. Others, such as the Baltic states and Slovenia, may follow soon.

¹⁶ A thorough discussion of EU trade preferences is contained in Möbius (1994).

Table 8.4 Non-tariff barriers against imports from transition economies (in per cent) ¹

	European Union				United States				Austria			
	Trade Coverage ²		Frequency ³		Trade Coverage ²		Frequency ³		Trade Coverage ²		Frequency ³	
	1989	1993	1989	1993	1989	1993	1989	1993	1989	1993	1989	1993
Bulgaria	40.3	35.2	734	647	0.0	0.0	1	0	29.4	32.1	26	36
CSFR	29.9	25.1	2321	2043	17.4	3.2	29	12	13.1	17.0	126	249
Hungary	36.1	30.0	2179	1897	16.3	10.1	82	39	17.6	23.5	204	240
Poland	27.5	16.6	1927	1605	24.1	15.8	170	126	9.1	12.9	69	90
Romania	37.7	36.2	1268	1211	31.0	21.1	94	109	16.8	23.9	46	57
Former USSR	8.7	8.7	565	728	0.7	0.7	2	2	0.5	1.1	21	28

Source: UNCTAD Database on Trade Measures.

¹ Refers to the so-called "narrow" group of non-tariff barriers which includes quantitative restrictions (including prohibitions, quotas, non-automatic licensing, "voluntary" export restraints, restraints under MFA and other textile agreements), surcharges, variable levies, price surveillance, minimum pricing and "voluntary" price restraints.

² "Trade coverage" measures imports under 8-digit tariff lines in which restrictions are encountered as a share of total imports. The base year for trade weights is 1989.

³ "Frequency" measures the number of 8-digit tariff lines with restrictions.

Table 8.5 The importance to transition economies of the sensitive sectors

Share of particular items in each identified country-origins 1993 exports to the EU (in per cent)					Share of particular items in each identified country-origins non FSU 1990 exports (in per cent)				
From:	CSFR	Hungary	Poland	Romania	Bulgaria	Turkmenistan	Uzbekistan	Russia	Former Soviet Union weighted total
Iron and Steel	11	4	12	7	7	0	0	3	4.8
Chemicals	8	9	6	4	7	5	5	4	5
Footwear, textiles and apparel	17	23	21	49	38	66	57	1	2.2
Food and agriculture	4	18	11	5	18	4	2	2	2.2
Total	40	54	50	65	70	75	64	10	14.3

Sources: Deutsches Institut für Wirtschaftsforschung, Wochenbericht 23/94, GATT, International Trade Statistics, 1993.

Agreements, and the Free Trade Agreements implemented with EFTA. Nevertheless, progress in eliminating non-tariff barriers (NTBs) to trade has so far been less impressive than these agreements may suggest.

Table 8.4 shows trade coverage ratios of "narrow" NTBs in selected Western markets (note that anti-dumping and other trade remedy action, taken up further below, is not included in the table). While the use of NTBs against transition economies has visibly declined in the EU and the United States between 1989 and 1993, it still remains substantial and Austria's use of NTBs has actually increased. This is explained by the fact that NTBs are concentrated in so-called "sensitive sectors", which often remain subject to special regimes even within the trade agreements. At the same time, as shown in Table 8.5 for the case of exports to the European Union, sensitive sectors are of particular importance to the transition economies' exports and cover product ranges in which they appear to

have a comparative advantage (agriculture, processed foods, footwear, simple manufactures).¹⁷ As the table indicates, these products accounted for at least half of EA partners' exports into the EU in 1993 (with the exception of the CSFR), while the EU accounts for over 65 per cent of all Western imports of "sensitive goods" from the region.

Given the weight of the European Union as an export destination (see Chart 8.1), and in the absence of more widespread membership of the GATT, the provisions of the Europe Agreements (EAs, Box 8.1) are effectively setting the post-cold-war standard on trade rules for their signatories in eastern Europe. The Agreements provide far-reaching improvements in EU-market access to the transition economies, including the rapid elimination of tariffs and quantitative restrictions. The EAs have been criticised for the relatively slower liberalisation of EU imports in sensitive sectors such as textiles,¹⁸ and for the lack of progress in the liberalisation of agricultural trade. These points have been

¹⁷ Some studies show a comparative advantage for central and eastern Europe in food, crude materials, basic manufactures and (oddly) fuels; and in fuels and crude materials for the former Soviet Union (Collins and Rodrik, 1991). Others, in turn, conclude that the region may have an advantage in industries that are intensive in capital and unqualified labour, such as motor cars, steel, transformation of metals, wood, plastics and textiles, (e.g. Neven, 1994).

¹⁸ However, market access in all sectors except textiles and agriculture is to be unrestricted from January 1995 ("Visegrad countries") and January 1996 (Bulgaria and Romania), respectively. In textiles, restrictions are to last through 1997. Note that the EAs thus chose to liberalise trade in textiles significantly sooner than the corresponding dates set in the Uruguay Round Agreements.

discussed in the EBRD's 1993 *Annual Economic Outlook* and are not taken up again here.

While the visibility of tariff cuts and quota increases is high, it can be out of proportion to their relevance. Improved procedures governing trade "remedy" action (i.e. defensive action against "unfair" or "disruptive" imports) and local content requirements may in reality be more important for the economies of eastern Europe. The EAs contain some weaknesses in this respect:

- The EAs fail to discourage the use of *contingent protection measures*, which can undermine the benefits of the tariff and quota liberalisation.

(i) The Agreements contain not just one, but seven safeguard clauses, of which six refer to specific product groups or types of activity,¹⁹ as well as the dominant general safeguard of Article 30/31.²⁰ While the preamble to the EAs commits the parties to "compliance with the rights and obligations arising out of the [GATT]", the specific Article 30/31 lacks any such provision.²¹ Moreover, it lacks the GATT reference to "unforeseen developments" as a condition for invoking the clause, explicitly refers to quantitative restrictions and minimum prices as measures available to the importing country, and, unlike GATT Article XIX, is conceived in purely bilateral terms. This makes selective use very likely, as exemplified by the restrictions imposed on Czech and Slovak steel imports shortly after the coming into force of the respective interim agreements.²² Furthermore, Article 30/31 offers an additional loophole for managed trade as safeguard measures are permitted if imports cause "serious disturbances ... or difficulties which *could* bring about serious deterioration in the economic situation of the region" (*italics added*). The lack of definition of "serious deterioration" or "region" – which may refer to depressed areas within countries, for instance – as well as the pre-emptive spirit of the phrase, leave wide latitude in the application of the clause.

(ii) The EAs have not significantly altered the regulations governing anti-dumping (AD) measures. The Agreements specify that AD actions must accord with Article VI of the GATT, but this has not hindered GATT-consistent behaviour to be biased against exporters in the past.²³ Nevertheless, the recent evidence on AD action is encouraging. Table 8.6 reports the number of AD measures against countries of eastern Europe and the former Soviet Union taken in 1980–91, as well as those currently in place. In the first half of 1993, new rulings against EA partners occurred in only two cases, while in the second half of the year there were none (one procedure, against Romania, was initiated in the second half of the year). By contrast, measures were introduced by the EU against non-EA transition economies in seven cases in 1993.²⁴ The relative decline of AD cases under the EAs is perhaps partly explained by the recourse in the steel sector to the relatively less constraining safeguard clauses of the Agreements, and partly by the flattening of EA partner export growth in 1993. It cannot be excluded, and would be unfortunate, if the decline in AD cases were to some extent proof of the effectiveness of the earlier action in this area, i.e. if potential exporters in the transition economies had been discouraged from a dynamic search for EU markets.

- A further drawback of the EAs is the "hub-and-spoke bilateralism" implicit in the stipulated rules of origin.²⁵ By setting a very high local content requirement of 60 per cent, the EAs have investment-detering effects as, for example, assembly plants seeking to utilise cheap skilled labour with low value added will not qualify for EA trade preferences if too many inputs originate outside the area of the EA partners and the EU. Moreover, since cumulation of local content (to reach the value added threshold) between the "Visegrad countries" on the one hand, and Bulgaria, Romania²⁶ and the EFTA countries on the other is not permitted under the EAs, the EAs effectively discourage economic integration between the countries, thereby "marginalising the spokes" and reducing the potential for trade in the region. The EFTA Free Trade Agreements with the same countries allow both bilateral

¹⁹ Referring to agriculture, meat, processed agricultural products, re-exports to third parties that undermine export restrictions, eastern Europe infant industry protection, and textiles.

²⁰ The numbering differs in the various EAs.

²¹ Not surprisingly, the GATT secretariat has critically reviewed the safeguard provisions of the EAs in its 1993 Trade Policy Review for the EU: "the Community seems to consider these [safeguard] provisions to allow not only for the suspension of concessions granted under the Agreement but also of obligations under GATT (e.g. Article XIX)," (GATT, 1993).

²² Note that while the EAs have hence introduced less stringent safeguard clauses, the Uruguay Round has actually tightened the GATT provisions on safeguard measures. According to Section VI of the Agreement on Safeguards, all "grey areas" (Voluntary Export Restraints, Orderly Marketing Arrangements, etc.) usually resulting from a sidestepping of the safeguard Article XIX of GATT will be phased out, and "members shall not encourage or support the adoption or maintenance by public and private enterprises of non-governmental measures equivalent to those referred to".

²³ Notably, the Uruguay Round has tightened GATT rules also in this regard. While administrative proceedings have been made more transparent by more detailed rules for the conduct of investigations and criteria for determining dumping margins and injury to domestic industry, the Agreement on Implementation of Article VI (the GATT AD article) also prohibits price undertakings without the prior establishment of dumping and injury caused by such dumping.

²⁴ Six of these occurred during the second half of the year (source: GATT, Semi-Annual Reports by the EU under Article 14:4).

²⁵ On this issue, see Baldwin (1994).

²⁶ It appears that the "Visegrad countries" may have resisted multilateral cumulation with Bulgaria and Romania in order to reinforce the redirection of their own trade towards the West.

Table 8.6 Anti-dumping action by the European Community

Countries	EC anti-dumping cases, 1980-91		EU anti-dumping rulings presently in force		
	No. of EC cases	Restrictiveness rate ¹	No. of anti-dumping measures in force as of 21.5.94	Average rate of duty imposed	No. of other measures (U/T, min. price) ²
Bulgaria	6	50	1	–	1
CSFR	25	76	4	19.5	3
Hungary	16	56.3	2	21.7	1
Poland	15	73.3	4	9.6	2
Romania	21	76.2	3	18.1	1
Russia	na	na	7	39.6	2
Other former Soviet Union	na	na	8	38	2
Total former Soviet Union	22	76.2	15	–	4
Total for the region	105	71.2	29	–	12
Goods					
Industrial chemicals	50	81.6	8	18.2	4
Iron and steel	6	83.3	5	23.7	–
Non-electrical machinery	7	85.7	0	–	–
Other	–	–	1	–	–
Total	63	–	14	–	–

Notes: 1 restrictiveness rate = restrictive outcomes as percentage of all known outcomes

2 U/T: price undertakings

Sources: For columns 1 and 2: P. Messerlin, "The EC and Central Europe", *The Economics of Transition*, 1:89

For columns 3 – 5: Commission of the EC, DG1, 21.05.1994

and multilateral cumulation of rules of origin, thereby encouraging integration within the region.

With the implementation of the Europe Agreements progressing, the main threat to eastern European exports and investment comes from actual, threatened, and "latent" trade remedy action employed for purposes of managing trade to support industrial policy objectives in the EU. Much of the problem of contingent protection is linked to the uncertainty it generates for exporters and potential investors. In addition, the administration of measures of contingent protection (especially so called "voluntary export restraints") can strengthen bureaucracies in the affected countries as well as existing exporters at the expense of new entrants; both of these effects are inimical to the objectives of transition.

Improvement of access to EU markets should therefore centre on making such action harder to invoke, more transparent and predictable, and on making procedures faster than is currently the case. One possibility is to use the agreement on the European Economic Area as a blueprint for dispute avoidance and resolution between the EU and eastern Europe. This implies, (a) the swift introduction and implementation of EU competition and state subsidy regulations and other areas of

"acquis communautaire" in the partner countries (this is foreseen as part of the EAs and may receive further support under recent proposals by the Commission), (b) the subsequent elimination of anti-dumping and anti-subsidy provisions, and (c) subjecting remaining trade disputes to settlement within a joint committee and, if that fails, the European Court of Justice. A clear and short deadline should be set for implementation of such a system. Regarding rules of origin, the value added thresholds should be substantially lowered and multilateral cumulation among all EA partners and with all members of the European Economic Area permitted. At its Copenhagen meeting in June of 1993, the EU commissioned a feasibility study on the possibility of multilateral cumulation, the results of which are still pending.

8.5 Deficiencies of the commercial financial infrastructure

While there has been significant positive restructuring of trade, there has also been a considerable destruction and obstruction of commercial links that it would have made sense to maintain or create. A variety of reasons for this were discussed in the EBRD's 1993 *Annual Economic Outlook*.²⁷ The following concentrates on an important factor that is institutional in nature, namely the weakness of market-based, decentralised mechanisms of trade finance.

²⁷ They include austerity programmes that reduced the demand for imports, especially those that were investment-related; the abrupt elimination of the internal plan-and-command based coordination of factor and input flows without the immediate emergence of functioning markets as a substitute; restrictive trade policies especially with regard to exports; the absence, initially, of functioning international payment and settlement systems; the tying of trade credits by Western countries and preferential trade agreements which introduced biases to the detriment of the previous commercial links; and extreme cases of under- and overvaluation.

Switching from plan-based allocations and state-orders to market-based transactions places particular demands on financial, legal and information systems, factors largely outside the sphere of control of the individual supplier.²⁸ In a developed market economy, the financial system provides the services necessary to extend transactions over time, clear and settle them, and it reduces the information needs of the transacting partners by assuming the default risk for a fee. As intermediaries of the transaction, therefore, the exporter's and importer's banks assume a central role in the efficient conduct of trade. Collectively, deficiencies in these areas raise the transactions costs of trade to the point where many transactions are obstructed altogether. Trade finance in the centrally planned economy was highly centralised; while foreign trade banks such as Vneshekonombank would offer payment guarantees and provide finance in foreign currency, they would have only one office in the capital and deal almost exclusively with the foreign trade organisations (with some exceptions in eastern Europe). There was no infrastructure for providing direct trade finance services to the enterprises.

Although differences regarding the availability and quality of financial services exist between the economies in transition, the financial infrastructure for cross-border trade shares a number of common features:

- Country risk is high because of economic and political instability, often high levels of foreign debt, uncertain capacity to generate the foreign exchange necessary to service it, and thus precarious convertibility of currencies even on current account. Country risk not only intervenes in the assessment by banks in eastern Europe and the former Soviet Union of the virtues of extending trade-related credit denominated in hard currencies, it also impedes their ability to source matching funds with Western banks, irrespective of their soundness as financial institutions. The resulting exchange risk can severely hamper trade finance.
- Reliable, high-speed electronic interbank clearing and settlement facilities, whether bilateral or multilateral, are being established only slowly.
- The information necessary for banks to assess each other's risk – and thus be able to price its assumption – is often deficient due to lack of a track record in market-based trade finance.
- Banks often lack the technical skills required to assess the quality of trade documentation or to engage in the intricacies of risk management with assets and liabilities denominated in foreign currencies.

- Beyond directly trade-related issues, the soundness of domestic financial systems and the progress in their market-oriented transformation (or lack thereof) can obviously have serious repercussions on the availability and quality of financial services.

The transactions costs implied by these factors can amount to a significant and sometimes prohibitive tax on trade. Like other taxes, it carries an economic cost by preventing trade from taking place in conformity with the countries' resource and factor endowments. This, and the consequent impact on the pattern and speed of economic restructuring, is further aggravated by the fact that access to the limited available services is often rationed. To the extent that they receive access to funds for trade finance, and in the absence of financial reform, for instance, state-owned banks in particular tend to favour their traditional clients – large state-owned enterprises – to the detriment of the emerging private sector.

A crucial question that arises in the context of higher-than-necessary transactions costs is whether the market will rapidly erode them. There is unlikely to be a common answer in all circumstances, but some comments can be made. In certain cases, the observed deficiencies may be due to government interventions and it may be sufficient to eliminate those interventions to overcome the problems. This is true, for instance, when the financial system has not been restructured in a way that generates the necessary incentives for bank managers to seek out opportunities for trade finance in the entrepreneurial sector. To take a different example, capital account controls may prevent banks in the reforming countries from obtaining matching funds in hard currencies, or from paying them back later.

Risk management by Western financial institutions raises a complex set of questions as to the functioning of markets. Banks tend to control certain types of risk by subjecting them to quantitative ceilings instead of by pricing them, i.e. a credit may not be available to a borrower with certain characteristics, such as a particular country risk level, at any price. As explained in a footnote, the rationing of potential borrowers is the result of market failure: gaps in the availability of instruments for hedging risk, and information failure.²⁹ In the economies in transition – where country risk plays an important role in addition to the risk of the individual institution – a large number of potential borrowers can therefore be cut off from borrowing in the West because of such market failure. Even though there were both current and capital account convertibility, this can, as mentioned, make it very difficult

²⁸ The legal framework is outside the scope of this analysis.

²⁹ Fundamentally, the cause of this is that there are limits to the availability of placements that may be used to diversify risk, so that "insurance" (hedging) is unavailable. Meanwhile, the high level of interest rates necessary to price high risk can induce risk-seeking behaviors in the borrower that the creditor cannot control for lack of information (moral hazard), or attract only borrowers whose risk is higher than reflected in the price, thus lowering the quality of the portfolio (adverse selection).

for banks to hedge their exposure to hard-currency-denominated credits. It should be noted, however, that this will be true in particular for loans of longer maturity; in fact, even during the worst of the debt crisis in Latin America, very short-term foreign trade credits were mostly serviced – since they represented a lifeline for these economies – and tended to continue to be forthcoming.

The limited capacity to assess other banks' soundness and the establishment of cross-border clearing facilities may involve elements of coordination failure that are not easily overcome by the market alone. Thus, the possibility to use other banks' track records as information devices both depends on trade taking place so that track records can be established and is – to some extent – a condition for it. Clearing facilities among commercial banks, in particular with multilateral netting, are based on trust and can therefore face a similar hurdle. To “invest” in the information necessary to gain a thorough picture of the soundness of banks in other countries can therefore be quite costly for the individual bank (almost impossible without laws on transparency).³⁰ In both cases, the market tends to inch its way towards efficient solutions, but the process takes time and carries a high opportunity cost.

In spite of market failure as a result of imperfect information, which is endemic in financial markets, there is rarely a point to be made for government intervention. While government may be capable in theory of internalising externalities, of breaking coordination deadlock, and of overcoming other market failures, it will tend in practice – if anything – to be even more strictly constrained by information deficiencies than would individual commercial agents. The main problem to be confronted is probably the difficulty of differentiating between “correct” market decisions and market failure in the non-emergence of an institution or the failure of certain transactions to come about. Even in the absence of this problem, the complexity of government motives and the administrative challenge of translating them into action make it hard to intervene in a non-distortionary way.³¹ Western export credit agencies, many of which have a history of subsidisation – not least in transactions with eastern Europe and the former Soviet Union³² – attest to the potential cost of such interventions.

In the end, trade finance problems will be overcome by the strengthening of commercial financial institutions (based on growing experience and perhaps supported by technical assistance), and a gradual widening of access to sources of finance.³³ This is a process which the international financial institutions can play a main role.

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³⁰ It also again involves an externality: the information obtained is transmitted to others via the decision to establish working relations with particular banks, so that the social value of that information is higher than the private one and investment in information remains suboptimal.

³¹ For an extensive discussion of “government or institutional failure”, see Stern (1991).

³² Germany's Hermes was reported to have written off over DM 5 billion in 1993, much of it related to transactions with the area of the former Soviet Union.

³³ The EBRD supports various projects aimed at strengthening financial institutions engaged in trade finance; these can be linked with credit and guarantees in an effort to gradually push back the risk frontier on the basis of track record.

9. Foreign direct investment

This chapter examines the environment for foreign direct investment (FDI) and the motivations of investors. Although governments in much of eastern Europe and the former Soviet Union have made substantial (and sometimes costly) efforts to attract foreign investors, FDI flows into the region have been concentrated on a few countries. This pattern may reflect an investor preference for macroeconomic and institutional stability as well as certain self-reinforcing characteristics of FDI. An interesting observation is that, according to surveys, the wish to gain access to local markets is the dominant factor inducing foreign companies to invest in the economies in transition (although the countries that have received the bulk of the region's FDI inflows represent relatively small markets). The relation between trade policies and FDI decisions may be particularly important in explaining this. Among other factors, the chapter analyses the role of protection in attracting FDI.

9.1 A summary of developments

Foreign direct investment may be defined as the transfer by a firm of resources - including capital, technology and personnel - into a foreign business venture with the objective of acquiring control of the venture.¹ In the transition economies, equity stakes have often been acquired by foreigners through in-kind contributions. As a result, the volume of FDI is hard to assess on the basis of financial flows alone. Even for balance of payments data, comparability across countries is often limited given definitional problems such as different thresholds for the equity stake that distinguishes direct investment from portfolio placement and failure to record reinvested earnings. In spite of these measurement difficulties, there is little doubt that foreign investment into the region has responded to the transition, though the amounts may have been smaller than the governments of the region had expected. Most strikingly, FDI flows have been heavily skewed towards a subset of countries. Table 9.1 provides some evidence on FDI based on balance of payments data.

- Annual measured FDI inflows into eastern Europe and the former Soviet Union rose 10-fold between 1990 and 1993. Even so, however, they represented only

approximately 10 per cent of total FDI flows into developing countries in 1993.² In fact, in 1992 China and Mexico each reported FDI inflows that were substantially higher than those recorded for eastern Europe and the former Soviet Union as a whole, and Argentina and Malaysia received comparable amounts.

- While cumulative FDI flows into the region amounted to over US\$ 12 billion between 1990 and 1993, the Czech Republic, Hungary and the Slovak Republic alone attracted two-thirds of the total. Together with Estonia and Slovenia, these countries accounted for shares of inflows into the region out of proportion to their size. The rest of the region, with 91 per cent of the population, received only 32 per cent of cumulative inflows.
- From the limited information available on the sectoral distribution of FDI, it appears that a strong majority of projects represent manufacturing activities (see Table 9.2).³ In Hungary, for which disaggregated data are available, there is a more recent trend towards investment in the service sector, with commerce gaining particular prominence, but also with substantial flows into the telecommunications, roads and utility sectors.⁴
- FDI projects in the transition economies tend to be smaller than in other countries; nevertheless, a few large investments account for the bulk of capital invested. For instance, the region accounted in 1992 for only 1.3 per cent of registered German capital abroad, but for 3.4 per cent of the number of German FDI projects.⁵ In Hungary, by the end of 1992, 32 foreign enterprises had each invested over one billion forints (about \$10 million), whereas the average amount associated with FDI projects in Hungary was 21 million forints; half of the projects were for less than 1 million forints. The top 5 per cent of projects accounted for 85 per cent of the total paid-in capital in all projects in Hungary.⁶

What explains these developments? The analysis of FDI suffers not only from problems of measurement, but also from weaknesses in the theoretical foundation. Economics has never been renowned for its ability to predict domestic

¹ See Meyer (1994). Operational definitions, usually following the IMF's *Balance of Payments Manual*, recognise that data on actual control are hard to obtain. The IMF recommends measuring FDI as cross-border equity participations whose original capital share surpasses a 10 per cent benchmark, reinvested earnings, and long-term loans by parent companies.

² Note that the distribution of FDI among developing countries, just as in the transition countries, is far from homogenous, with a handful of countries in East Asia and Latin America - and China in particular - taking the lion's share.

³ Note that Table 9.2 refers to investment commitments by number of projects, not effective flows, and is based on journalistic evidence and thus incomplete for smaller projects.

⁴ Hungarian data are discussed by Lane (1994).

⁵ Meyer (1994).

⁶ As reported in Lane (1994).

Table 9.1 Foreign direct investment into eastern Europe and the former Soviet Union ¹

	FDI (millions of US dollars)				Cumul. 1990-93	% of total	FDI per capita		% of PPP \$-GNP ³	% of current \$-GDP ⁴
	1990	1991	1992	1993 ²			1990-93	1993		
Albania	-	-	19	20	39	0%	13	6	-	-
Bulgaria	4	56	42	62	164	1%	19	7	0.15%	0.49%
Croatia	-	-	16	30	46	0%	10	6	-	0.25%
Former CFSR	188	592	1,054	-	2,600	21%	167	-	-	-
Czech Republic	-	-	983	606	-	-	-	59	0.82%	1.92%
Slovak Republic	-	-	71	160	-	-	-	30	0.56%	1.46%
Estonia	-	-	58	122	180	1%	113	76	1.31%	7.05%
Hungary	311	1,459	1,471	2,200	5,441	44%	528	214	3.81%	6.03%
Kazakhstan	-	-	100	300	400	3%	24	18	0.42%	1.40%
Latvia	-	-	43	60	103	0%	38	22	0.54%	-
Lithuania	-	-	5	40	45	0%	12	11	0.34%	-
Poland	88	117	284	350	839	7%	22	9	0.18%	0.41%
Romania	-18	37	73	48	140	1%	6	2	0.08%	0.19%
Russia	-	100	800	1,100	2,000	16%	13	7	0.14%	0.63%
Slovenia	-2	41	113	123	275	2%	138	62	-	1.03%
Uzbekistan	-	-	100	45	145	1%	7	2	0.08%	0.18%
Totals/Averages	571	2,402	4,178	5,266	12,417	100%	41	18	0.37%	1.17%
Central Europe	585	2,209	2,938	3,469	9,201	74%	129	49	1.38%	2.38%
The Baltics	-	-	106	222	328	3%	40	27	0.69%	-
Southern Europe	-14	93	134	130	343	3%	10	4	0.12%	0.35%
Central Asia	-	-	200	345	545	4%	14	9	0.27%	0.75%

Sources and notes:

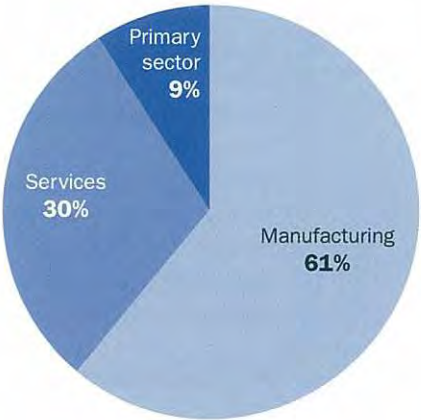
- ¹ FDI values from national balance of payments statistics.
- ² Results for 1993 are preliminary.
- ³ 1993 FDI divided by 1993 GNP at purchasing power parity (PPP values from *World Development Report*) as defined in footnotes in Appendix 10.1.
- ⁴ 1993 FDI divided by 1993 current dollar GNP.

Table 9.2 FDI by sector in eastern Europe and the former Soviet Union

Sector	number of projects	per cent of the total number of projects
Electricals, electronics, computers, telecommunications	472	11.4%
Food & beverage production, agribusiness	426	10.3%
Oil & gas, mining & metals	389	9.4%
Automotive, aircraft, railway manufacture, shipbuilding	373	9.0%
Financial services	340	8.2%
Chemicals, plastics, glass	188	4.5%
Engineering, heavy machinery	180	4.4%
Building materials, construction	165	4.0%
Textiles, fashion, footwear	157	3.8%
Miscellaneous services	901	21.8%
Miscellaneous manufacturing	544	13.2%
Total	4,135	100.0%

Source: *East European Investment Magazine* database. Based on the number of completed, failed, announced and tentative projects in the period 1991 to March 1994, as reported in the Press.

Sector breakdown



Source: *East European Investment Magazine* database. Based on the number of completed, failed, announced and tentative projects in the period 1991 to March 1994, as reported in the Press.

investment, and the cross-border dimension of FDI adds further difficulties.

The principal industrial organisation theories of FDI focus on the internalisation of transaction costs and on the behaviour of oligopolies. The internalisation approach may explain why a firm would favour one particular organisational form in a foreign country over others – direct investment over licensing or subcontracting, for instance.⁷ The oligopoly approach derives the investment decision from company strategies aimed at gaining or preventing competitors from acquiring (additional) market share. Both approaches stress firm-specific and sector-specific factors in the investment decision, and neither is well suited to explain aggregate levels of FDI or its variation across countries.

Other theories of FDI emphasise locational factors – market size, factor cost advantages, proximity to major markets, and the legislative, political and economic environment – but suffer from the diversity of motives that firms might have in establishing production bases abroad. The classical focus on differential returns to capital across countries has provided only limited explanatory power in empirical tests.⁸ In a classification according to J. Dunning,⁹ firms may seek resources (e.g. raw materials, labour and technology), markets, efficiency (in optimising multinational production networks), or strategic assets (such as brand names or existing distribution systems, which refers back to the oligopoly approach). The weight of individual locational factors differs depending on these motives.

In view of these difficulties, the discussion on FDI in the region in the following section adopts an eclectic approach. First, the legislative environment for FDI is analysed. Second, a number of investor surveys are examined to detect patterns in the motivations and obstacles perceived by actual and potential investors. These results then form the basis for a discussion of the observed patterns. The aim, at this stage of analysis, is to raise questions; the provision of answers will have to await further research.

9.2 The legislative environment for FDI

Almost all countries of eastern Europe and the former Soviet Union have passed legislation designed to make the environment for foreign investment more attractive.

Table 9.3 contains some of the salient features of the present legislation. In spite of the progress made, it remains difficult to start and to operate a business, and the pace of change in the region often leads to legal inconsistencies and a lack of clarity. To overcome some of these difficulties, 10 countries have established agencies to facilitate and promote FDI, and more plan to do so.¹⁰ The establishment of “one-stop-shops” should help in tackling the lack of transparency and reduce the frustrations of dealing with frequent modifications and complex administrative processes.

In the pre-reform transition economies, FDI was generally prohibited or suffered from excessive regulation. The majority of countries in eastern Europe and the former Soviet Union are in the process of removing restrictions.¹¹ Over the past three years most have enacted or amended specific foreign investment laws, often in advance of other legislation to support the new market environment. The former Yugoslavia’s Foreign Investment Laws (1967) have been revised in Slovenia, but are still valid in Croatia. New laws have been submitted for parliamentary approval in Russia and Armenia. Only in the Czech and Slovak Republics have foreign investment laws been replaced by new Commercial Codes (similar to those in force in most Western countries) which deal with both foreign and domestic investments in the same legislation.

As markets have been liberalised, most organisational forms and most economic activities have been opened to foreign capital. It is now common for governments to guarantee that foreigners will be no less favourably treated than their domestic counterparts. Complete foreign ownership is permitted everywhere (except for Georgia where foreigners are, somewhat mysteriously, limited to 99 per cent). FDI regulation typically stipulates that FDI is allowed unless prohibited by other legislation. Yet special registration of ventures with foreign participation is still required in two-thirds of the countries in eastern Europe and the former Soviet Union, and, depending on the sector of operation, authorisation and licences are frequently required. Restrictions on FDI are generally in the sensitive military, financial and mass media industries, but can be more extensive, as in Latvia. Foreign participation in privatisation programmes is increasingly permitted but is often subject to approval by different levels of authorities.

⁷ See, for instance, Casson (1987).

⁸ See, for instance, Agarwal (1980).

⁹ For instance, Dunning (1993); this is based on earlier work by J. Behrman.

¹⁰ Many of the foreign investment agencies (FIAs) have been established with the assistance of the EC-PHARE programme. FIAs can be found in Albania, the Czech Republic, Hungary, Kazakhstan, Kyrgyzstan, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. Russia, Estonia and Tajikistan are expected to open offices before the end of 1994. Further assistance is available from the chambers of commerce, and government foreign economic relations departments.

¹¹ Two recent examples illustrate progress in the lagging economies of the former Soviet Union. In August 1993, the Belarus National Bank abolished the special investment exchange rate. In another conscious effort to remove barriers to FDI, Kazakhstan abolished the local taxes levied on the purchase and sale of foreign exchange. Before February 1994, these taxes had accounted for up to 20 per cent of transaction value.

In most transition countries foreign investors are guaranteed unrestricted after-tax repatriation of profits, yet many countries limit capital repatriation to the cessation of operations. In addition, the Czech Republic, Hungary and the Slovak Republic restrict, in support of capital controls, the transfer abroad of salaries to expatriates. Five countries (Romania, Slovenia, the Slovak Republic, Ukraine and Uzbekistan) charge withholding taxes of 10–15 per cent on remittances. Conversion of local currency revenues into foreign exchange may be subject to approval. Furthermore, in a number of CIS republics, local currency profits must be exchanged at rates that are less favourable than those applied to other current account transactions.

In various countries governments extend guarantees to foreign investors against losses due to property restitution. In the majority of countries, foreign enterprises may own buildings and other assets, although this is often subject to restrictions and regulations. In contrast, land ownership is either prohibited or remains a strongly debated issue in more than half of the countries. Restrictions on property ownership may be offset by government guarantees, leases of up to 99 years and legislative loopholes. For example, while foreign land ownership is highly restricted in Russia, foreign investors theoretically have the right to own all assets acquired through privatisation, including the land under the facility's buildings.

Investment incentives for foreigners and new domestic enterprises can be found to varying degrees in most countries of the region, with tax holidays and reduced profit tax rates being the most common. Tax holidays tend to be available for periods from two to five years after the first year's profit has been recorded. However, in Turkmenistan foreign companies can enjoy up to 16 years relief, with further extensions possible if profits are reinvested. Apart from profit tax exemptions, many of the transition economies try to entice FDI with special trade regulations. In nearly every country, FDI is exempt from some export licensing and quota requirements, as well as from duties and other fees.¹² The extent and duration of incentives is often dependent on the amount of capital contributed, the degree of foreign ownership, and the reinvestment of profits. Several countries provide extra incentives to encourage investment in less developed regions. Concessions are also often granted in areas, such as infrastructure development, which have been identified as priority sectors. Furthermore, 14 of the countries for which information is available have

established free economic zones with special operating conditions for export producing ventures.

While the attractiveness of investment incentives in developing countries is often offset by restrictions tied to them, special performance criteria for FDI, such as export or local content requirements, are rare in eastern Europe and the former Soviet Union.¹³ Incentives linked to industrial or social policy objectives tend to be available to both foreign and domestic enterprises.

Special incentives for FDI, that emerged at the beginning of the transition period, are being removed in some countries where legislation is shifting towards genuine “national treatment” of all investment and portfolio placements. The Czech Republic eliminated nearly all special FDI incentives in 1993. At the beginning of 1994, Hungary followed suit by abolishing tax holidays for companies with foreign participation. Yet, faced with a sharp decrease in foreign investment in 1994, the newly established socialist government in Hungary has promised to reinstate broader incentives. Russia, Bulgaria and Estonia have also recently removed tax relief for foreigners.

Certain governments offer foreign investors guarantees which are meant to mitigate risk. In Azerbaijan and Bulgaria the FDI legislation is contained in laws with the title “Protection of Foreign Enterprises”. In Uzbekistan, the law on foreign investments protects management from government interference. Turkmen legislation places FDI squarely under “state protection”. Furthermore, several countries have included “grandfathering” clauses which exempt foreign enterprises from unfavourable legal changes for up to ten years.¹⁴

9.3 Investor motivations

While the overview over legislative provisions shows several shortcomings and some contrast between countries, these appear hardly sufficient to explain the pattern of FDI that has been observed. Additional evidence can be derived from surveys among potential investors in eastern Europe and the former Soviet Union. Summaries of 10 such surveys are contained in chronological order in Table 9.4, which lists obstacles to and motivations for investment by order of importance. Comparing and interpreting these surveys is problematic, since they cover different groups of countries and respondents with different characteristics. They also sometimes use radically different methodologies.¹⁵ Nevertheless, keeping these shortcomings in mind, the combination of surveys reveals

¹² In the Czech Republic, it is estimated that total savings of companies with foreign participation as a result of duty-free imports might amount up to one billion Koruna annually (*East West Investment News*, No.4, 1993).

¹³ However, participation in privatisation programmes may be subject to employment and other guarantees (such as in Estonia).

¹⁴ Azerbaijan, Tajikistan, Ukraine and Uzbekistan stipulate that foreign companies are protected from legislative changes for 10 years, and Belarus offers 5 years protection. Although automatic tax holidays were abolished in Hungary in 1994, existing beneficiaries may theoretically continue to enjoy benefits until 2003.

¹⁵ In addition, the quality of some of the surveys is questionable; unfortunately, full methodologies cannot be reproduced here.

Table 9.3 Legal environment for foreign investment in each country in transition
Eastern Europe and the Baltic states

	Foreign investment laws	Restrictions on activities	Profit & capital repatriation	Property ownership
Albania	Law on Foreign Investment (Nov. 1993). Law on Profit Tax (1993).	Restrictions on basis of national security and public order. National treatment. 100% ownership by foreigners not explicitly allowed. Licence for activities that affect the environment.	No restriction on after-tax profit or capital repatriation. 10% withholding tax eliminated in 1993.	May lease property for up to 99 years, or own in cases of "special importance" subject to parliamentary approval.
Bulgaria	Law on Protection of Foreign Investment (June 1992) repeals Foreign Investment Law (July 1991).	Licence or permission required for defence, banking, natural resource sectors, and if in certain geographic areas.	No restriction on after-tax profit or capital repatriation.	Constitution prohibits foreign land ownership. Foreign "persons" may own buildings, and lease land. If foreign ownership is less than 50%, may acquire agricultural land.
Croatia	Former Yugoslav Investment Law (1967) still valid. Law of Companies forthcoming in 1995.	Restrictions for military, rail and air transport, telecommunications, publishing and media. Foreign investor personal liability only possible if Croatian co-owner is also personally liable.	No restriction on after-tax profit or capital repatriation.	May own buildings and sites if business is performed in Croatia. Agricultural lands and coastal sites are excluded. No restitution law set or planned.
Czech Republic	Commercial code (1991) supplants Foreign Investment Laws.	Prohibited in some infrastructure sectors. Approval generally not required unless large privatisation, defence, financial sector or trade projects.	No restriction on profit repatriation. Capital may be repatriated at cessation of business. Restriction on salary repatriation.	Property ownership is a guaranteed constitutional right. Only Czech-registered businesses may own property.
Estonia	Law on Foreign Investments (Sept. 1991), some amendments by Act on Implementation of the Rights in Things, Dec. 1993.	No restrictions on sector. Specific licences for foreign investors required in banking, mining, energy, certain utilities, transport, retail sales of medicines and communication.	No restriction on profit or capital repatriation. Reporting requirements on foreign exchange abolished May 1994.	Property ownership allowed, with approval for offices and business purposes. Land not yet subject to trade, but can be owned if part of production premises. Uncertainty due to restitution.
FYR Macedonia	Foreign Investments Act (May 1993).	Investment in insurance, banks regulated by law.	1991 Constitution (Art 59) guarantees free transfer of profit and invested capital.	Former Yugoslav Property Law that has been accepted as a republic law since 1980 still applies. Draft law on restitution in preparation.
Hungary	Act XXIV of 1988 on the Investments of Foreigners in Hungary (amended 1990, 1991 and 1994), Act LXXXVI of 1991 on Corporate Tax (amended 1992 and 1993).	Prior government approval necessary in banking. Otherwise, foreign investors face the same rules as domestic companies.	No restriction on profit or capital repatriation. Only 50% of expatriate salaries may be remitted outside the country.	Restriction on acquisition by foreign individuals or companies. No restriction for Hungarian companies with foreign ownership.
Latvia	Law on Foreign Investment (Nov. 1991) amended (March 1993).	Must be limited liability or joint stock. Permission needed if gaining control of company with capital greater than \$1 million. Few industries prohibited, many others require licences.	No restriction on profit or capital repatriation.	May not own land. May lease for up to 99 years, and own buildings on leased land. Uncertainty due to restitution but claims had to be filed by 1 June 1994.
Lithuania	Law on Foreign Investments (Dec. 1990, amended Feb. 1992). New law expected to be adopted before end-1994.	Foreign activity subject to licensing, but not the buying of shares in stock corporations. Restrictions in a number of sectors. Permission of Council of Ministers required for monopolies.	No restriction on after-tax profit or capital repatriation.	Non-citizens may not own buildings and structures. May not own land, but can lease at fixed rent for up to 99 years, with priority right to prolong lease.
Poland	Law on Companies with Foreign Participation (1991), Commercial code (1932), Law on Public Trading in Securities (1991).	Permit required for defence, real estate, port and airports, wholesale trade in securities and legal activities. Approval required for bank, insurance and other financial services.	No restriction on profit or capital repatriation with the exception of banks.	Permit from the Ministry of Interior is required unless foreign shareholding is below 50%. In certain situations a permit from the Ministry of Privatisation is required.
Romania	Foreign investment Law no. 35 (1991, amended 1993), Privatisation Law no. 58 (1991), Foreign Investment in Petroleum Sector Law no.66 (1992), Law on Additional Incentives for Investments in Industrial Sector no.71 (July 1994).	Allowed in all sectors provided not against environment, national security and public order, health and good morals. Special authorisation required for banking, insurance and securities transactions.	No restrictions on profit or capital repatriation. 10% withholding tax on dividends and profits transferred.	Romanian registered company may theoretically buy land for business activity; in practice, the most accepted vehicles are long-term lease or concession. May lease agricultural land. In June 1993 parliament refused to confirm foreigners' right to buy land.
Slovak Republic	Commercial Code supplants Foreign Investment Laws. Decree on Tax Holidays and other fiscal incentives (March 1993).	Not in national security, some infrastructure sectors. Approval required for JV with state participation, or international trade projects. Special permission required for banks.	No restriction on profit repatriation. Capital may be repatriated at cessation of business. Some restrictions on salary repatriation. Repatriation subject to some withholding taxes. Licence required to hold foreign currency.	May own property. Slovak-registered businesses may own land.
Slovenia	Foreign Investment Law (1967, revised 1988), Law on Foreign Trade Transactions (Feb. 1993).	May operate in any sector. 100% ownership prohibited in military, rail & air transport, mass media and insurance sectors. Minimum investment of \$950 for limited liability, \$9,500 for joint stock.	No restrictions on profit repatriation in currency of original investment. Capital may be repatriated at cessation of business. 15% tax on paid out dividends.	Foreign companies or JVs may own real estate, but not foreign legal or natural persons.

Tax treatment and incentives	Participation in privatisation	Other
Corporate tax rate is 30%, 40% for tourism, 50% for 100% foreign owned oil or gas activities. Exempt 2 years, reduced by 50% next 3 years. 60% rebate on tax if profits are reinvested.	Participation in privatisation permitted with approval from National Agency for Privatisation; approval by Council of Ministers required for large-scale enterprises.	Exemption from payment of customs duties may be granted.
Corporate tax rate is 30%. Tax relief for foreign investors removed. Priority industries may be tax exempt. If in free economic zones, exempt for 5 years, then reduced by 20%.	Participation in privatisation permitted with authorisation from relevant economic ministry. If investment is greater than 10 million levs, authorisation from Privatisation Agency is required. If greater than 200 million levs (\$ 33 million), authorisation from Council of Ministers is required.	Laws refer to foreign persons instead of foreign investment. Free economic zones. Despite FDI exemption from import duties for export production, these are charged in practice.
Corporate tax rate is 25%. Exempt up to 2 years, or longer if profits are reinvested.	Participation in privatisation requires approval by management, employees and Croatian Fund for Privatisation.	Custom duties (average 8%) on invested equipment unless foreign ownership is greater than 20%.
Corporate tax rate is 42%. Most exemptions for foreign investors eliminated in 1993, but negotiable for priority sectors. Some incomes are tax exempt (i.e. electricity plants), others are taxed at special rates (i.e. consulting services).	Participation in privatisation is permitted with approval from the Ministry of Privatisation.	Free economic zones. If foreign ownership is greater than 30%, exempt 1 year from custom duties.
Corporate tax rate is 26%. Special tax holidays for foreigners eliminated in new tax law in force since Jan. 1994 (but "grandfathering" clause).	No specific restrictions on foreigners. Evaluation of "entire bid" takes employment and investment into consideration.	
Corporate tax rate is 25%, 5% for food production, 10% for most services. Income tax reductions in initial period and if profit reinvested.	Privatisation programme to begin in 1994. Foreign participation in certain JVs permitted.	Some customs duty relief for foreign investors. Large monetary fines for economic crimes such as not meeting investment laws.
Corporate tax rate is 36%. Automatic holidays abolished in 1994, but "grandfathering" until 2003. Priority investments (independent of foreign participation) may get tax preferences. 85% tax holiday for 100% foreign-owned offshore companies under certain conditions.	Participation in privatisation permitted upon agreement with State Property Agency (AVU) and State Holding Company (AV Rt.).	Free economic zones. Offshore companies. Export licence and import quota and licences required for certain goods. Technology and infrastructure projects may receive grant from the Investment Promotion Fund.
Corporate tax rate is 35%, 25% for non-incorporated companies, 45% financial, trade sectors. If foreign ownership greater than 30%, exempt 2 years after first profit, reduced 50% next 2 years. If in priority sector, or foreign ownership greater than 50% and more than \$50,000, exempt 3 years, reduced 50% next 5 years.	Participation in privatisation permitted with approval from branch of the appropriate Ministry and from Ministry of Economic Reforms. Foreign investment encouraged in priority industries such as construction and light industry.	
Corporate tax rate is 29%. If investment made before Dec. 93, tax reduced 70% for 5 years, reduced 50% next 3 years. If invested Jan. 94-Dec. 95, reduced 50% for 6 years. Further reductions for priority sectors or if profits are reinvested. Exemptions pro-rated for JVs.	Participation in privatisation permitted if objects on special list of privatisation against hard currency (confirmation by Central Privatisation Commission). Employees have right to obtain up to 50% of shares in privatising company.	Drafting group established to set up free economic zones.
Corporate tax rate is 40%. 3-6 years exemption may be granted if investment in priority sector, made before Dec. 1993, and greater than ECU 2 million. If exports and other conditions, may be reduced 25-50%. Revenue from agriculture, forestry exempt.	Participation in privatisation permitted with approval from the Ministry of Privatisation.	Free economic zones.
Corporate tax rate is 30% for profit up to Leu 1 million, 45% thereafter. If foreign ownership is greater than 20% or \$10,000 exempt 2-5 years depending on sector. Reductions may be extended for activities with certain characteristics (exports, R&D, other). Additional special tax incentives in petroleum and industrial sectors.	Participation in privatisation permitted with approval from the State Ownership Fund and, as the case may be, the Private Ownership Fund. Foreign participation not allowed in natural resources, infrastructure and arms sectors.	Free economic zones. Exemption for 2 years on custom duties on raw materials used for production purposes. Special import duty exemptions in petroleum and industrial sectors. Exempt from import duty on equipment if contributed in kind or financed by foreign cash contribution.
Corporate tax rate is 40%. If investment was made after 1993, exempt 1 year, 2 years in specified regions. If foreign ownership is greater than 30%, exempt next 2 years. Further reductions if profits are reinvested. Special reductions for banks.	Participation in privatisation permitted with approval from the Ministry of Administration and the Ministry of Privatisation of National Property.	If foreign ownership is greater than 30%, or 10 million crowns (\$3 million), duty-free import of investment goods valid until end of 1995. Free economic zones.
Corporate tax rate is 30%. Reduced 20% for 1 year. If profits are reinvested in Slovenia, tax reduced up to 10% for next 4 years. Further incentives to hire, train unemployed workers.	Participation in privatisation permitted with approval from the Agency for Privatisation. Decision to privatise must come from management and employees.	Six free economic zones. Discounts on customs duties if the products are not manufactured domestically.

Commonwealth of Independent States

	Foreign investment laws	Restrictions on activities	Profit & capital repatriation	Property ownership
Armenia	Law on Foreign Economic Activity (Jan. 1992) New law submitted to parliament.	May form JV with government or private firms.	No capital controls in place.	May not own land, but may lease for up to 99 years.
Azerbaijan	Law on Protection of Foreign Investments (Jan. 1992). New FDI law is to be debated in parliament in autumn 1994.	Allowed in any activity not prohibited. Some require licences. Government may impose territorial restrictions for national security. Must pay in 50% of declared capital by end of first year.	No restriction on after-tax repatriation of profit and capital.	May be granted use or lease of land.
Belarus	Law on Foreign Investment (1991, amended 1993).	Must pay in 50% of declared capital in the first year, entire amount in 2 years. Foreign ownership in insurance limited to 49%.	If foreign investment is greater than 30%, may repatriate export currency earnings. Limits on purchase of foreign-exchange. Capital may be repatriated at cessation of business.	May own property and lease land for up to 99 years according to laws. May lease land for farming.
Georgia	Law on Foreign Investments (Aug. 1991, review planned).	May own up to 99%. Capital contribution calculated at official rate.	No restriction on profit or capital repatriation.	May not own land. No land disposition rights.
Kazakhstan	Presidential Decrees (1994), Foreign Investment Law (Jan. 1991, amended April 1992).	Prohibited in military sector. Must register. Authorisation required for finance sector and large investments.	No restriction on after-tax profit repatriation, limits on capital repatriation before cessation of business.	May own buildings. No private market in land. Presidential Decree of April 1994 allows markets in all land rights including permanent use, except absolute ownership. Legal entities may buy such rights.
Kyrgyzstan	General Principle of Foreign Economic Activity (April 1991), Law on Foreign Investments (June 1991, amended May 1993), Law on Concession (March 1992).	Must pay in 50% of declared capital in first year. Many activities require licences or permits. These may be cancelled if investment not implemented within 12 months.	No restriction on profit repatriation. 5% withholding tax if tax concessions used.	May acquire buildings necessary for business. May use and transfer investment to other juridical persons. May lease land.
Moldova	Law on the basis of foreign activity (Jan. 1992).	JVs limited to certain sectors. Minimum investment of \$10,000. Foreign ownership in banks limited to 35%.	No restriction on profit or capital repatriation.	May not own land, but may lease for up to 99 years with possibility of extension.
Russian Federation	Law on Foreign Investments (July 1991), Law on Currency Regulation and Control (October 1992), Law on Enterprises and Entrepreneurship (Dec. 1990), Presidential Decree No. 1,466 (Sept. 1993), a number of Government Decisions concerning various aspects of foreign investor activity, "Regulation governing the activity of joint-stock companies" (Decision No. 601, Dec. 1990).	No restrictions to foreign investment unless imposed by law or Presidential Edicts. Certain types of activities (insurance, banking, some others) are subject to licence issued by the relevant state authority.	No restriction on profit or capital repatriation. Non-resident dividend withholding tax. Must convert at authorised banks. Use of cash foreign currency banned, but other forms of foreign currency allowed.	May buy land and buildings used for business, but difficult in practice, especially in relation to land. May own land occupied by enterprises bought during privatisation. In certain regions (e.g. Moscow) only lease rights are available.
Tajikistan	Law on Foreign Investment (1991, amended 1992).		No restriction on profit or capital repatriation.	May not own land. Government guarantee that foreign property will not be nationalised.
Turkmenistan	Special Presidential decree (1993), Foreign Exchange Control Law (1993), Exemptions in tax law (March 1994).	Allowed in any activity not prohibited. Some sectors require licences.	No restriction on profit repatriation. Capital may be repatriated at cessation of business.	No restriction on the right to use property or capital.
Ukraine	State Programme (1994) revises Decrees on Foreign Investments (May 1993) which replaced Law (March 1992). Law on Protection of Foreign Investments (Sept. 1991).	Allowed unless prohibited. Some sectors incl. financial activities require licences. Permission required if foreign investment is greater than \$1 million. Minimum investment of \$500,000 for joint stock. Ten priority areas.	No restriction on profit repatriation, yet cumbersome as exchange subject to screening. Capital may be repatriated at cessation of business. 15% tax on transfer of income, profits, assets.	May own buildings, and lease land for up to 50 years. Ownership of natural resources is regulated.
Uzbekistan	Law on Foreign Investments (June 1991, amended July 1993, May 1994).	Allowed unless prohibited. May require authorisation. Finance, agribusiness, resources, tourism, telecommunications are priority sectors. Foreign trade barter deals prohibited, except in construction, timber and oil where they are taxed.	No restriction on profit or capital repatriation, subject to 10% tax. 15% tax on hard currency earnings.	May own facilities, and lease land. No decision yet made on land privatisation.

Table 9.3 Legal environment for foreign investment in each country in transition

Tax treatment and incentives

Corporate tax rate is 30%. If foreign ownership is greater than 50%, reduced 50%. If greater than 30%, may carry loss forward 5 years.

Progressive 25-35% corporate tax rate. 45% for banks and insurance. If foreign ownership is greater than 30%, corporate tax rate is 25% on foreign share of profits. JVs may have 2-year tax holiday in cases of "material production".

Corporate tax rate is 30%. If foreign ownership is greater than 30%, exempt for 3 years. If in priority industries, reduced 50% next 3 years.

General corporate tax rate is 20%, 10% for industry and construction, 35% for banks and insurance. New enterprises exempt 1 year, reduced 50% next 2 years. Foreigners exempt 2-5 years.

Corporate tax rate is 35%. If foreign ownership greater than 30% and priority sector, exempt 5 years after first profit, reduced 50% next 5 years. If in free economic zone, exempt up to 5 years. Exemptions now in doubt since apparently abolished by March 1994 "Explanation Letter" of Min. of Finance.

Corporate tax rate is 35%. If foreign ownership is greater than 50%, exempt 5 years, reductions extended if profits are reinvested. Priority activities exempt 100% for 5 years, reduced 50% next 5 years.

Corporate tax rate is 35%. Exempt up to 6 years depending on industry.

National treatment. Maximum rate of profit tax is 38%, but 43% for Banks and insurance companies. In certain activities, small enterprises (<100 employees) with less than 25% state participation exempt from profit tax for 2 years after registration. A number of regional and local taxes, but also regional incentives.

Corporate tax rate is 30-45%. If foreign investment is greater than 30%, rate is 30% and there is a 2-year exemption. In free economic zones may carry operating loss forward 5 years.

Corporate tax rate is 25%. If foreign ownership is greater than 30% exempt 3 years, 50% next 3 years, 30% reduction next 10 years. Further exemption if more than 50% of profit is reinvested.

Corporate tax rate is 35%. If foreign investment is greater than \$10,000 exempt 1 year after first profit. Reduction for priority sectors extended 1 year, 2 years if investment is greater than \$500,000, 3 years if greater than \$5 million, 5 years if greater than \$50 million.

Corporate tax rate is 18%, 30% for banks. If foreign ownership is greater than 30%, or if priority, tax reduced up to 5 years. Further reductions if foreign ownership is greater than 50%.

Participation in privatisation

Participation in privatisation permitted as per Privatisation and De-Statism Law (July 1992). Investment subject to certain hard-currency requirements.

Participation in privatisation permitted as per Privatisation Law (Jan. 1993).

Participation in privatisation permitted as per Foreign Investment and Privatisation and De-Statism[Statism?] Laws (1993).

No limits on foreign participation in privatisation.

No limits on foreign participation in privatisation. Licence from the National Agency for Foreign Investment required.

Participation in privatisation permitted in priority sectors including hydro-electricity, military conversion, oil and gas industries.

No relevant legislative provisions.

National treatment with several exceptions. Participation in privatisation in certain branches of industry subject to approval of RF government or local authorities. If foreign investor is only participant in an auction or tender, a special price applies.

No relevant legislative provisions.

Privatisation remains largely at planning stage.

Participation in privatisation permitted with approval from the State Property Fund or the local privatisation agency.

Mass privatisation planned for 1994-95.

Other

50% export surrender requirement at official rate.

JVs exempt from export licences. 10-year "grandfathering" clause. Export surrender requirement at official exchange rate, but JVs with more than 30% foreign participation are exempt from this requirement, as well as from export licences where they export their own goods.

All concessions for foreign investors only valid after 50% of declared capital has been certified. 5-year "grandfathering" clause. Free economic zones in development regions.

Price controls for electricity, water, natural gas, coal and transportation. Current account convertibility through licensed foreign exchange dealer. 32% export surrender requirement at official rate.

Must insure assets, etc. with Kazakh insurance companies. Free economic zones. 50% export surrender requirement to local currency market, but rates largely unified.

Material imported custom free. Other privileges in free economic zones.

Legislation brought forward which would require 10% of declared capital to be paid up front. 35% export surrender requirement. JVs with investment over \$250,000, foreign dividends, profits from securities are exempt this requirement.

Free economic zones. 60% tax on personal items brought in by expatriate employees (if in excess of \$2,000). Contributions to the charter fund of JV with Russian partner exempt from taxes if made within specified time period. Exporters obliged to sell minimum 50% of currency earnings to Republican Fund or 30% to foreign currency exchanges.

Free economic zones. 10-year "grandfathering" clause. 30% export surrender requirement.

Foreign Investment "under the protection of the State". 40% export surrender requirement at official rate, plus 10% at double the official rate.

Free economic zones. Marginal personal income tax for income over \$150 per month is 90%. 10-year "grandfathering" clause. 50% of export earnings must be sold to foreign exchange fund at official fixed rate.

Law protects foreign investors from government interference. 10-year "grandfathering" clause. 15% export surrender requirement at official rate. This requirement exempt if foreign ownership is greater than 50%.

Table 9.4 Results of foreign investor surveys

Survey	Sample and date	Obstacles
Susan Collins & Dani Rodrik, "Eastern Europe and The Soviet Union in the World Economy", Institute for International Economics, 1991.	Survey of 54 large firms (of which 21 investors) from Europe, Japan, US on investment intentions for CEE and the FSU. Winter 1990-91.	Political and economic uncertainty, lack of protection of private property, repatriation restrictions.
Jonathan B. Welch, "Investing in Eastern Europe: Perspectives of Chief Financial Officers", The International Executive, Vol. 35 (1) Jan./Feb. 1993.	Survey of 39 chief financial officers of Boston companies with actual or planned investments in eastern Europe. April-May 1991.	Primary risk in financing, distribution systems and technology. Political unrest, low labour skill levels less important. Relatively less concerned with regulatory and hard currency problems. National Economic Research
Associates (NERA), "Foreign Direct Investment to the Countries of Central and Eastern Europe", 1991.	Survey of 144 large companies (of which 79 investors) from Europe, Japan, US interested in East Germany, CEE and the FSU. Oct.-Nov. 1991.	Political and economic uncertainty.
Pietro Genco, Siria Taurelli & Claudio Viezzoli, "Private investment in central and eastern Europe: survey results", EBRD Working Paper, July 1993.	Survey of 82 companies already in eastern Europe, and their 34 parent companies in France, Germany, UK and Italy. Sept. 1991 - March 1992.	Lack of clearly defined legislation more important than economic problems. Operational problems, often associated with lack of infrastructure.
Deloitte Touche Tohmatsu International, "Successfully Managing Investments in Eastern Europe", 1992.	Survey of 168 companies with JVs in Bulgaria, Czechoslovakia, Hungary, Poland, Romania and Russia. April - Sept. 1992.	Lagging infrastructure. Regulatory issues. General economic situation.
Zhen Quan Wang, "Foreign Investment in Hungary: A Survey of Experiences and Prospects", Communist Economies & Economic Transformation, Vol. 5. No. 2, 1993.	Survey of 90 Western small and large companies with JVs in Hungary; conducted in 1992.	Major problems are inconsistent rules, poor infrastructure, shortage of hard currency and insufficient convertibility of the forint. Less frequent responses included inflation and economic uncertainty, difficulty of negotiating with local partner and operating problems.
Creditanstalt and The Economist Intelligence Unit (formerly Business International), "1992 East European Investment Survey", 1993.	Survey of 87 companies (of which 48 investors) in CEE and the FSU followed by some in-depth interviews. July 1992	Political, economic, legal environment. Dealing with governments. Restructuring costs. Less concern with currency issues and ownership.
Matija Rojec & Marjan Svetlicic, "Foreign Investment in Slovenia: Experience, Prospects and Policy Options", Communist Economies & Economic Transformation, Vol. 5. No. 1, 1993.	Interviews of 11 Slovene enterprises and their foreign parent companies; conducted in 1993.	Economic and financial instability and risk due to transition. Inadequacy of and gaps in legal framework, particularly lack of privatisation law. Ambiguities about access to former Yugoslav markets.
Miklós Szanyi, "Experiences with Foreign Direct Investment in Hungary", Institute for World Economics, Hungarian Academy of Sciences, Working Paper No. 32, April 1994.	Survey of 15 European and American firms in a variety of sectors operating in Hungary. Aug.-Oct. 1993.	Deficient flow of information. Bureaucratic inefficiency and high tax. Problems with the financial system, physical infrastructure, privatisation practice. Economic and political uncertainty.
Arthur Andersen, "Assessing Investment Opportunities in Economies in Transition", for the OECD Advisory Group on Investment, forthcoming in 1994.	Interviews with 291 Western companies (162 investors) in CEE and the FSU, and professionals. Nov. 1993.	Main obstacles are bureaucratic administration and legislation, and weak infrastructure. Concern with economic and political climate. 50% claim no internal constraints. Others mention human resources.

Motivations

New and expanding market, potential to beat out competitors by being first and proximity to EC markets most important. Low labour costs, skilled labour force, and investment incentives not considered strong attractions.

Motivated by both defensive (eroding domestic profit) and offensive (market opportunities) reasons. Higher expected profits in the long term.

Market potential most important. A few manufacturing companies also interested in export potential to other countries in the region and EC.

New or broader markets for own products. Gather experience and establish a foothold. Acquire a dominant position. Much lower importance given to cheap labour, immediate profits, incentives.

Motivations for forming a JV: Western partners look for knowledge of local market, access and tax advantages; Eastern partners look for access to capital, new products, training, new technology.

Firms had multiple objectives. Top were market oriented: better access, expanding exports, maintain a foothold, transition opportunities. Less important motives include previous experience, relatively low cost labour, incentives, defending position against competition and diversification.

Establishing market share. Base for regional market and EC. Low cost sourcing less important. Also following the client and going where resources and opportunities are.

Market considerations (access, preserve, serve by export) by far most important. Some export-oriented FDI attracted by reduced costs.

Size of domestic and regional markets most important motives. FDI also to follow key suppliers and customers. Attracted to Hungary by geographical location and quality of labour force. Financial incentives play almost no role.

Key attraction is domestic market rather than low wages, cheap resources, investment incentives.

Other findings

Number of investors expected to increase, but remain small in size.

Best opportunities in next 5 years. Required ROI distribution concentrated between 16-20%. Low perception of education levels, work ethic.

Small investment size indicates wait and see attitude. Little diversion of FDI from lagging EC regions where conditions and skill levels are deemed to be comparable.

Low opinion of skills of local managers. Prefer to set up new company rather than acquiring and restructuring.

Major staffing issues include task management, lack of language skills, lack of understanding of free markets, rising salaries due to excess demand and inflation.

Past contacts with Hungarian firms affected FDI decision. While most JVs were less or equally profitable, 20% were more profitable than home-based operations. The majority said ROI had reached expectations and JV was successful.

Investment type and size dependent on key motivation, industry and country. Perception of problems differs by investor nationality and host country.

Given small size of domestic market, preferential access to rest of former Yugoslavia very important. Slovenia's relative stability makes it attractive to serve other republics.

FDI is part of a global strategy with a strong emphasis on seeking regional markets. Hungary regarded as a regional centre.

Most use a country-specific approach; however. some US and UK developing regional strategy. Obstacles led to change of strategy for 40%, cancellation or postponement of 18% of projects.

some interesting patterns regarding locational factors and investor strategies.

Most striking perhaps is the predominance of market access among factors of importance to investor decisions. Eighty per cent of respondents in the NERA study of 1991, for instance, professed to be primarily interested in the local market, with little variation across (potential) host countries. More recent studies, such as the Arthur Andersen survey from late 1993, support this finding. While the domestic market of the host economy appears to be the main target, some studies also indicate that the possibility of subsequent expansion into regional (transition economy) market is of importance to investors.

Factor cost advantages are clearly rated as less important than market access in all the surveys. While some surveys (Collins and Rodrik, NERA, Creditanstalt) suggest that proximity to EU markets matters to investors - indicating perceived efficiency gains in locating production in the transition economies - most studies explicitly play down the role of cheap labour. The Szanyi study gives some importance to human capital in decisions to invest into Hungary, but in the Collins and Rodrik survey labour skills are discounted as a significant motive. In fact, findings reported in the last column of Table 9.4 suggest that Western executives often have a low perception of both labour and managerial skills and of the working ethic in the countries in transition. It is worth mentioning that other studies have shown that this perception tends to improve markedly with experience.¹⁶ The virtual absence of access to natural resources as a motivation - in spite of the substantial commitments of foreign investment funds for this purpose reported in the press - is probably explained by the fact that projects in that sector tend to be large but few, as well as by the geographical bias towards central Europe of many of the surveys.

Strategic considerations reinforce the incentive to seek market access. Some of the surveys stress the importance of gaining a foothold in the new markets - a strategy designed to reduce capital exposure in risky environments while enabling companies to exploit potential opportunities. In the study by Collins and Rodrik, Genco et al. and in the Creditanstalt surveys, the role of some objectives, such as those of acquiring a dominant market position or beating

competitors by acquiring first-mover advantages, suggests oligopolistic behaviour that is often dissociated from immediate profit motives. Lastly, the Creditanstalt and Szanyi surveys reflect some investors' desire to follow existing (Western) clients into the new markets.¹⁷

Given the substantial tax privileges granted by most countries of the region to foreign investors (as described in the previous section) it is remarkable how little weight is given by potential investors to tax incentives. This conforms with experience with FDI in other regions of the world.¹⁸ While sectors with standard cost structures and few linkages into the local economy - such as clothing - have been shown to respond to such incentives, most others have not. Investors tend to perceive incentives as a windfall but base their decisions on more stable and fundamental considerations. Consequently, tax breaks are often judged to be a costly and unnecessary luxury that countries with fiscal constraints can ill afford.¹⁹

The investor surveys also identify various obstacles which foreign investors encounter in doing business in eastern Europe and the former Soviet Union. Economic and political uncertainty in the process of transition rate high among investor concerns, particularly in some of the earlier surveys. Hungary, which receives the most favourable rating on political uncertainty (Creditanstalt survey, 1992), has attracted the lion's share of FDI in eastern Europe. This may suggest that FDI to date has been concentrated in the handful of countries whose transition and macroeconomic stabilisation is particularly advanced, while low threshold levels of economic and political risk has not yet been reached elsewhere. However, while early research highlights these preconditions for foreign investment, more recent findings tend to focus on micro-level operating difficulties.

Legislative uncertainty and regulatory hassle are the most commonly cited investment obstacles. The prospect of changes in the legislative environment is an important consideration in FDI decisions. Also, foreign companies are attracted to tax systems that are transparent and impose a reasonable overall burden, yet a biased system is deemed preferable to one which changes constantly. Only a limited legal framework currently exists to deal with FDI disputes, and investors appear concerned with incomplete and inconsistent legislation and patchy enforcement.²⁰

¹⁶ See, for instance, OECD, "Barriers to trade with the CEECs and NIS", Synthesis Report, 1993; this suggests that some of the findings reported in Table 9.4 are influenced by differences in the perceptions of investors and non-investors.

¹⁷ This motive may be of particular relevance for suppliers - note the moves by Renault's suppliers into Slovenia described in Box 7.1 - as well as for service sector firms such as advertising agencies or consultancies.

¹⁸ See, for instance, Guisinger (1985).

¹⁹ Note, however, that certain forms of incentives, such as negotiable tax certificates, have apparently been successful in risky environments by reducing the capital exposure of the investor in the crucial first years. Examples include Costa Rica in the 1980s. See EBRD (1993) Section 4.3.

²⁰ For example, Bulgarian laws are viewed as confusing because they refer to foreign persons instead of investments. Furthermore, while one decree provides exemption from import duties on machinery, equipment and raw materials for exportable production, this is inconsistent with another law, and thus not applied.

Many of the operational problems encountered refer to either management difficulties or limited infrastructure (particularly as regards telecommunications, financial markets and established distribution networks). The Deloitte Touche Tohmatsu International survey underlines the differences in Western and Eastern partners' objectives in entering a joint venture. Apart from the difficulty of finding a suitable local partner, some surveys identify as important the problems of negotiating and successfully working together, as well as locating and training staff. Related internal constraints include the difficulty of obtaining quality expatriate management with appropriate business, language and culture skills as well as a willingness to relocate.²¹

9.4 Explaining FDI patterns

As discussed earlier, there is no general theory of FDI which explains the relationship between the investment environment, motivations and outcomes. A full discussion of the different facets of FDI behaviour is beyond the scope of this report. Nevertheless, some of the characteristics of FDI that have been described invite comment and offer some basis for speculation about future developments. The key challenges are to understand, first, the dominance of market access as a motive for investment; and second, why so much FDI has been concentrated in a few, relatively small countries.

9.4.1 The relation between trade and FDI

To approach these questions, it is useful to consider the relation between foreign trade and investment, which cuts across both locational and firm-level characteristics. While trade and FDI are usually approached separately in both economic theory and policy, they are in fact strongly interrelated, not least since they tend to be undertaken by and often within the same multinational enterprise.²² It has been estimated that in 1990 multinational enterprises were responsible for 80 per cent of world trade, while a third of worldwide exports took the form of intra-firm trade.²³ Trade and FDI can be substitutes, as happens when FDI is undertaken to jump import barriers or to reduce transport costs in serving a particular market.²⁴ On the other hand, they can be complements, for instance when a company invests in distribution systems or in trade-related services to boost exports to a foreign market. FDI can create trade, where it is undertaken to serve world or regional markets from a low-cost production base, and conversely the opportunity to trade can cause FDI while restrictions may dissuade it. Lastly, FDI can contribute to trade diversion in the context of rules of origin within free trade areas or quota restrictions on imports from certain locations but not from others. In sum, a large number of influences on trade will affect FDI and vice versa.²⁵

Table 9.5 Trade regime, investor motivation and enterprise strategy

Situation	Trade regime	Investor motivation	Multinational enterprise strategy
A	Protected markets and no regional preferences	Domestic market-seeking (most products)	Multi-domestic production, little trade in final products
B	Strong regional preferences	Domestic market-seeking (in particular non-tradable products). Cost reduction (in particular easily tradable products, incl. input outsourcing)	(i) Multi-domestic production and sales (ii) Regional strategy - few production centres serving the regional market
C	Liberal trade regimes and regional preferences of little importance	Domestic market-seeking (non-tradable products). Cost reduction (easily tradable products, incl. input outsourcing)	(i) Multi-domestic production and sales (ii) Global strategy - even fewer production centres

21. Several other unusual restrictions that affect the investment climate are worth mentioning. In Russia, foreigners are subject to a 60 per cent tax on personal items brought in by expatriate employees. In Kazakhstan, foreign enterprises may only take out insurance with Kazakh providers. Furthermore, FYR Macedonia's 1993 Foreign Investment Act sets out penalty regulations with monetary fines of up to 250 monthly salaries. Improperly drawing up the investment contract, as well as failing to register profit reinvestment or transfer of ownership are considered punishable economic crimes.

22. On the relations between trade and FDI see also Meyer (1994).

23. UNCTAD (1993).

24. In fact, often FDI undertaken with the motive of avoiding trade restrictions substitutes the import of final products into the host economy by the import of intermediate goods that are necessary in production.

25. Also, clearly, the benefits of a "unit" of FDI can be leveraged up or they can be (partly) offset by the accompanying effect on trade.

Building on these observations it is possible to make some broad - but certainly not comprehensive - associations between the trade policy environment and investor motivations on the one side and investor strategies on the other. This is illustrated in Table 9.5 and discussed further below.

- *Situation “A”*: A country’s market may be hard to penetrate through imports, perhaps as a result of high tariff or non-tariff barriers or limited convertibility of currencies. If this situation is perceived to be likely to persist for some time, the market-seeking motive will dominate foreign investor decisions even in (potentially) tradable product sectors. Not only exports to, but also export-oriented production within the protected area may be unprofitable - since protection from imports effectively constitutes a tax on exports. The strategy of multinational enterprises operating throughout a particular region would then tend towards the establishment of production sites in each country, producing the same final product for each local market (“multi-domestic”).
- *Situation “B”*: When an economy is linked into regional multi-lateral trade schemes with substantial barriers to the outside - including restrictive rules of origin - but a relatively free flow of goods within the regional market, then it may make sense for companies or their suppliers to distribute the different components of their production process across member countries of the scheme in accordance with factor cost or other considerations; the whole of the regional market could then be supplied from the most efficient “platform”.
- *Situation “C”*: This same logic can apply to wider geographical areas or even globally when restrictions to trade are few, a process that has gained increasing prominence with progress in GATT-led trade liberalisation and technological developments which have reduced effective distances.²⁶

Other components of the investment environment being equal (legal, uncertainty, etc.), it would appear reasonable to expect situation “A” to prevail in many countries of the former Soviet Union, where - as described previously - convertibility as well as other components of the trade regime remain precarious (and where some markets,

including the Russian and Ukrainian markets, are large).²⁷ Situation “B” appears to describe the context of many countries of eastern Europe, in which the trade environment is strongly influenced by the progressive integration into the western European economic sphere.²⁸ Situation “C”, lastly, may be of relevance for many of the same countries in product groups for which neither their own trade regimes nor those of the EU or EFTA create impediments to extra-regional trade.²⁹

9.4.2 What explains the domestic-market orientation of FDI ?

The domestic market-orientation of FDI emphasised by the surveys is easy to reconcile with investments in most sectors of the larger countries of the former Soviet Union and in the services and other non-tradable sectors of eastern European countries, where these sectors were often neglected under central planning. However, the emphasis on market access sits somewhat uneasily with the concentration of investment in the (mostly tradable) manufacturing sectors that characterised the early transition, and with the smallness of the countries that have been most successful at attracting FDI.

There appears to have been limited investor interest in exploiting factor cost advantages for regional strategies in central Europe. This is surprising, given the abundant supply in central Europe of human capital at relatively low wages (Table 9.6 below lists average monthly wages in US dollars).³⁰ Educational achievements in the transition economies are on average much higher than in non-transition countries in the same income group.³¹

These apparent contradictions may be explained by other factors which may have been important to foreign investors. Factors reducing investor interest may include the lack of investor experience with, for instance, fluctuations in the real exchange rate and the transience of its level during the economic transition. Meanwhile, some countries may have been able to stimulate inflows by discretionary government policies designed to attract foreign investors.

Factors linked to the process of transition

The Genco et al. survey points to the importance of “foothold” investments, presumably with low capital exposure, which

²⁶ These developments are extensively described in UNCTAD (1993) and in Oman (1994).

²⁷ However, foreign investment agencies in nations along the East-West border stress their strategic geographical location. Both Poland’s PAIZ and the Estonian Ministry of Economic Affairs attempt to entice companies by offering their relatively stable environments as an entry point into the huge Russian market.

²⁸ Note, however, that the rules of origin of the Europe Agreements do not encourage intermediate product trade among all the associated countries (hub-and-spoke bilateralism), and that threats from contingent protection remain on the EU market. See Section 8.4 and Baldwin (1994).

²⁹ However, political tension between Russian and Estonia has resulted in higher tariffs on Estonian trade.

³⁰ Labour efficiency incorporates both labour related expenses (wages, non-wage benefits and training costs) and productivity which is a function of education, skill level, experience and work ethic.

³¹ See Box 1.1 in Chapter 1. This compares 1992 data on enrolment or completion of secondary education (usually attended between the ages of 12 and 17) of transition countries with the average for the middle income group of countries. Source of data: *World Development Report* (1994). On country by country information on education levels, see also Chapter 3 of the present report. The poorer performance by the Baltic republics and Moldova may be attributed to a lack of comparability of educational systems.

would partly explain the small size of FDI in the region. More generally, investors might treat some of the smaller, more stable, higher-income countries of central Europe as a testing ground for subsequent expansion of sales and production into the region as a whole, including the EU market.³² Local production may also be favoured over exports since foreign exchange risk may be reduced by using local sourcing to match the currency composition of payables with that of receivables.

In addition, some investors clearly do not view current (low) factor costs as permanent, believing them to be affected by the adjustment processes during the economic transition. Thus, they avoid pre-committing their regional strategies at this stage. Wages account for a diminishing proportion of costs in many manufacturing processes. Investors to whom labour costs remain important may opt to rely on more predictable locations.³³ Even where the quality and potential of labour are appropriately recognised, retraining is expensive, and weak company loyalty may result in wasted efforts. This may induce investors to adopt a free-rider strategy: for the individual investor it may appear sensible to wait until others have prepared the ground.

Lastly, existing deficiencies in the transport and communications infrastructure may bias choices towards somewhat autonomous, domestic-market-centred ventures. Local production may minimise transportation expenses and time, and increase responsiveness to demand conditions.

Most of these factors are of a temporary nature. As the economic transition progresses and some of the current obstacles are overcome, regionally oriented FDI, based on factor cost advantages, should gain in prominence. In fact, over half of American ventures in the most recent survey (by Arthur Andersen - see Table 9.4), had adopted some form of regional strategy, including a pan-European strategy.

The active use of trade policy to attract FDI

Some of the largest investments have been at least partly enticed by selective, "tailor-made" protection from imports, even in countries that otherwise display very open trading systems,³⁴ (i.e. countries position themselves, at least in targeted sectors, in the type "A" situation described in Section 9.4.1).

Table 9.6
Monthly wages in the economies in transition ¹

	Wages (in US dollars/month)
Eastern Europe and the Baltic states	
Albania	na
Bulgaria	114
Croatia	250
Czech Republic	221
Estonia	85
FYR Macedonia	na
Hungary	317
Latvia	98
Lithuania	65
Poland	194
Romania	82
Slovenia	421
Slovak Republic	201
CIS	
Armenia ²	6
Azerbaijan	28
Belarus	73
Georgia	na
Kazakhstan	119
Kyrgyzstan ³	12
Moldova ²	31
Russia	99
Tajikistan	na
Turkmenistan ²	54
Ukraine ²	20
Uzbekistan ²	25

¹ Nominal monthly dollar wages at going exchange rates based on average 4th quarter 1993 earnings.

² Covers 3rd quarter 1993.

³ Covers 2nd quarter 1993.

Source: OECD and IMF.

³² Given historical links, and reform progress, Hungary is often considered a regional centre for FDI (Institute for World Economics survey). For example, GM has used its JV with car components maker Rába in Hungary as an entry point to eastern Europe (Creditanstalt survey, 1991).

³³ Romania, where investments in the textile sector play a significant role, may be an exception to this.

³⁴ Governments in the transition economies are not alone in employing trade policy actively as a means of attracting FDI. Use of trade-policy measures for that purpose is probably more common in developing than in developed countries, but some member states of the EU, for example, are alert to the fact that EU actions against imports - anti-dumping action, for instance - may induce foreign producers to manufacture or assemble their products in the EU.

Table 9.7 FDI and import protection in Hungary and Poland

Table 3.1									
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Sources: GATT Trade Policy Review, Volume I: Hungary (1991) and Poland (1992), P.Messierlin.

Notes: ¹ 1988 Tariff schedule² Simple average tariff rates³ Numbers of non-tariff barriers (NTBs) observed at 2-digit level⁴ 1992 Tariff Schedule⁵ Includes steel and aluminium⁶ Simple average tariff rates for the whole economy⁷ Simple averages based on rates by sector.

Trade policy inducements can take various forms. J.Gács³⁵ discusses several examples of “active” trade policy aimed at attracting FDI into Hungary, ranging from changes in effective rates of protection reflecting elimination of tariffs on inputs and increases in tariffs on final goods (as in the TV-assembly industry) to the introduction of discriminatory and product-specific import quotas (as in the paper industry).³⁶ Also, since the sale of the Hungarian cement industry to foreign companies was preceded by a series of safeguard actions against imports of cement from neighbouring countries, it is not unreasonable to conjecture that the Hungarian government had been offering inducements to the foreign investors.³⁷ Similar policies have been used in both Hungary and Poland to attract FDI into the local motor vehicle industry. Some policy actions in this regard are sketched in Box 9.1 and Table 9.8.

More generally, Table 9.7 shows that high levels of protection against imports are accompanied by high levels of FDI, at least in the manufacturing sectors of Poland and Hungary. In Poland, FDI-intensive industries have average tariffs on imports that are 66 per cent higher than in manufacturing as a whole. The corresponding figure for Hungary is 10 per cent, but Hungary uses quantitative restrictions more heavily than Poland. When non-tariff barriers are taken into account, the strong link between high protection and high FDI appears also in Hungary.

A common justification for government incentives for FDI is the notion that FDI generates economic gains for residents of the host country – gains that will be neglected by potential investors when deciding whether to proceed with the investment. Some of these externalities have been discussed in Box 7.1 which suggests that, when FDI occurs “naturally” – that is, without policy inducements – it is reasonable to presume that the host country benefits from it. When FDI is induced by policy, however, there is less ground for such a presumption, since the cost of the intervention can conceivably surpass the investment’s benefits.

A government might find trade-policy action necessary to attract a particular investment. However if such

action is required, this strongly suggests that the potential investor’s costs of production would be higher in the transition economy than elsewhere. Compensation of the investor for this will be paid from public funds and/or cause a loss of consumer welfare in the host country.³⁸ Moreover, in some cases, where special incentives are not required for investments to be realised, investors may nevertheless manage to convince host governments that inducements are needed.

- Positive externalities associated with the investment may theoretically justify the cost to the public. However, as argued in Chapter 7 and in Section 8.3, externalities are hard to identify and measure in the context of an individual project, and the neat trade-off suggested by theory may look quite different in practice, where imperfect information, bureaucratic limitations and interest-group pressure often combine to turn well-meant interventions into costly failures. This is reinforced by the fact that many of the costs of such intervention are even less visible than the benefits of the investment: they can include, apart from the standard costs of protection (lost consumer surplus and excess costs of production given the higher sales price that protection affords the investor), a loss of dynamism and efficiency given the lack of market discipline, as well as a strengthening of the discretionary powers of bureaucracies and therefore, in a period of transition, the wrong signal to the rest of the economy. Is it really plausible that estimated benefits are concentrated on the few sectors that enjoy substantial protection? And is it a coincidence that these have the lobbying power either of large indigenous enterprises or large multinational corporations?
- A government offering active inducements to FDI must face the problem that its policy creates an incentive for potential investors to deceive it. A company that would undertake an investment without governmental inducements nevertheless has an incentive to persuade the government that the investment will be undertaken only if the government provides sweeteners – so that sweeteners are provided.

³⁵ Gács (1992).

³⁶ Reporting on lobbying for increased protection in the Hungarian TV-assembly industry, the *Financial Times* commented (30 May, 1992) that “Ironically, western multinationals have become eastern Europe’s most effective lobby for protection and their efforts to link investment commitments to guaranteed markets have become all the more intense as local demand has fallen below expectations.”

³⁷ See also Box 8.2 on Hungary’s use of non-tariff barriers.

³⁸ When FDI is actively induced, however, comparison of costs at the start of an investment might seem over-simplistic. A major part of the expected benefit of FDI is that the skills and management techniques it brings will reduce costs over time. It might be argued, therefore, that lower costs in the future will compensate a host country for high current costs. At first glance, this might seem an attractive position (it is, of course, very close to the infant-industry argument for protection). But private investors can know that current investment will give rise to lower costs in the future, and they can take that possibility into account in their own calculations about the value of the investment.

If trade-policy inducements are necessary, therefore, the investor probably does not believe that future costs will be low enough to compensate him for higher present costs. To reconcile that assessment with a possibility of net social gain to the host country, some distortion in the investor’s vision must be claimed – the mere fact that costs will be lower in the future is not enough.

Box 9.1**FDI in motor vehicle production**

(Information based on Press reports that have not been independently confirmed by EBRD.)

The motor-vehicle industry has been a particular focus for FDI-related trade policy.

Poland

In late 1991, Poland raised its tariff on imported new cars from 15 to 35 per cent. General Motors is reported to have made the increase a condition of GM participation in a joint venture with Poland's FSO (Financial Times, 9 March 1992). The increase, however, raised a problem in the context of Poland's Europe Agreement, which aims, in part, at free trade in manufactured products between Poland and the EU. To "compensate" for the tariff increase, Poland introduced a duty-free quota of 30,000 cars, reserved for EU carmakers. Officially, the quota is available on a "first come, first served" basis. In fact, it is allocated under complex rules that allow biases in favour of firms that have invested in Poland.³⁹ The Financial Times (9 March 1992) commented that "...much of GM's \$75m investment could well be financed through increased sales volume in Poland under the duty free quota. Indeed, earlier talks with GM broke up when the outgoing Polish government decided that the revenues it would forego by giving GM the 40 per cent of the duty free quota it wanted would be greater than the \$75m GM was willing to put on the table..."

In 1993, Poland prohibited imports of cars older than 6 years. It also eliminated GSP concessions to India, apparently to bar imports of Suzuki cars assembled in that country, and excluded the entire car sector from offers for tariff concessions in the Uruguay Round.

Hungary

Ford has established in Hungary a plant producing components for export to the EU. It is discussing with the Hungarian government plans for another plant to manufacture cars. In May 1992, the Hungarian government abolished the 18 per cent tariff on commercial vans. "Commercial van" was so narrowly defined, however, that the elimination of duties applied only to Ford Transit vans. After fierce opposition from other EU producers of vans (Renault-Matra and Peugeot-Citroen in France, and Fiat in Italy), the 18 per cent duty was restored in June 1992. In April 1993 - again after objections from EU producers - the Hungarian government withdrew a tax concession to Ford. Ford then asked the Hungarian government for "restitution of benefits lost". It claimed that these would amount to more than US\$ 25 million by 1999 (Ward's Automotive International, April 1993).

Czech Republic

In 1991, Volkswagen made maintenance of high tariffs on imports of passenger cars for four years a condition of its purchase of capital in Skoda. This commitment of the Czech government did not become generally known, however, until August 1993, when the sixth increase in Skoda list prices since 1990 led to suggestions that tariffs should be reduced. VW-Skoda's prices for similar models increased by 15 per cent in real terms between 1991 and 1993.

The Czech government has also engaged in negotiations with Mercedes. The Financial Times commented (on 27 February 1992) that "... Mercedes last month ... [requested] ... high duties on imported trucks and a long tax holiday. The Czech government, which approves all large joint ventures, has objected to such demands, which Mercedes insists are only a basis for negotiations".

Consequences

- (a) Imports of cars into all three countries have fallen since 1991 - barriers on imports of used cars were important in achieving this result.
- (b) Domestic sales (local production plus imports) by local firms represent between 60 per cent of registrations of new cars in Hungary and 80 per cent in the Czech Republic and Poland - a situation strongly reminiscent of that prevailing in 1989.
- (c) Domestic production is very concentrated - from a near monopoly in the Czech case to a duopoly with a largely dominant firm in Poland (Fiat). However, between 1989 and 1992 there has been noticeable increase in the share of exports in domestic production.
- (d) The share in new registrations of cars imported from firms of Japanese origin is very low by world - or even EU - standards. Moreover, the 1994 share is only one-third of the 1992 share. This atypical evolution is shown by imports from all Japanese firms, whether or not they operate plants in the "Visegrad"-EU region.

³⁹ Messerlin (1994).

Table 9.8 Central European car markets: selected indicators (in per cent), 1988-94

	1988	1989	1990	1991	1992	1993	1994 ³
CSFR ¹							
Dom. sales/New car regist.	75.5	74.5	81.6	58.4	80.5	–	–
Dom. sales/Total regist.	73.3	68.2	72.8	28.4	48.8	–	–
Imports/Total regist.	26.7	31.8	27.2	71.6	51.2	–	–
Exports/Production	38.9	37.5	34.1	66.4	53.7	–	–
Used car regist./Total regist.	3.0	8.5	10.7	51.4	39.4	–	–
Hungary ¹							
Dom. sales/New car regist.	0.0	0.0	0.0	0.0	29.4	–	–
Dom. Sales Total regist.	0.0	0.0	0.0	0.0	7.2	–	–
Imports/Total regist.	100.0	100.0	99.7	100.0	92.8	–	–
Exports/Production	0.0	0.0	0.0	0.0	0.0	–	–
Poland ¹							
Dom. sales/New car regist.	82.0	87.6	85.4	68.7	68.8	–	–
Dom. sales/Total regist.	76.8	62.5	54.1	28.3	56.9	–	–
Imports/Total regist.	23.1	37.5	43.5	71.7	43.1	–	–
Exports/Production	34.4	33.6	21.8	7.8	37.6	–	–
Used car regist./Total regist.	6.4	28.6	36.7	58.8	17.2	–	–
Total sales by companies producing locally (dom. produced & imported cars) as a percentage of new registrations ²							
Czech Republic & Slovak Republic						79.5	
Volkswagen	–	–	–	–	–	79.5	–
Hungary					48.5	66.7	45.6
Ford	–	–	–	–	3.0	6.0	3.4
GM-Opel	–	–	–	–	23.4	27.3	23.5
Suzuki	–	–	–	–	22.1	33.4	18.7
Poland					76.5	83.7	73.9
Fiat-FSO	–	–	–	–	38.2	53.5	44.4
FSO-GM-Opel	–	–	–	–	38.3	30.2	29.5
Imports of Japanese cars as a percentage of new car registrations ²							
Czech Republic & Slovak Republic	–	–	–	–	–	3.7	–
Hungary	–	–	–	–	14.2	10.4	5.5
Poland	–	–	–	–	6.7	3.0	2.7

Sources:

¹ Calculated from data by DRI/McGraw-Hill Automotive Group quoted in Ward's Automotive International, March 1993.² Ward's Automotive International, April and May 1994.

Notes:

³ for 1994, annual estimates are based on data for the first quarter of 1994.

Dom. sales: Domestic sales of domestic producers.

Total regist.: Total registrations of (new and used) cars.

Production: domestic production.

– : information not available.

9.4.3 The concentration of FDI on a few locations

As noted, FDI has been concentrated in only a few countries of the region. The Czech Republic, Estonia, Hungary, the Slovak Republic and Slovenia have attracted shares of total investment flows to the region which are out of proportion to their size. These four are relatively advanced as regards social stability, macroeconomic stabilisation, and thus perceived country risk. Even relatively small amounts of risk and uncertainty can significantly “leverage” benchmark levels of return for an investment decision. However, it is still surprising how “elastic” FDI appears to be in reacting to these factors, in particular since the countries in question lack other advantages such as market size (the main FDI motivation according to the surveys). This suggests that other issues are at play.

Proximity to countries that are the source of FDI matters, in both geographical and cultural terms. The Czech Republic, Hungary, the Slovak Republic and Slovenia share borders and history with countries of origin for much of the FDI, namely Germany, Italy and Austria. Estonia is a short distance away from Finland, with which it is culturally related.⁴⁰ Proximity promotes FDI by small and medium-sized enterprises. Marginal SMEs that are threatened by structural change in their home countries may save their industry-specific assets by moving “over the border”, and changing their labour force as they close down domestic operations.⁴¹

The organisation of the privatisation process has played an important role in attracting FDI. While most countries of the region permit foreign participation in the privatisation process - with certain restrictions (Table 9.3) - some, including Hungary and Estonia, have made it the central pillar of their privatisation strategies.⁴² Privatisation may be particularly effective at triggering FDI decisions in oligopolistic markets. Like all corporate actions, FDI decisions are not taken in isolation, but reflect current characteristics and anticipated changes in the competitive playing field. FDI may be action-oriented, aimed at pre-empting a rival’s move into a given market. While operating conditions may be less than ideal, the ability to acquire strategic assets (distribution systems and suppliers, local brand names) at low costs is a strong

motive for moving quickly, since it allows enterprises to secure market shares while pre-empting competitors from doing likewise.⁴³

Other factors may provoke a cumulative increase of FDI into a location once certain benchmark levels of foreign presence have been reached.

The behaviour not only of the leaders (i.e. the “first-movers”) but also of the followers should be taken into consideration. “Follower” strategies in oligopoly may induce FDI decisions which would not have been taken in isolation. Since, in certain industries, it is possible to raise entry barriers for subsequent competitors by building product commitment and luring consumers into products with high switching costs, the presence of a critical number and size of early investments may trigger a follow-the-leader (defensive) reaction to competitors’ moves among initially less-interested investors. In particular in consumer goods sectors (and in economies that “begin” with only a limited degree of saturation with consumer products), FDI may draw further FDI. In the Institute for World Economics’ survey of investors in Hungary, 40 per cent of firms declared their general investment behaviour as defensive.

The uncertainties of operating in a new environment, and one in which market institutions are only beginning to take hold, are one of the strongest deterrents to FDI. Early movers, by their mere presence, provide a strong and informative signal to more hesitant investors that operations in such an environment are feasible and potentially rewarding. Again, additional FDI decisions can thus be positively correlated with the amount of existing foreign capital in a transition economy.⁴⁴

Lastly, agglomeration effects (the effects of achieving a critical mass in a particular location, often the capital) may have played a role. Firms even in unrelated product sectors share common supporting services,⁴⁵ infrastructure and perhaps suppliers, and the size of the “pool” of skilled labour provided by an existing cluster of firms can reduce the entry costs for new projects. The existence and quality of these factors may - as has been described in Box 7.1 on the benefits of economic openness - be positively influenced by the presence of other foreign, rather than

⁴⁰ While ties with Greece have been close in south-eastern Europe, and with Turkey in some of the Central Asian and Caucasus republics, and investors from those countries have been fairly active, the amounts involved were smaller.

⁴¹ Meyer (1994).

⁴² See Transition Indicators (Appendix 2.1) and Box 7.1.

⁴³ Nevertheless, other countries that have remained relatively less prominent as FDI destinations, such as Poland, have also sought to draw foreign capital into the privatisation process.

⁴⁴ More formally, risk raises the benchmark level of financial returns required for an investment decision. The information derived from observing investment decisions by others may reduce the variability of potential outcomes and thus lower the risk premium, making a positive decision more likely.

⁴⁵ This can include services to production, for instance those provided by the government, communications, legal services, advertising etc., but also services (housing etc.) that affect the quality of life of expatriate managers - a factor that is often of some importance.

domestic, firms in the transition environment. A related issue, which has been stressed by a number of the investor surveys, is the desire to serve other foreign customers that are establishing themselves in eastern Europe. This is particularly true for service organisations where the nature of the business may preclude the transportation or storage of outputs. Such investments are often easier to get started as there is less need to adapt to the culture and practices of the region when serving foreign customers. Again, this would suggest that the number of investors in a country (and in particular locations within that country) may rise quickly once a certain “agglomeration threshold” has been surpassed.

None of these factors substitutes for the need to maintain open investment (and trade) regimes and to reduce uncertainties in the economic and political environment. Stable macroeconomic conditions and predictable government policies have doubtless been decisive in explaining the initial success of the principal FDI destinations. Once these conditions are met and induce a sufficient amount of “early” FDI, there may be a self-reinforcing effect on the inflows. There is therefore some ground for optimism that other transition countries that have met, or are beginning to meet, the fundamental requirement of stability may experience foreign investment activity in the future at the level seen to date in Hungary and the Czech Republic, raising the region’s total inflows towards amounts that had been predicted at the beginning of the reform process. It is important to note that discretionary, “activist” policies designed to attract FDI - except in the context of privatisation programmes - have little effect on these flows.

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Macroeconomic overview

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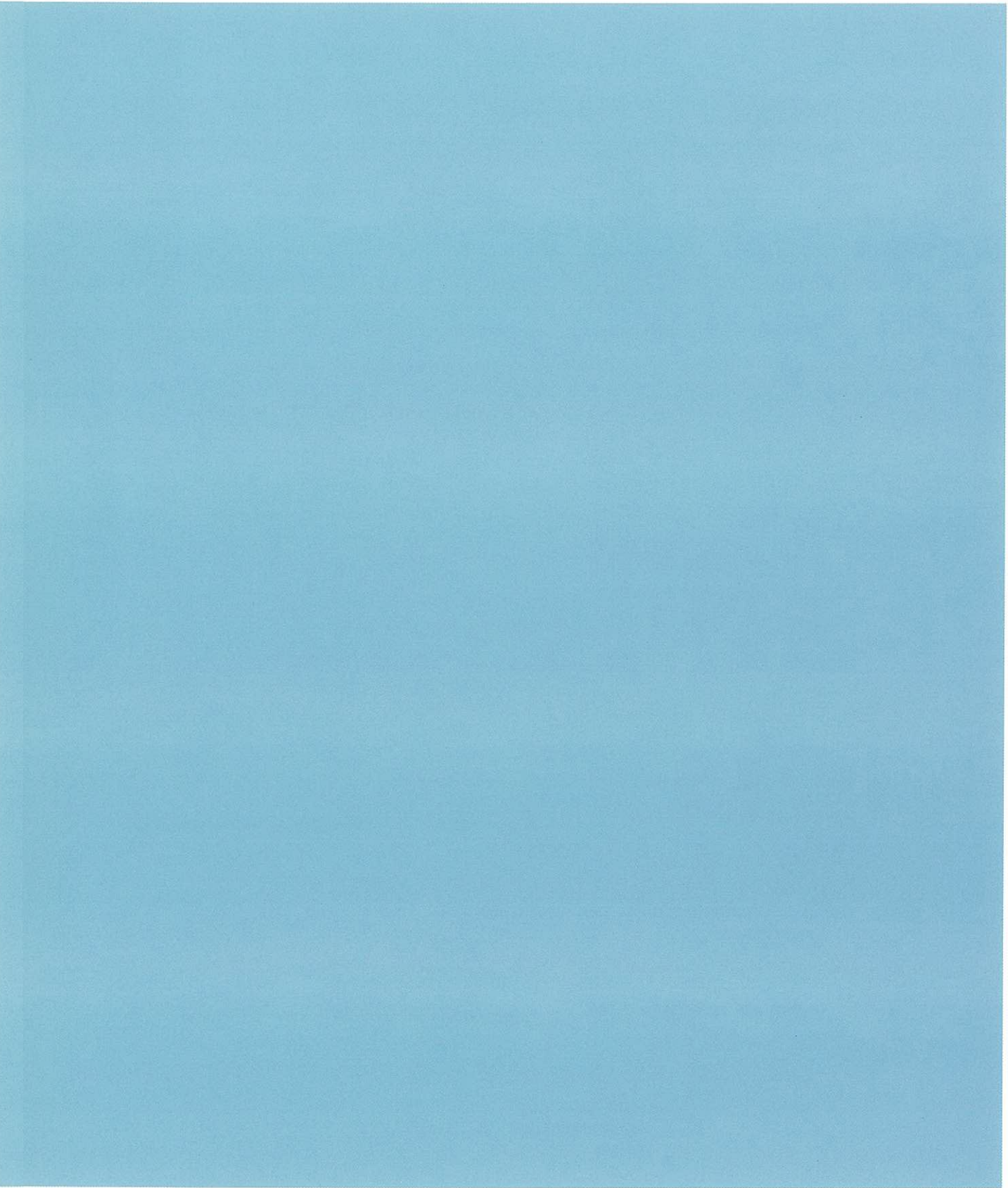
Chapter 11 Macroeconomic forecasting in transition

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10. Recent macroeconomic developments

The economies of eastern Europe and the former Soviet Union are becoming increasingly disparate, as former command systems and international trading links are being dismantled. The initial apparent homogeneity, especially within the former Soviet Union, of similar economies with centralised planning and heavy price distortions, is rapidly being eroded. The emerging heterogeneity has many sources, including political pressures and varying attitudes towards reform. There is also no doubt that the earlier apparent similarities concealed fundamental differences.

The experience of countries in the region ranges from the success story of the Czech Republic, where both inflation and unemployment have been kept low during the comprehensive market-oriented transition over the past three to four years, to some former Soviet republics that have suffered badly from the consequences of the break-up of the Union and have yet to embark upon serious market-oriented reform (see the tables in Appendix 10.1). These gaps are likely to widen in the coming years. Most east European countries appear poised to enter a more prosperous period in a stable financial environment. Meanwhile some countries of the former Soviet Union are likely to experience further output declines and high inflation, although Russia, which currently finds itself between these two extremes, may see more positive developments in the medium term.

10.1 Output and employment

Eastern Europe and the Baltic countries

The recession is over in many parts of eastern Europe. In 1992 Poland became the first country in the region to record positive growth in real GDP since the market-oriented transition began. In 1993, modest growth spread further to Romania and Slovenia, and Albania followed suit with a remarkable expansion, from a very low base. During the first half of 1994 most countries in the region saw increases in economic activity, including the Czech Republic, Hungary, the Slovak Republic and the Baltic countries, all of which had recorded falls in GDP in 1993.

There are, however, serious uncertainties over the official data on which these assessments are based. It has been widely argued that difficulties associated with measurement of activity in the rapidly growing private sector pull in the direction of underestimation of GDP-growth in official series. However, a counter-argument can be made for some countries, including Poland and Hungary, where official measures of the increase in domestic demand and exports fall short of recorded growth in production and imports (see

Appendix 11.1 for further details). This discrepancy may in part arise from underestimation of domestic demand and exports, but it does raise doubts about the notion that output-growth is under-recorded.

Nevertheless, despite these uncertainties, the measured output change since 1992 clearly shows a favourable trend. The region appears to have endured the harshest consequences of the dramatic systemic shifts of recent years, including in particular the collapse during 1990-91 of the former socialist trading block. The latter resulted in a sharp reduction in export-demand from Russia and much higher prices for Russia's energy deliveries. These external shocks came largely at the same time as the economies in eastern Europe experienced domestic policy-induced shocks from the initiation of comprehensive market-oriented reform and macroeconomic stabilisation. Some medium-term benefits of these measures are now beginning to emerge.

That most countries in eastern Europe are now recording positive growth reflects the relative decline in importance of the "old" mega-companies, most of which are still struggling. Performance in the private sector, which now accounts for more than half of GDP in most countries in the region (see Table 2.1), has become the main determinant of aggregate economic growth. The activity of private enterprises is generally growing at a rapid pace.

Measured unemployment ranges from 3½ per cent of the labour force in the Czech Republic to around 30 per cent in FYR Macedonia. The low rate in the Czech Republic represents the outlier in a region characterised mostly by unemployment rates of 10-15 per cent. Possible explanations for the modest level of unemployment in the Czech Republic include strict eligibility rules for unemployment benefits and low real wages (measured in US dollar terms), which have contributed to labour retention in export-oriented enterprises. Hungary's unemployment rate has declined over the past year primarily as a result of tighter eligibility rules.

The Commonwealth of Independent States

Recorded output continues to fall in the CIS. However, the pace of decline has slowed. Official data show real GDP for the CIS down by 12 per cent in 1993, following a drop of 18 per cent in 1992. There can be little doubt that these data exaggerate the fall in output: statistical systems in the CIS countries are dependent to an even greater extent than their counterparts in eastern Europe on reporting from

large “old” companies, and it is these companies that are contracting most rapidly. The coverage by official statistical agencies of the emerging private sector is very patchy.

Even after allowing for the prospect of rapid expansion of private sector activity, aggregate production is expected to shrink in the CIS for at least another year (see Chapter 11). This expectation is based on the assumption that industrial restructuring, with its attendant short-term costs and disruption, will intensify, especially in Russia.

According to official data Russian private consumption rose in 1993. This rise may at first sight appear inconsistent with the recorded production decline which might have been expected to entail a sharp drop in personal incomes. However, personal incomes have been buoyed by a terms-of-trade gain and by a fall in income-transfers out of Russia. These gains stem from Russia’s decisions to switch energy exports away from CIS countries towards higher-yielding Western markets, and to cut back sharply their provision of subsidies and soft trade credits to other CIS countries. In addition, growing real incomes from non-recorded activities are likely to account for a part of the increase in consumption.

Throughout the CIS the contrast between the falls in output and the relative stability of unemployment is striking. Russia’s official estimate for unemployment is just over 2 per cent, but would be far higher if the partially unemployed and those workers on unpaid leave were included. Many unemployed in Russia have preferred to remain on “unpaid leave” since access to the social support systems comes via the enterprise sector. The prospect of free or cheap shares in privatisation is an added incentive to remain linked to the firm.

10.2 Macroeconomic stabilisation: inflation and the external account

Eastern Europe and the Baltic countries

Efforts since 1990 at restraining inflation and checking external imbalances through control of credit expansion and state budget deficits have met with some success, most notably in the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. In all of these countries annual inflation in mid-1994 was below 35 per cent (in the Czech Republic below 10 per cent). Romania and Bulgaria have been less successful on this score, with inflation running in the first half of 1994 at more than 5 per cent per month. Both countries, however, have embarked on another round of IMF-supported financial policy adjustment, aimed *inter alia* at reducing the rate of inflation. Albania has pursued IMF-supported financial policies since August 1992 and has succeeded in reducing

inflation sharply, but the country is still struggling with a very large current account deficit. Croatia and FYR Macedonia have recently implemented vigorous macro-economic stabilisation programmes.

In some of these countries, including Bulgaria, Hungary and Poland, the current account began to deteriorate in the second half of 1992 and worsened in 1993. It had initially been hoped that most of the balance of payments deterioration could be attributed to temporary phenomena, such as a drought-induced decline in agricultural output and a weakening of export demand due to recession in western Europe.

However, as official data from Hungary and Poland indicated a persistent deterioration in the trade balance throughout 1993, some observers began to fear that the high household savings ratios recorded in preceding years had reflected mainly a one-off adjustment in portfolios, associated with a desire of individuals to guard themselves against the risk of unemployment, i.e. that the increase in the flow of savings represented the build-up by individuals of an “unemployment insurance”. Such a flow could be expected to stop once the desired “insurance level” had been reached. Thus the worsening current account position in Hungary and Poland in 1993 might reflect a lasting increase in domestic demand arising from a decline in the flow of household “unemployment insurance savings”. If the reduction in the flow of savings were indeed lasting rather than temporary then the current account problem would require policy action.

Such action was taken earlier in Poland than in Hungary. In Poland, where the fiscal imbalance has been reduced successfully in recent years, including in 1993, the officially measured trade deficit narrowed in the first half of 1994. In Hungary, the fiscal position worsened in early 1994 and the inflow of foreign direct investment slowed, although the officially measured current account deficit remained broadly unchanged. The new Hungarian Government – formed in July – has made it a top priority to reduce the external imbalance, primarily through fiscal action.

Having embarked in the second half of 1992 on tight stabilisation policies, the Baltic countries, especially Estonia and Latvia, saw a very sharp reduction in monthly inflation rates in 1993. Bound by their fixed exchange rate regimes, the Baltic states have, however, more recently seen financial inflows, attracted from abroad by high domestic interest rates, lead to an expansion in the money supply. They are therefore finding it difficult to reduce inflation below current rates of about 3 per cent per month (with substantial fluctuations from month to month).

The Commonwealth of Independent States

The largest CIS countries, Russia and Ukraine, have seen a substantial reduction in the rate of inflation over the past year. Monthly rates in Russia fell to about 5 per cent in the second quarter of 1994 after hovering during the last quarter of 1993 between 13 and 20 per cent. This reflected a sharp tightening in central bank financing of enterprises and of the state budget. In Russia, the adjustment of credit policies was helped by the cut-back in trade credits to other CIS states from 9 per cent of GDP in 1992 to less than 1 per cent of GDP now. However, the Russian government and central bank also took other measures during 1993 and the first quarter of 1994. They raised interest rates on rouble assets to levels that are positive in real terms and substantially reduced domestic fiscal expenditures, notably import subsidies and military outlays. The tightening of fiscal and monetary policy led to a sharp improvement in Russia's trade balance.

In Ukraine, the monthly rate of inflation was reduced to below 10 per cent in the first half of 1994, from 40-70 per cent in the last quarter of 1993, but there are doubts whether this achievement can be sustained in the absence of a much stronger state budget and further structural reform.

Part of the credit squeeze in both Russia and Ukraine reflects a large build-up of arrears on the part of the government – a method of reducing credit expansion that is clearly not sustainable in the longer run. Thus, a sharp fall in the US\$/rouble exchange rate during September of this year may be an indication that the credit and fiscal policies had been loosened during the preceding months.

The rouble zone collapsed between May and November 1993. Following the departure of the Baltic countries and Ukraine during 1992, Kyrgyzstan left the rouble zone in May 1993. The decision by Russia in July 1993 to withdraw old rouble notes from circulation and to restrict further the issuance of trade credits to other CIS countries left the other members of the zone dependent on a means of payment – the “old roubles” – for which there was no responsible authority. Against this background, Georgia left the zone in August and Turkmenistan, Uzbekistan, Kazakhstan and Moldova followed suit in November. Belarus has effectively departed as its national coupon has become the dominant means of payment. Tajikistan is now the only former Soviet state that has not established a new national currency or coupon.

The positive aspect of this development is that it leaves most of the CIS countries able to determine and implement their own policies on inflation and market-oriented reform. This could in principle provide at least some of the

governments with an opportunity to stem the economic setbacks of past years and prepare the ground for lasting growth, although it carries with it the responsibility for imposing their own monetary discipline.

However, the break-up of the rouble zone came at a particularly inopportune time for those countries. Since independence, fiscal pressures have intensified because of the sharp cutbacks in subsidies and credits from Russia and, in some cases, because of massive war-related budgetary outlays. Among the smaller CIS countries, only Moldova and Kyrgyzstan have implemented successful stabilisation programmes, reducing monthly inflation to 2-5 per cent in May-June this year in the wake of tough fiscal and credit policy adjustments over the preceding six months. War has severely impeded any attempt at stabilisation in Armenia, Azerbaijan, Georgia and Tajikistan.

10.3 Divergence

The economies of the countries in the region are diverging. This is reflected in a wide range of indicators including those associated with structural reform (see Chapter 2), real GDP and macroeconomic stabilisation.

An “advanced” group consisting of the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia appear to be in the recovery phase and have achieved substantial structural reform and a large measure of macroeconomic stabilisation. The Czech Republic and the Baltic states must now, as well as taking reform forward, cope with some of the problems of success, including inflationary pressures resulting from large inflows of foreign capital.

In an “intermediate group” major stabilisation and reform efforts have been made but, so far, with mixed results. Some, such as Romania and Bulgaria, have been wrestling with macroeconomic stabilisation for some years but with only limited success. Both of these countries as well as Croatia, FYR Macedonia, Kyrgyzstan and Moldova have recently implemented vigorous macroeconomic stabilisation programmes. Albania and the Baltic states, despite suffering even greater falls in GDP, have also made great strides towards macroeconomic stabilisation and the reduction of inflation. Following earlier declines, Albania's economy grew rapidly in 1993, and sustained growth and macroeconomic stability is in sight for Estonia, Latvia and Lithuania. For Russia, reform and stabilisation have been more gradual but privatisation has gone far and there are recent improvements regarding inflation.

Other CIS countries have made considerably less progress. It is unlikely that a decline in recorded output in much of the CIS will quickly be arrested. Economic reform has been limited and inflation remains high.

Appendix 10.1 Selected economic indicators for each country in transition

Growth and Inflation in eastern Europe and the former Soviet Union ¹								
	Real GDP ²				Retail/consumer prices (end-year)			
	1991	1992	1993	1994	1991	1992	1993	1994
	<i>Estimate Projection</i>				<i>Estimate Projection</i>			
Individual countries	<i>(Percentage change)</i>				<i>(Percentage change)</i>			
Albania	-27	-10	11	8	104	237	31	19
Armenia	-11	-52	-15	na	na	2,000	10,900	na
Azerbaijan	-1	-23	-13	-15	126	1,395	810	2,000
Belarus	-1	-10	-12	-30	93	1,050	2,775	na
Bulgaria	-12	-6	-4	0	339	79	64	70
Croatia	-14	-9	-3	2	149	937	1,150	0
Czech Republic	-14	-7	0	3	52	13	18	10
Estonia	-11	-26	-8	5	304	954	36	42
FYR Macedonia	-11	-15	-15	-8	115	1,691	244	70
Georgia	-21	-43	-40	na	119	1,653	2,656	na
Hungary	-12	-4	-2	1	32	22	21	20
Kazakhstan	-12	-13	-13	-11	150	1,176	1,925	900
Kyrgyzstan	-5	-25	-16	-10	170	1,771	1,366	90
Latvia	-8	-34	-12	5	262	958	35	25
Lithuania	-13	-38	-16	4	345	1,175	188	40
Moldova	-12	-25	-14	-3	162	1,275	837	120
Poland	-8	2	4	5	60	44	38	27
Romania	-13	-14	1	0	223	199	296	90
Russia	-9	-19	-12	-12	144	2,322	842	180
Slovak Republic	-15	-7	-4	1	58	9	25	13
Slovenia	-8	-5	1	4	247	93	23	16
Tajikistan	-13	-34	-28	na	204	1,362	7,344	na
Turkmenistan	-5	-5	-8	na	155	644	4,500	na
Ukraine	-12	-17	-14	-20	161	2,000	10,155	350
Uzbekistan	-1	-10	1	-8	169	787	927	600
Aggregates								
Eastern Europe and the Baltic countries ³	-10	-4	1	3				
The Commonwealth of Independent States ⁴	-9	-18	-12	-13				

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² NMP for Georgia and Tajikistan, GSP for FYR Macedonia. NMP excludes depreciation and the value added from most of the service sector. GSP excludes the value added by the government, the financial sector and some personal services.

³ Estimates for real GDP represent weighted averages for Albania, Bulgaria, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The weights used were national GDP estimates for 1992 converted into common currency at the average official exchange rate for 1992.

⁴ Here taken to include all countries of the former Soviet Union, except Estonia, Latvia and Lithuania. Estimates for real GDP represent weighted averages, using the nominal level of NMP in 1991 as weights.

Albania ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output and expenditure						
			<i>(Percentage change)</i>			
GDP	9.8	-10.0	-27.1	-9.7	11	8
Industrial production	5.0	-7.6	-36.9	-44.0	-10	na
Prices and wages						
Consumer prices (annual average)	0	0	36	226	85	na
Consumer prices (end-year)	0	0	104	237	31	19
Average real wages (public sector)	na	na	-5.8	-45	0 to -2	na
Monetary sector						
Broad money (end-year)	14.8	23.4	104	153	75	30
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance ²	-5.5	-3.7	-44	-22	-16	-8
General government expenditure	56.8	62.1	62	47	44	na
External data (convertible currency transactions)						
			<i>(In millions of US dollars)</i>			
Current account (excluding official transfers)	-49	-122	-293	-425	-399	na
Trade balance	-83	-150	-308	-454	-480	na
External debt, net of foreign exchange reserves	0	75	480	604	642	na
			<i>(Percentage change in the US dollar value)</i>			
Exports (data from the balance of payments)	25	-7	-41	-4	50	na
Imports (data from the balance of payments)	58	4	21	87	12	na
			<i>(In months of current account expenditures, excluding transfers)</i>			
Gross international reserves (end-year), excluding gold	12.5	6.6	0.3	0.6	2.2	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions)	3.2	3.3	3.3	3.3	3.4	na
Employment (percentage change, annual average)	1.9	0.2	-5.8	-16.6	-9.3	na
Unemployment rate (in per cent of labour force, end-year)	1.9	2.1	10.7	26.3	17.5	na
Exchange rate (lek per US dollar, end-year)	8	10	25	97	101	na
Exchange rate (lek per US dollar, annual average)	8	8	15	75	102	na
GDP (in millions of lek)	18,681	16,813	15,971	49,517	113,026	na
Agriculture's share of GDP (per cent) ³	26.3	28.0	30.5	54.1	56	na
Industry's share of GDP (per cent) ³	36.5	32.6	29.4	17.0	14	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Excluding from expenditures due but unpaid interest on foreign debt.

³ Based on national accounts at constant prices.

Armenia ¹

	1989	1990	1991	1992	1993
Output and expenditure					
		<i>(Percentage change)</i>			
GDP at constant prices	14.2	-7.4	-11	-52	-15
Exports at constant prices	na	na	-47	-36	-13
Imports at constant prices	na	na	-38	-34	-11
Prices and wages					
Consumer prices (annual average)	4.8	10.3	100	825	3,732
Consumer prices (end-year)	na	na	na	2,000	10,900
Monetary sector					
Domestic credit	na	33	38	201	734
Government sector					
		<i>(In per cent of GDP)</i>			
Consolidated central government balance (cash)	na	na	-1.9	-30.6	-46.4
Consolidated central government expenditure (cash)	na	na	28.0	64.2	68.6
External data					
		<i>(In millions US dollars)</i>			
Current account with non-FSU countries	na	na	na	-40.0	-6.5
Trade balance with non-FSU countries	na	na	na	-96	-142
Exports (data from the balance of payments)	na	na	na	335	207
to countries outside the former Soviet Union	na	na	na	12	29
to former Soviet republics	na	na	na	323	178
Imports (data from the balance of payments)	na	na	na	405	388
from countries outside the former Soviet Union	na	na	na	108	171
from former Soviet republics	na	na	na	297	217
Memorandum items					
		<i>(Denominations as indicated)</i>			
Population (in millions)	na	3.3	3.5	3.7	3.7
Unemployment rate (in per cent of the labour force, end-year)	na	na	3.5	3.5	5.8
Agriculture's share in NMP (per cent) ²	14.4	17.3	25.7	41	55
Industry's share in NMP (per cent) ³	50.2	45.4	54.8	53	32
GDP (in billions of roubles)	9.5	9.7	15.9	59.1	780
GNP per capita (in US dollars) at PPP exchange rates ⁴	na	na	na	2,500	na

¹ Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. For a discussion of some of the problems of interpreting official statistics, see Chapter 11.

² Includes forestry. NMP excludes depreciation and the value added from most of the service sector.

³ Includes the turnover tax. NMP excludes depreciation and the value added from most of the service sector.

⁴ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Azerbaijan ¹

	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output at constant prices		<i>(Percentage change)</i>			
GDP	-11.7	-0.7	-22.6	-13	-15
Prices					
Consumer prices (annual average)	8	106	616	833	1,500
Consumer prices (end-year)	na	126	1,395	810	2,000
Government sector		<i>(In per cent of GDP)</i>			
General government balance	na	-5	2.8	-13.6	na
General government expenditure	na	40.7	46.4	52	na
External data		<i>(In millions of US dollars)</i>			
Current account	na	153	488	169	-100
Trade balance	na	60	489	55	na
vis-à-vis countries outside the former Soviet Union	na	-42	371	-23	na
vis-à-vis former Soviet republics	na	102	118	78	na
Exports	na	395	1,275	659	na
to countries outside the former Soviet Union	na	24	755	299	na
to former Soviet Republics	na	371	520	360	na
Imports	na	336	786	604	na
from countries outside the former Soviet Union	na	67	384	322	na
from former Soviet republics	na	269	402	282	na
Memorandum items		<i>(Denominations as indicated)</i>			
Population (in millions)	na	na	7.3	na	na
GDP (in billion of roubles, till 1992, in billions of manats thereafter)	1.5	2.7	25.1	165.8	na
Agriculture's share of NMP (per cent)	37.4	41.1	32.5	29.4	na
Industry's share of NMP (per cent)	34.8	37.2	50.5	45.6	na
GNP per capita (in US dollars) at PPP exchange rates ²	na	na	2,650	na	na

¹ Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Belarus¹

	1989	1990	1991	1992	1993	1994
					Estimate	Projection
Output and expenditure						
			<i>(Percentage change)</i>			
GDP at constant prices ²	8	-3	-1.2	-9.6	-11.6	-30
Consumption at constant prices	5	6	-6	-11	na	na
Investment at constant prices ³	29	-13	28	-6	na	na
Industrial production	na	na	-1.5	9.6	-10	na
Prices and wages						
Consumer prices (end-year)	na	na	93	1,050	2,775	na
Consumer prices (annual average)	1.7	4.5	94	969	1,188	na
Average real wages	na	11.1	-2.6	-11	12.5	na
Monetary sector						
Net domestic credit (end-year)	na	na	na	830	660	na
Broad money (M3, end-year)	na	na	na	482	927	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance (incl. extra-budgetary funds)	na	na	3.6	-4.5	-9.4	-21
General government expenditure	na	na	45.5	48.5	57	na
External data						
Current account	na	na	na	3.7	-7.3	-6
Trade balance						
<i>vis-à-vis</i> countries outside the former Soviet Union	na	na	-2.8	5.8	-3.8	na
<i>vis-à-vis</i> former Soviet republics	na	na	6.3	0.5	-2.5	na
			<i>(In millions of US dollars)</i>			
Exports (merchandise)						
to countries outside the former Soviet Union	na	na	1,661	1,082	838	na
Imports (merchandise)						
from countries outside the former Soviet Union	na	na	1,957	741	996	na
			<i>(In billions of roubles)</i>			
Exports (merchandise)						
to former Soviet republics	na	na	37	380	2,004	na
Imports (merchandise)						
from former Soviet republics	na	na	32	374	2,277	na
			<i>(In months of current account expenditures, excluding transfers)</i>			
Gross international reserves of the central bank	na	na	0	0	0.1	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions)	10.2	10.3	10.3	10.3	10.4	na
Unemployment (in per cent of labour force, end-year)	na	na	na	0.5	1.5	na
Agriculture's share of NMP (per cent)	na	29.3	25.2	24.0	na	na
Industry's share of NMP (per cent)	na	44.0	47.2	47.1	na	na
GNP per capita (in US dollars) at PPP exchange rates ⁴	na	na	na	6,840	na	na

¹ Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Figures are for NMP until 1990, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

³ The data for investment stems from the accumulation account of the NMP system.

⁴ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Bulgaria¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output and expenditure						
			<i>(Percentage change)</i>			
GDP at constant prices	0.5	-9.1	-11.7	-5.6	-4.2	0
Industrial production ²	-1.4	-16.5	-22.4	-12.2	-7.0	-6
Prices and wages						
Consumer prices (annual average)	6.4	23.9	334	82.0	73.0	na
Consumer prices (end-year)	10	72.5	339	79.4	63.9	70
Wages in the state sector (annual average)	8.7	31.7	166	103	59	na
Monetary sector						
Broad money (end-year)	10.6	16.6	122	43.5	52.9	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance ³	-1.4	-12.7	-15.1	-14	-15.1	na
General government cash balance ⁴	-1.4	-8.5	-3.3	-5	-11.1	na
General government expenditure ⁴	61.4	64.3	50.7	43.9	41.7	na
External data (convertible currency transactions)⁵						
			<i>(In billions of US dollars)</i>			
Current account	-1.5	-1	-0.3	-0.4	-0.9	na
Trade balance	-1.4	-0.6	0.4	0.5	-0.7	na
External debt, net of reserves	6.4	9.6	11.3	12.0	12.2	na
			<i>(Percentage change in the US dollar value)</i>			
Exports (data from the balance of payments)	-13.8	-1.7	7.8	27.9	-28.6	na
Imports (data from the balance of payments)	-3.0	-22.0	-24.0	48.0	-6.0	na
			<i>(In months of current account expenditure excluding transfers)</i>			
Gross international reserves (end-year), excluding gold	1.9	0	1.2	2.2	2.2	na
Memorandum Items						
			<i>(Denominations as indicated)</i>			
Population (in millions, end-year)	8.99	8.98	8.97	8.96	na	na
Employment (percentage change, end-year)	-2.3	-6.2	-13.0	-12.7	na	na
Unemployment (in per cent of the labour force, end-year)	na	1.5	11.1	15.3	16.4	16
Exchange rate (lev per US dollar, end-year)	2	7	21.8	24.5	32.7	na
Exchange rate (lev per US dollar, annual average)	1.8	5.7	17.7	23.4	27.9	na
GDP (in billions of leva)	39.6	45.4	131.1	210	350	na
Agriculture and forestry's share of GDP (per cent) ⁶	11	18	15	16	na	na
Industry's share of GDP (per cent) ⁶	59	51	48	43	na	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	5,130	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Including logging and fishing, excluding publishing, gas and water.

³ General government includes the state, municipalities and extra-budgetary funds.

⁴ Excluding (from expenditures) unpaid due interest.

⁵ Central bank data. Data for 1989-92 were compiled on a settlement basis, then the central bank switched to the FOB system. Settlement data for 1993 in US dollar terms would show a fall in exports by 7.7 per cent and in imports by 0.9 per cent with a trade surplus of US\$ 134 million.

⁶ At current prices.

⁷ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Croatia ¹						
	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output and expenditure						
			<i>(Percentage change)</i>			
GDP ²	-1.6	-8.6	-14.4	-9	-3.2	2
Industrial production	na	-11.3	-28.5	-15	-6	na
Prices						
Retail consumer prices (end-year)	na	136	149	937	1,150	0
Monetary sector						
Narrow money (end-year)	na	na	na	598	989	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance ³	na	na	-5	-3	-1	na
General government expenditure	na	na	na	na	33.8	na
External data ⁴						
Current account	na	6.6	-4.3	6.6	2.4	na
Trade balance	na	-7.3	-3.9	1.1	-6.4	na
Exports	na	25.3	24.2	37.1	32.5	na
Imports	na	32.6	28.1	36.0	38.9	na
			<i>(In millions of US dollars)</i>			
Gross international reserves of the central bank (end-year)	na	na	0	167	619	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions)	na	4.7	4.7	4.8	4.8	na
Unemployment rate (in per cent of labour force, end-year)	na	9.3	15.5	17.8	17.5	18
Exchange rate (end-year, in dinars per dollar)	na	na	19.7	798	6,471	na
GDP (millions of dollars)	na	15,900	13,619	12,393	11,997	na
Agriculture's share of GDP at factor cost (per cent)	na	10.6	10.2	10.6	na	na
Industry's share of GDP at factor cost (per cent) ⁵	na	30.4	26.5	25.0	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² For 1989, the data refers to GSP, the value-added concept of former Yugoslavia which excludes government, financial and some personal services.

³ General government includes the state, municipalities and extra-budgetary funds.

⁴ Data for 1990 and 1991 exclude trade with other states of the former Yugoslavia.

⁵ Including construction, figures predate revisions to GDP series.

Czech Republic¹						
	1989	1990	1991	1992	1993	1994
						<i>Projection</i>
Output			<i>(Percentage change)</i>			
GDP at constant prices	1.4	-0.4	-14.2	-7.1	-0.3	3
Industrial production	0.8	-3.5	-22.3	-10.6	-5.3	0
Prices and wages						
Consumer prices (annual average)	2.3	10.8	56.7	11.1	20.8	10
Consumer prices (end-year)	1.5	18.4	52.0	12.7	18.2	10
Producer prices (annual average)	-0.7	4.4	74.7	9.9	13.1	6
Average wages in industry	3.2	4.5	16.7	22.2	23.8	na
Monetary sector						
Broad money (end-year)	3.5	0.5	26.8	17.3	19.8	na
Net domestic assets (end-year)	0.9	5.2	21.9	14.8	na	na
Interest rate (3 month inter-bank deposit)	na	na	na	13.8	13.2	na
Government sector			<i>(In per cent of GDP)</i>			
General government balance	-2.4	0.1	-2	-3.3	1.4	0
General government expenditure	64.5	60.1	54.2	52.8	48.5	46
External data (convertible currency transactions)			<i>(In billions of US dollars)</i>			
Current account balance	0.4	-1.1	0.4	0.2	0.6	0
Trade balance	0.4	-0.8	-0.4	-1.6	-0.5	-1.5
External debt, net of reserves	6.8	7.7	8.3	8.6	3.9	na
			<i>(Percentage change in the US dollar value)</i>			
Exports (data from the balance of payments) ²	8.5	10.1	39.2	35.2	27.5	na
Imports (data from the balance of payments) ²	-1.5	35	29.6	46.2	13.9	na
			<i>(In months of current account expenditures, excluding transfers)</i>			
Gross international reserves (end-year) excluding gold	1.8	0.7	1.4	1	3.2	na
Memorandum items			<i>(Denominations as indicated)</i>			
Population (in millions, end-year)	10.3	10.3	10.3	10.3	10.3	10.3
Unemployment rate (end of period)	0	0.8	4.1	2.6	3.5	6
Exchange rate (crowns per US dollar, end-year)	14.3	28	27.8	28.9	29.8	na
Exchange rate (crowns per US dollars, annual average)	15.1	18	29.5	28.3	29.2	na
GDP (in billions of crowns)	758.8	567.3	716.6	803.3	923	1,015
Agriculture's share of NMP (in per cent) ³	6.3	8.4	6	na	na	na
Industry's share of NMP (in per cent) ³	59.6	63.2	67.7	na	na	na
GNP per capita (in US dollars) at PPP exchange rates ⁴	na	na	na	7,160	na	na

¹ Figures in bold type are those for the Czech Republic and figures in normal type are those for the former CSFR. As a rule, data for the Czech Republic are shown for years after 1991 where possible. Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Increases in 1991 and 1992 reflect in part the fact that as CMEA's non-convertible trading arrangement collapsed, some trade that had previously been channelled through the multilateral clearing arrangements began to be settled in convertible currencies.

³ NMP excludes depreciation and the value added from most of the service sector.

⁴ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Estonia ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices ²	-1.1	-8.1	-11	-25.8	-7.8	5
Prices and wages						
Consumer prices (annual average)	6.1	23.1	210.5	1,076	89.8	47
Consumer prices (end of period)	na	na	303.8	953.5	35.6	42
Average real wages	3.6	1.1	-36.2	-45	5	na
Monetary sector						
Broad money (M3, end-year)	na	na	312.4	69.4	52.8	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance ³	2.8	2.9	4.6	0.5	-1.4	0
General government expenditure ³	36.7	32.8	31.8	31.0	33.9	35
External data						
			<i>(In millions of US dollars)</i>			
Current account	na	na	570	113	40	-185
Trade balance	na	-249	560	-34	-128	na
Exports (merchandise)	na	1,843	2,822	457	812	na
to former Soviet republics	na	1,763	2,749	215	342	na
to countries outside the former Soviet Union	na	80	72	242	470	na
Imports (merchandise)	na	2,093	2,261	520	940	na
from former Soviet republics	na	1,887	2,079	266	243	na
from countries outside the former Soviet Union	na	206	183	254	697	na
			<i>(In months of goods imports)</i>			
Gross international reserves (end-year)	na	na	na	4.5	4.8	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions)	1.6	1.6	1.6	1.6	1.6	1.6
Unemployment (in per cent of labour force, end-year) ⁴	na	na	0.1	1.9	2.6	na
Exchange rate (kroons per US dollar, end-year)	na	na	na	12.6	13.8	na
Exchange rate (kroons per US dollar, annual average)	na	na	na	12.1	13.2	na
GDP (in millions of kroons)	na	na	1,781	14,247	22,845	na
GDP per capita at current exchange rates (in US dollars)	na	na	na	738	1,079	na
Agriculture's share of GDP (per cent) ⁵	na	na	20.1	13.2	11.5	na
Industry's share of GDP (per cent) ⁵	na	na	40.4	32.5	26.3	na
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	6,320	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² The figure for 1993 may underestimate real growth in the second half of the year.

³ General government includes the state, local governments and extrabudgetary funds.

⁴ Officially registered unemployment.

⁵ At current prices.

⁶ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

FYR Macedonia ¹

	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output					
			<i>(Percentage change)</i>		
GSP at constant prices ²	-9.9	-10.7	-14.7	-15.2	-8
Industrial production	-10.6	-17.2	-16.1	-17.2	na
Prices					
Retail prices (end-year)	608	115	1,691	244	70
Monetary sector					
Denar M2 (end-year)	na	na	450	1120	na
Government sector					
			<i>(In per cent of GSP)</i>		
General government balance	na	-3.6	-7.2	-10.7	-7
General government expenditure	na	40.4	36.1	45	na
Central government balance ³	na	na	-5.6	-6.8	na
Central government expenditure ³	na	18.2	19.6	25.2	na
External data					
			<i>(In millions of US dollars)</i>		
Current account	-400	-262	-10	-52	-50
Trade balance	-418	-225	-7	-47	na
Exports ⁴	1,113	1,150	1,199	1,009	na
Imports ⁴	1,531	1,375	1,206	1,056	na
External debt (end-year) ⁵	828	806	848	844	na
Memorandum items					
			<i>(Denominations as indicated)</i>		
Population (in millions) ⁶	2.13	2.15	2.17	2.19	na
Unemployment rate (annual average) ⁷	23.5	25.7	27.9	28.7	na
Official exchange rate (denar per US dollar, end of period)	11.3	19.7	509.1	42.7 ⁸	na

¹ Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to the official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² GSP is the value-added concept of former Yugoslavia which excludes the value added by government, financial and some personal services.

³ Include transfers to extrabudgetary funds. Figure for 1992 refers to end-December. Figure for 1993 is for end-September 1993.

⁴ The inclusion of trade with other republics of the former Yugoslavia from 1991 results in a discontinuity in this series.

⁵ Estimated stock of debt excluding interest arrears, penalty interest and the FYRM's share of the unallocated debt of the former Yugoslavia.

⁶ Figures for 1992-93 do not include refugees (30-60,000).

⁷ These data may overstate unemployment: some of the registered unemployed may work in the private sector.

⁸ Figure for 1993 expressed in new denar (=100 old denar).

Georgia ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>
Output and expenditure at constant prices					
	<i>(Percentage change)</i>				
NMP ²	-4.8	-12.4	-20.6	-43.4	-40
Gross fixed investment	-1.2	-14.4	-47.3	-61.6	na
Industrial output	-6.9	-29.9	-24.4	-43.3	-21
Agricultural output	-24.3	61.8	-10.6	-34.2	-41.6
Prices					
Retail prices (end-year)	0.9	4.8	119	1,653	2,656
Retail prices (annual average)	na	3.3	79	913	3,126
Monetary sector					
Domestic credit	na	na	na	794	2,282
Broad money (end-year)	na	na	na	464	4,319
Government sector					
	<i>(In per cent of GDP)</i>				
Consolidated government balance (cash-basis)	na	na	-3	-28	-34
Consolidated government expenditure (cash-basis)	na	na	33	39	46
External data					
	<i>(In millions of US dollars)</i>				
Current account	na	na	na	-247.8	-191.1
Trade balance	na	na	na	-377.9	-363.1
Exports	na	na	na	266.6	359.8
to countries outside the former Soviet Union	na	na	na	160.6	222.1
to former Soviet republics	na	na	na	106	137.7
Imports	na	na	na	644.5	722.9
from countries outside former Soviet Union	na	na	na	269.1	460.5
from former Soviet republics	na	na	na	375.4	262.4
Memorandum items					
	<i>(Denomination as indicated)</i>				
Population (in millions)	5.4	5.4	5.4	5.4	5.4
Unemployment rate (in per cent of the labour force, end-year)	na	na	na	5.4	na
Exchange rate (coupons per US dollar, end-period)	na	na	na	na	102,300
Agriculture's share of NMP (per cent)	20.2	37.2	41.9	48.1	46.2
Industry's share of NMP (per cent)	43.7	35	33.3	32.9	42.8
GDP (in billions of roubles until 1992; in billions of coupons thereafter)	15.7	16.2	20.8	167.2	12,681
GNP per capita (in US dollars) at PPP exchange rates ³	na	na	na	2,470	na

¹ Data for 1989-93 largely represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. For a discussion of problems of interpreting official estimates see Chapter 11.

² NMP excludes depreciation and the value added from most of the service sector.

³ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Hungary ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output and expenditure						
<i>(Percentage change)</i>						
National accounts at constant prices						
GDP	0.7	-3.5	-11.9	-4.3	-2.3	1
Private consumption	-0.3	-3.6	-5.8	-2.3	1.4	na
Public consumption ²	0.2	2.6	-2.7	3.9	30.5	na
Gross fixed investment	8.8	-5.2	-0.6	-2.8	-0.7	na
Exports of goods and services	1.2	-5.3	-15.3	5.4	-11.9	na
Imports of goods and services	1.8	-4.3	-8.8	0.5	18.6	na
Industrial gross output	-1.0	-9.6	-18.8	-9.7	4.0	na
Agricultural gross output	-1.3	-3.8	-3.5	-11.6	-11.8	na
Prices and wages						
Consumer prices (annual average)	17.0	28.9	35.0	23.0	22.5	na
Consumer prices (end-year)	18.9	33.4	32.2	21.6	21.1	20
Producer prices (annual average)	15.4	22.0	32.6	11.5	10.8	na
Gross monthly earnings per employee	16.4	26.5	34.4	24.7	22	na
Monetary sector						
Broad money (end-year)	13.8	29.2	29.4	27.4	20.0	na
Government sector						
<i>(In per cent of GDP)</i>						
General government balance ³	-1.3	0.5	-2.5	-5.5	-5.9	-8
General government expenditure ³	60.5	57.2	57.0	61.6	61.9	na
Central government balance ³	-0.8	0.8	-4.4	-6.9	-7.1	-8
Central government expenditure ³	49.3	47.5	54.9	54.1	54.6	na
External data (convertible currency transactions)						
<i>(In billions of US dollars)</i>						
Current account	-1.4	0.1	0.3	0.3	-3.5	-3
Trade balance	0.5	0.3	0.2	0.0	-4.0	na
External debt, net of reserves	19.2	20.2	18.7	17.1	19.2	na
<i>(Percentage change in the US dollar value)</i>						
Exports (data from the balance of payments) ⁴	17.1	-1.6	45.9	8.3	-19.3	5
Imports (data from the balance of payments) ⁴	17.8	1.5	51.2	11.1	12.5	5
<i>(In months of current account expenditures, excluding transfers)</i>						
Gross international reserves (end-year), excluding gold	1.5	1.3	3.5	4.2	5.4	na
<i>(In per cent of current account revenues, excluding transfers)</i>						
Debt service	48.8	47.1	34.8	35.5	45.5	na
Memorandum items						
<i>(Denominations as indicated)</i>						
Population (in millions, end-year)	10.4	10.4	10.3	10.3	10.3	10.3
Employment (percentage change, end-year) ⁵	-0.6	-2.6	-9.1	-6.3	-6.6	na
Unemployment (in per cent of the labour force, end-year)	0.3	2.5	8.0	12.3	12.1	11
GDP (in billions of forints)	1,723	2,089	2,475	2,886	3,503	na
GDP per capita (in thousands of US dollars)	2.8	3.2	3.0	3.4	3.5	na
Agriculture's share of GDP (per cent) ⁶	9.7	9.6	8.6	7.3	6.4	na
Industry's share of GDP (per cent) ⁶	30.1	28.8	25.5	26.4	25.2	na
Exchange rate (forint per US dollar, end-year)	62.5	61.5	75.6	84.0	100.7	na
Exchange rate (forint per US dollar, annual average)	59.1	63.2	74.8	79.0	91.9	na
Interbank interest rate (14-30 days maturity, end-year)	na	na	35.4	15.4	19.9	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	5,740	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² High growth in public consumption in 1993 reflects the receipt of aircraft from Russia as settlement of Russian CMEA-related debt to Hungary.

³ General government includes the state, municipalities and extra-budgetary funds. Central government comprises the state and extra-budgetary funds and includes the activities of the State Development Institution from 1990.

⁴ Balance of payments data are prepared by the central bank and are presented on a settlement basis.

⁵ For 1992: change between 1st quarter 1992 and 1st quarter 1993. For 1993: change between 1st quarter 1993 and 1st quarter 1994.

⁶ At constant 1991 prices through 1990. At current prices thereafter.

⁷ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Kazakhstan ¹

	1989	1990	1991	1992	1993	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices	-0.4	-0.4	-12	-13	-13	-11
Prices and wages						
Retail prices (annual average)	na	4.2	90.9	1,381	1,517	1,100
Retail prices (end-year)	na	na	149.5	1,176	1,925	900
Wages (annual average)	8.8	13.2	66.4	910	1,446	1,500
Monetary sector						
Broad money (end-year)	na	na	210.7	388.5	526	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance	0	1.4	-7.9	-7.3	-1.1	-4
Total expenditure	35.4	31.4	32.9	31.9	23.5	na
External data						
Exports to countries outside the former Soviet Union ²	2.4	1.5	1.3	26.4	14.2	na
Exports to former Soviet republics	17.8	15.3	17.9	26.7	20.2	na
Imports from countries outside the former Soviet Union ²	3.4	2.9	3.6	21.4	17.1	na
Imports from former Soviet republics	31.6	26	21.8	40.7	22.9	na
Trade balance vis-à-vis countries outside the former Soviet Union	-0.7	-1.2	-1.1	0	0	na
Exports	1.6	1.3	0.8	1.5	1.6	na
Imports	2.3	2.5	1.9	1.5	1.6	na
Trade balance vis-à-vis other former Soviet republics	-5.8	-5.4	-3.5	-170	-445	na
Exports	7.5	7.7	16.5	324	3,371	na
Imports	13.4	13.1	20.0	494	3,816	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions, end-year)	16.5	16.6	16.7	16.9	17.1	17.3
Unemployment rate (end-year)	0	0	0	0.5	9.3	11
Industry's share of GDP (per cent)	29.9	21	37.1	45.4	43	45.2
Agriculture's share of GDP (per cent)	34.8	41.8	34.1	37.7	36.1	38.2
Nominal GDP (in millions of US dollars)	64,205	64,906	78,581	14,592	21,400	25,600
GNP per capita (in US dollars) at PPP exchange rates ³	na	na	na	4,780	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² The value of trade was converted to roubles using the nominal exchange rate.

³ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Kyrgyzstan¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices	3.8	3.2	-5.0	-25.0	-16	-10
Prices and wages						
Consumer prices (annual average)	0	3	85	855	1,209	280
Consumer prices (end-year)	na	na	170	1,771	1,366	90
Monetary sector						
Net domestic assets	na	na	na	736	na	na
Government sector						
			<i>(In per cent of GDP)</i>			
Government balance	2.1	0.3	4.6	-13.5	-8.2	-4
Government expenditure	35.9	38.3	31.1	26.2	14.0	na
External data						
Current account balance ²	na	na	10.8	-10.1	-8.7	-8
Trade balance	-22.3	-18.9	-1.5	-10.1	-10.5	na
Memorandum items						
			<i>(Denomination as indicated)</i>			
Population (in millions, end-year)	4.3	4.4	4.4	4.4	4.4	4.4
GDP (in billions of roubles until 1992, in billions of soms thereafter)	7.6	8.3	15.4	183.0	9.4	na
GNP per capita (in US dollars) at PPP exchange rates ³	na	na	na	2,820	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² In 1991, the difference between the trade balance and the current account balance reflects mainly transfers from the Russian Federation.

³ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Latvia ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices ²	6.8	2.9	-8.3	-33.8	-11.7	5
Gross manufacturing output	na	na	0.4	-48.7	-32.6	na
Gross agricultural output	na	na	-2	-29	-14.1	na
Prices and wages						
Consumer prices (annual average)	4.7	10.5	124.4	951.2	109	36
Consumer prices (end-year)	na	na	262.4	958.1	34.8	25
Real average wage in the state sector ³	na	na	-16.3	-15.7	0.6	na
Monetary sector						
Domestic credit (end-year)	na	na	90.6	303.8	135	na
Broad money (M2) (end-year)	na	na	153.1	169.9	84.1	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance, excluding lending	1	2	6.4	0	1	-2
General government expenditure	51	44	31	28.2	32.5	na
External data						
Current account balance	na	na	na	1.6	8.4	-7
			<i>(In millions of US dollars)</i>			
Exports (merchandise) ⁴	na	na	na	831	998	na
to CIS and Baltics	na	na	na	396	539	na
to other countries	na	na	na	435	460	na
of which: re-exports of energy	na	na	na	134	117	na
Imports (merchandise) ⁴	na	na	na	1,046	1,058	na
from CIS and Baltics	na	na	na	626	715	na
from other countries	na	na	na	420	343	na
Net service exports ⁴	na	na	na	236	253	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in million)	2.7	2.7	2.7	2.7	2.7	na
Unemployment (end-year, per cent of labour force)	0	0	0.1	2.1	5.3	na
State sector in total employment (per cent)	89.5 ⁵	80.9	77.5	56.3	50.3	na
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	4,690	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² The final figure for 1993 may be adjusted upwards.

³ Annual averages.

⁴ Because of valuation problems available pre-1992 data are not meaningful.

⁵ 1985 figure used for 1989.

⁶ PPP stands for purchasing parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Lithuania¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices ²	1.5	-5	-13.1	-37.7	-16.2	4
Domestic demand at constant prices	na	na	na	-40.5	-20.1	na
Industrial production ³	na	na	na	-50.9	-42.7	na
Prices and wages						
Consumer prices (annual average)	2.1	8.4	225	1,021	390	70
Consumer prices (end-year)	na	na	345	1,175	188	40
Average real wages	8.1	7.3	-18.3	-32.8	na	na
Monetary sector						
Domestic credit	4.6	11.1	79.2	427	123	na
Broad money (M2)	14.2	55.4	70.7	351	160	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance ⁴	-3.8	-4.5	5	0.5	-4.6	1 to 2
General government expenditure ⁴	53.8	49.2	38.9	32.8	29.7	na
External data						
Current account	na	na	na	3.4	-6.2	-8
Trade balance	-8.4	-8.8	9.1	3.4	-8.6	na
			<i>(In millions of US dollars)</i>			
Exports (merchandise)	na	na	na	1,145	1,877	na
to countries outside the former Soviet Union	na	na	na	557	713	na
to former Soviet republics	na	na	na	588	1,164	na
Imports (merchandise)	na	na	na	1,084	2,144	na
to countries outside the former Soviet Union	na	na	na	341	486	na
to former Soviet republics	na	na	na	742	1,657	na
Net international reserves of the central bank	na	na	na	23.6	227	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions)	3.69	3.73	3.75	3.76	na	na
Unemployment (end-year, per cent of labour force)	na	na	0.3	1	1.4	na
Exchange rate (end-year) ⁵	na	17.5	113.9	378.9	3.9	na
Agriculture's share of GDP at factor cost (per cent)	27.2	24.9	23.8	28.2	na	na
Industry's share of GDP at factor cost (per cent)	34.5	36.4	36.9	25.4	na	na
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	3,710	na	na

¹ Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Figures are for NMP until 1990, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

³ All manufacturing in 1992; state enterprise sector only in 1993.

⁴ General government includes the state, municipalities and extra-budgetary funds.

⁵ Roubles per US dollar in 1990 and 1991, talonai per US dollar in 1992, and litai per US dollar in 1993.

⁶ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Moldova¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices ²	8.8	-1.5	-11.9	-25	-14	-3
Prices						
Consumer prices (annual average) ³	na	4.2	98	944	789	350
Consumer prices (end-year) ³	na	na	162	1,275	837	120
Government sector						
			<i>(In per cent of GDP)</i>			
State budget balance ⁴	2	3	0	-23.4	-8.8	-4
State budget expenditures and net lending ⁴	na	na	na	43.6	25.9	na
External data						
			<i>(In millions of US dollars)</i>			
Current account	na	na	na	-39	-177	-250
<i>vis-à-vis</i> countries outside the former Soviet Union	na	na	na	-22	-21	na
<i>vis-à-vis</i> former Soviet Republics	na	na	na	-17	-156	na
Trade balance	na	na	na	-37	-162	na
<i>vis-à-vis</i> countries outside the former Soviet Union	na	na	na	-20	-35	na
<i>vis-à-vis</i> former Soviet Republics	na	na	na	-17	-127	na
Exports	na	na	na	868	449	na
to countries outside the former Soviet Union	na	na	na	185	174	na
to former Soviet Republics	na	na	na	683	275	na
Imports	na	na	na	-905	-611	na
from countries outside the former Soviet Union	na	na	na	-205	-210	na
from former Soviet Republics	na	na	na	-700	-402	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions)	4.4	4.4	4.4	4.3	4.3	na
GDP (in millions of Moldovan lei)	na	na	na	215	2,131	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	3,870	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² NMP at constant prices until 1991, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

³ For 1989-91 the figures cover retail prices.

⁴ Includes republican and local budgets but exclude the Trans-Dniester region.

⁵ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Poland¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output and expenditure						
	<i>(Percentage change)</i>					
GDP at constant prices ²	0.2	-11.6	-7.6	1.5	3.8	4.5
Consumption at constant prices	-1.3	-11.7	3.3	5	5.3	na
Gross fixed investment at constant prices	5.1	-24.8	-14.2	-2.6	2.9	na
Exports volumes	0.1	13.7	-2.4	-3.5	na	na
Imports volumes	1.5	-17.9	37.8	12.6	na	na
Industrial production	-1.4	-26.1	-11.9	3.9	5.6	na
Prices and wages						
Consumer prices (annual average)	251.1	585.8	70.3	43.0	35.3	30
Consumer prices (end-year)	639.5	249	60.4	44.3	37.6	27
Producer prices (annual average)	212.8	622.3	48.1	28.5	32.2	na
Wages and salaries (annual average)	291.8	398	70.6	38.9	37.9	na
Monetary sector						
Broad money (end-year)	526.5	160	36.9	57.5	36	na
Net domestic assets (end-year)	471.8	84.6	63.4	49.2	31.5	na
Government sector						
	<i>(In per cent of GDP)</i>					
General government balance ³	-7.4	3.1	-6.5	-6.7	-2.9	na
General government expenditure ³	48.8	39.8	48	50.7	48.4	na
State budget balance ⁴	-6.1	0.7	-7	-6.8	-3.4	-4
State budget expenditure ⁴	36.9	32.7	32.7	33.8	32.5	34
External data convertible currency transactions						
	<i>(In billions of US dollars)</i>					
Current account balance ⁵	-1.4	0.8	-2.3	-0.3	-2.3	-3
Trade balance	-0.1	1.4	-0.8	0.5	-2.3	-2
External debt	40.2	48.9	48.3	47.6	48.4	46
	<i>(Percentage change in the US dollar value)</i>					
Exports (data from the balance of payments)	4.5	43.4	17.5	9.7	-2.9	4
Imports (data from the balance of payments)	16.3	17.9	46.9	6.1	17.7	2
	<i>(In months of current account expenditures, excluding transfers)</i>					
Gross international reserves (end-year), excluding gold	2.4	3.8	2.5	2.9	2.6	1.7
Memorandum items						
	<i>(Denominations as indicated)</i>					
Population (in millions)	38	38.2	38.3	38.4	38.5	na
Employment (percentage change, end-year)	-0.8	-6.2	-3.9	-3.1	-2.8	-1.5
Unemployment (in per cent of the labour force, end-year)	0.1	6.1	11.8	13.6	15.7	na
Exchange rate (zloty per US dollar, end-year)	6,500	9,500	11,072	15,449	21,079	na
Exchange rate (zloty per US dollar, average)	1,446	9,500	10,583	13,631	18,145	na
Interest rate (refinancing rate, end of period)	140	55	40	38	35	na
GDP (in trillions of zloty)	118.3	591.5	824.3	1,142	1,552	na
Private sector share of GDP (per cent)	28.6	30.9	30	40	45	na
Agriculture's share of GDP (per cent) ⁶	7.8	8.4	9.3	8.3	na	na
Industry's share of GDP (per cent) ⁶	49.5	43.6	39.2	39.6	na	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	4,880	na	na

¹ Data for 1989-93 represent the most recent official estimates of outcomes as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outcomes for the first half of 1994.

² A recent report from the Central Statistical Office puts the decline in real GDP between 1989 and 1991 at 5-10 per cent, significantly below the official figures quoted to date.

³ General government includes the state, municipalities and extrabudgetary funds. The data are compiled on a commitment basis, except for external interest payments which are cash-based (i.e. the exclude due but unpaid interest).

⁴ For the period 1988-90 the state budget includes central government accounts and accounts of local and regional authorities. The state budget for 1991 and subsequent years includes the central government accounts, the accounts of regional authorities and accounts of several previously extra-budgetary funds. Flows are compiled on a commitment basis, except for external interest payments which are cash-based.

⁵ Includes (in expenditures) due but unpaid interest on foreign debt.

⁶ At constant prices.

⁷ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Romania¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output and expenditure	<i>(Percentage change)</i>					
National accounts at constant prices						
GDP ²	-5.8	-5.6	-12.9	-13.6	1.0	0
Private consumption ²	0.6	8.0	-15.7	-9.8	-3.0	na
Public consumption ²	1.2	14.0	10.0	2.9	-1.0	na
Gross fixed investment ²	-1.6	-35.5	-26.0	-1.1	0.8	na
Exports of goods and services ²	-10.2	-44.6	-4.4	15.1	12.0	na
Imports of goods and services ²	2.9	7.4	-14.1	9.4	5.6	na
Industrial output ³	-5.3	-23.7	-22.8	-21.9	1.3	na
Grain output ³	-5.8	-6.6	12.5	-36.3	26.0	na
Prices and wages						
Consumer prices (annual average)	1.1	5.1	174.5	210.9	256.1	na
Consumer prices (end-year)	0.6	37.7	222.8	199.2	295.5	90
Wholesale prices (annual average)	0.0	26.5	255.8	191.7	165.0	na
Wages (annual average)	3.9	10.6	121.2	170.0	202.1	na
Monetary sector						
Broad money (end-year)	5.3	22.0	101.2	79.6	143.2	na
Government sector						
	<i>(In per cent of GDP)</i>					
Central government balance (national definition)	na	na	-1.9	-4.4	-1.8	-2
General government balance ⁴	8.4	1.2	0.6	-4.6	-0.1	na
General government expenditure ⁴	42.7	39.3	40.4	42.2	31	na
External data (convertible currency transactions)						
	<i>(In billions of US dollars)</i>					
Current account balance	2.9	-1.8	-1.3	-1.7	-1.5	-1
Trade balance	2.6	-1.8	-1.3	-1.4	-1.1	na
Gross external debt, net of reserves (end-year)	-1.3	0.6	1.6	2.7	3.5	na
	<i>(Percentage change in the US dollar value)</i>					
Exports (data from the balance of payments)	-7.9	-44.0	-1.7	22.9	13.6	na
Imports (data from the balance of payments)	17.3	49.9	-10.2	16.3	6.2	na
	<i>(In months of current account expenditures, excluding transfers)</i>					
Gross international reserves (end-year), excluding gold	6.0	0.8	1.0	1.3	1.6	na
Memorandum items						
	<i>(Denominations as indicated)</i>					
Population (in millions, mid-year)	23.1	23.2	23.2	22.8	22.7	na
Employment (percentage change, end-year)	1.3	-1.0	-0.5	-5.4	-6.2	na
Unemployment rate (in per cent of the labour force, end-year)	na	na	3	8.4	10.2	na
Exchange rate (lei per US dollar, end-year) ⁵	14.4	34.7	189.0	460.0	1,276.0	na
Exchange rate (lei per US dollar, average) ⁵	14.9	22.4	76.3	308.0	760.1	na
Bank lending rate (end-year) ⁶	3	3	8.18	52	86	na
GDP (in billions of lei)	800	858	2,199	5,982	18,835	na
GDP per capita (in US dollars) at current exchange rates	2,321	1,649	1,242	852	1,087	na
Agriculture's share of GDP at current prices (per cent)	13.9	18.0	18.5	20.1	21	na
Industry's share of GDP at current prices (per cent)	52.8	48.2	43.6	44.3	41	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	2,750	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² The source of these series is the Institute of International Finance, *Romania Country Report*, May 1994. Figures on national accounts for Romania differ substantially across different national and IFI sources.

³ For 1988 and 1989, the sector's is value added at constant prices.

⁴ General government includes the state, local governments and extra-budgetary funds.

⁵ During most of the period covered in this table, the exchange rate facing individuals has differed from that facing enterprises. The rates quoted here are the officially quoted rates facing enterprises.

⁶ For 1988-91, The central bank's refinancing rate. For 1992, commercial bank rate on medium-term lending to enterprises. For 1993, average end-year commercial bank rate on lending to enterprises.

⁷ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Russian Federation ¹

	1989	1990	1991	1992	1993	1994 <i>Projection</i>
Output and expenditure						
			<i>(Percentage change)</i>			
GDP at constant prices	na	na	-9	-19	-12	-12
Investment at constant prices	4.1	0.1	-11	-45	-15	na
Industrial production	1.4	-0.1	-8	-18.8	-16	na
Prices and wages						
Retail prices (annual average)	2	5.6	92.7	1,354	896	300
Retail prices (end-period)	na	na	143.9	2,322	842	180
Wages (annual average)	9.9	14.8	73.9	1,065	885	na
Industrial wholesale prices (annual average)	1.2	3.9	138.1	1,949	na	na
Industrial wholesale prices (end-year)	na	na	236.3	3,275	1,007	na
Monetary sector						
Credit to enterprises and households	na	na	127	803	452	na
Broad money (end-period) ²	14.6	17.6	77	545	442	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance (cash basis) ³	na	na	na	-18.8	-8.0	-10
External data ⁴						
			<i>(In billions of US dollars)</i>			
Current account balance						
<i>vis-à-vis</i> non-CIS countries (excl. gold)	na	-2.5	1.5	-1.7	7.9	7
Current account balance						
<i>vis-à-vis</i> non-CIS countries (incl. gold)	na	-0.9	3.6	-0.6	8.5	na
Trade balance <i>vis-à-vis</i> non-CIS countries	13.1	10.0	6.4	5.4	13.7	12
Gross external debt in convertible currencies (of the Soviet Union/Russia, end of period)	54.4	61.1	67	78.2	86.8	na
			<i>(Percentage change in US dollar value)</i>			
Exports to non-CIS countries	8.5	0.8	-19.8	-16.7	1.4	5
Imports from non-CIS countries	13.8	7.3	-16.9	-16.8	-21	13
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions, end-year)	147.6	148.3	148.9	148.6	148.3	na
Unemployment rate (end-year, in per cent of the labour force) ⁵	0	0	0.1	0.8	1.1	3.5
Exchange rate (roubles per US dollar, end-year)	0.6	1.7	1.7	415	1,247	na
Exchange rate (roubles per US dollar, annual average)	0.6	na	1.7	222	930	na
Refinancing rate	na	na	6 to 9	80	210	na
Nominal GDP (in billion roubles)	573	622	1,130	18,065	162,300	na
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	6,220	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Excluding foreign currency deposits.

³ After inclusion of import subsidies on the expenditure side.

⁴ All external data (except projections for 1994) are PlanEcon estimates which are based on official data from Roskomstat.

⁵ Officially registered unemployed.

⁶ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Slovak Republic¹

	1989	1990	1991	1992	1993	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices	1.4	-0.4	-14.5	-7.0	-4.1	1
Industrial production ²	-0.7	-3.6	-17.6	-14.0	-10.6	-4
Prices and wages						
Consumer prices (annual average)	2.3	10.8	61.1	9.9	23.2	15
Consumer prices (end-year)	1.5	18.4	58.3	9.2	24.8	13
Producer prices (annual average)	-0.7	4.4	68.8	5.3	17.2	13
Average wages in industry	3.2	4.5	16.5	20.2	16.8	na
Monetary sector						
Broad money (end-year)	3.5	0.5	26.8	17.3	18.0	na
Net domestic assets (end-year)	0.9	5.2	21.9	14.8	21.0	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance	-2.4	0.1	-2	-13.1	-7.5	-6
General government expenditure	64.5	60.1	54.2	63.8	55.5	50
External data in convertible currencies						
			<i>(In billions of US dollars)</i>			
Current account balance	0.4	-1.1	0.4	0.1	-0.4	-0.5
Trade balance	0.4	-0.8	-0.4	-0.7	-0.9	-1
External debt, net of gross reserves (excluding gold)	5.6	6.8	6.1	4.9	3.0	na
			<i>(Percentage change in the US dollar value)</i>			
Exports (data from the balance of payments) ³	8.5	10.1	39.2	35.2	-16.7	na
Imports (data from the balance of payments) ³	-1.5	35	29.6	46.2	-12.3	na
			<i>(In months of current account expenditures, excluding transfers)</i>			
Gross international reserves (end-year) ex. gold	1.8	0.7	1.4	1.1	2	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions, end-year)	5.3	5.3	5.3	5.3	5.3	5.3
Unemployment rate (in per cent of the labour force, end of period)	0	1.5	11.8	10.4	14.4	na
Exchange rate (crowns per US dollar, end-year)	14.3	28	27.8	28.9	33.2	na
Exchange rate (crowns per US dollars, annual average)	15.1	18	29.5	28.3	30.8	na
GDP (in billions of crowns)	758.8	244	291.8	281.5	336	na
Agriculture's share of GDP (per cent) ⁴	6.3	8.2	5.8	6.3	6.7	na
Industry's share of GDP (per cent) ⁴	59.6	61.6	63.9	49.0	37.3	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	5,620	na	na

¹ Figures in bold type are those for the Slovak Republic and figures in normal type are those for the former CSFR. As a rule, data for the Slovak Republic are shown for years after 1991 where possible. Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Covers only state enterprises until 1991, but includes the private sector from 1992.

³ Increases in 1991 and 1992 reflect in part that as, CMEA's non-convertible trading arrangement collapsed, some trade that had previously been channelled through the multilateral clearing arrangements began to be settled in convertible currencies. From 1993, growth rates include transactions with the Czech Republic.

⁴ Share of NMP until 1991, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

⁵ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Slovenia¹

	1989	1990	1991	1992	1993 Estimate	1994 Projection
Output						
			(Percentage change)			
GDP at constant prices	-1.8	-4.7	-8.1	-5.4	1.3	4
Industrial production	1.1	-10.5	-12.4	-13.2	-2.8	na
Agricultural production	-0.7	3.5	0.4	-11.6	-3.5	na
Prices and wages						
Retail prices (annual average)	1,306.0	549.7	117.3	201.3	32.3	na
Retail prices (end-year)	2,829.6	104.6	247.1	92.9	22.9	16
Producer prices (annual average)	1,413.3	390.4	124.1	215.7	21.6	na
Real net wages (end-year) ²	15.5	-25.9	-10.9	-8.9	16.4	na
Monetary sector						
Broad money (end-year)	na	na	na	131.6	64.7	na
Government sector						
			(In per cent of GDP)			
General government balance	0.3	-0.3	2.6	0.2	0.5	-1
General government expenditure	42.1	49.6	41.1	46.8	49.4	49
External data						
			(In billions of US dollars)			
Current account ³	1.1	0.5	0.1	0.9	0.2	na
Trade balance ³	0.2	-0.6	-0.3	0.8	-0.1	na
External debt, net of reserves ⁴	na	1.7	1.5	0.6	0.3	na
			(Percentage change in US dollar value)			
Exports (data from the balance of payments) ³	3.2	21.8	-6	8.1	-9.0	4
Imports (data from the balance of payments) ³	9.9	47.7	-12.6	0.1	5.9	1
			(In months of current account expenditures, excluding transfers)			
Gross international reserves, excluding gold	na	0.6	0.9	2.8	2.5	na
Memorandum items						
			(Denominations as indicated)			
Population (in millions, annual average)	2	2	2	2	2	na
Employment (percentage change, annual average)	-1.1	-3.8	-7.2	-6.0	-4.1	na
Unemployment (in per cent of the labour force, annual average)	2.9	4.7	8.2	11.1	14.5	14
Exchange rate (tolar per US dollar, end-year) ⁵	11.8	10.7	57.7	96.2	131.8	na
Exchange rate (tolar per US dollar, annual average) ⁵	2.9	11.3	27.6	81.3	113.2	na
Working capital nominal interest rate (end-year)	na	na	562.6	72.2	42.6	na
GDP	34.8	196.1	349.6	1,005.6	1,414.7	na
Agriculture's share of GDP (per cent)	4.4	4.7	5.4	5	4.9	na
Industry's share of GDP (per cent)	44.4	37.7	42.2	37.8	33.8	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² Data for 1989-91 covers only the social sector; starting from 1992 private enterprises employing three or more persons are included.

³ Until 1991 excluding trade with former Yugoslavia.

⁴ Excluding non-allocated federal Yugoslav debt.

⁵ Dinars per US dollar prior to 8 October 1991.

Tajikistan ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>
Output					
			<i>(Percentage change)</i>		
NMP at constant prices ²	-2.9	-1.6	-12.5	-33.7	-28
Industrial production	1.9	1.9	-7.4	-35.7	na
Agricultural production	-13	-9.2	-9.9	-27.7	na
Price and wages					
Retail prices (annual average) ³	na	4	103	1,156	2,195
Retail prices (end-period) ³	na	na	204	1,362	7,344
Average monthly wages	6	10	64	461	712
Monetary sector					
Broad money, end-year	na	na	68	579	1,429
Government sector					
			<i>(In per cent of GDP)</i>		
State budget balance	2.5	4	7	-37	na
State budget expenditure	38.6	44.7	37.4	63.7	na
External data					
			<i>(In per cent of GDP)</i>		
Trade balance					
<i>vis-à-vis</i> countries outside the former Soviet Union	-3.9	-6.5	0.1	na	na
<i>vis-à-vis</i> former Soviet republics	-15.4	-9.4	2.1	na	na
Exports					
to countries outside the former Soviet Union	5.2	4.3	2.9	na	na
to former Soviet republics	30.7	23.5	30.3	na	na
Imports					
from countries outside the former Soviet Union	9.1	10.8	2.8	na	na
from former Soviet republics	46.1	32.9	28.2	na	na
Memorandum items					
			<i>(Denominations as indicated)</i>		
Population (in millions)	5.1	5.2	5.3	5.6	na
Employment (in millions)	1.873	1.934	1.967	1.908	na
NMP (in millions of roubles)	4,817	5,490	10,540	43,105	na
GDP per capita (in US dollars) at PPP exchange rates ⁴	na	na	na	2,000	na
Industry's share in NMP at 1992 prices (in per cent)	67.6	71.2	73.3	77.7	71.3

¹ Data for 1989-93 largely represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. For a discussion of problems of interpreting official statistics, see Chapter 11.

² GDP for 1993. NMP excludes depreciation and the value added from most of the service sector.

³ For consumer goods.

⁴ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Turkmenistan¹

	1989	1990	1991	1992	1993
Output					
		<i>(Percentage change)</i>			
GDP at constant prices	-6.9	2	-5	-5	-8
Price and wages					
Consumer prices (annual average)	2.1	4.6	102	493	1,850
Consumer prices (end-period)	na	na	155	644	4,500
Government sector					
		<i>(In per cent of GDP)</i>			
General government expenditure	30.1	43.6	38.2	45	24
Balance before Union transfers	-8.7	-8.7	-5.8	14.1	-3
Balance before gas revenues	-1.9	1.2	1.1	-13.9	-14
Overall general government balance	-1.9	1.2	2.5	14.1	-3
External data					
		<i>(In millions of US dollars)</i>			
Current account <i>vis-à-vis</i> countries outside the former Soviet Union	na	-306	361	415	381
Trade balance <i>vis-à-vis</i> countries outside the former Soviet Union	na	-248	557	601	570
Exports to countries outside the former Soviet Union	na	148	1,037	1,145	1,247
Imports from countries outside the former Soviet Union	na	397	480	453	678
		<i>(In billions of roubles)</i>			
Trade balance <i>vis-à-vis</i> former Soviet republics	na	-0.5	1.1	104	625
Exports to former Soviet republics	na	2.5	6.7	194	1,510
Imports from former Soviet republics	na	2.9	5.6	90	886
Memorandum items					
		<i>(Denominations as indicated)</i>			
Population (in millions)	3.6	3.7	3.8	3.8	3.9
Employment (in millions)	1.49	1.54	1.57	1.57	na
GDP (in billions of roubles)	6.7	7.3	17	306	5,584
Agriculture's share of NMP (in per cent) ²	43	48	46	48	17
Industry's share of NMP (per cent) ^{2, 3}	23	16	20	11	39
GNP per capita (in US dollars) at PPP exchange rates ⁴	na	na	na	3,950	na

¹ Data for 1989-92 largely represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Figures for 1993 are EBRD staff estimates. For a discussion of problems of interpreting official statistic, see Chapter 11.

² NMP excludes depreciation and the value added from most of the service sector.

³ The methodology used by the Turkmen Statistical Office leads to an understatement of the contribution from natural gas production.

⁴ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Ukraine ¹

	1989	1990	1991	1992	1993	1994 <i>Projection</i>
Output and expenditure						
	<i>(Percentage change)</i>					
GDP at constant prices	4.1	-3.4	-12	-17	-14	-20
Industrial production	2.8	-0.1	-4.8	-6.5	-8	na
Prices and wages						
Consumer prices (annual average)	2.2	4.2	91	1,210	4,735	na
Consumer prices (end-year)	na	na	161	2,000	10,155	350
Producer prices (annual average)	na	4.5	125	2,384	3,962	na
Producer prices (end-year)	1.7	4.5	163	4,129	9,668	na
Real wages (monthly average)	6.9	9.5	19	-28	-30	na
Monetary sector						
Broad money (end-year)	na	13.2	101	921	1,768	na
Government sector						
	<i>(In per cent of GDP)</i>					
General government balance	na	na	-13.6	-29.3	-13.3	na
General government expenditure ²	na	na	51.9	73.3	55.6	na
State budget balance	5.8	2.6	-14.9	-34	-14.3	na
State budget expenditure	27.3	31.4	41.0	63.1	46.7	na
External data						
	<i>(In billions of US dollars)</i>					
Trade balance						
<i>vis-à-vis</i> countries outside the former Soviet Union	-0.8	-2.6	-2.7	0.5	1.6	na
<i>vis-à-vis</i> other former Soviet republics	-8.2	-10.1	-0.7	-1.1	-3.3	na
Exports						
to countries outside the former Soviet Union	14	13.2	7.3	6	6.3	na
to former Soviet republics	63.1	61.4	42.7	5.3	8.6	na
Imports						
from countries outside the former Soviet Union	14.8	15.8	10	5.5	4.7	na
from former Soviet republics	71.3	71.5	43.4	6.4	11.9	na
Memorandum items						
	<i>(Denominations as indicated)</i>					
Population (in millions)	51.7	51.8	51.9	52	52.1	52.1
Employment (percentage change, end-year)	na	-3.5	-1.6	-5	-5.9	na
Unemployment rate (in per cent, end-year)	0	0	0	0.3	0.4	na
Exchange rate (annual average) ³	0.62	0.59	1.74	198	6,185	na
GDP ⁴	154	165	295	4,090	153,490	na
Agriculture and fisheries' share of NMP (per cent)	28	30.3	30.2	22.5	16	na
Industry and mining's share of NMP (per cent)	42.6	41.3	42.4	50.7	52	na
Construction's share of NMP (per cent)	10.4	9.7	10.9	14.7	12	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	5,010	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² General government includes the state, local governments and extra-budgetary funds.

³ Roubles per US dollar until 1991, karbovantsi per US dollar thereafter.

⁴ In billions of roubles until 1991, in billions of karbovantsi thereafter.

⁵ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report* 1994. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Uzbekistan ¹

	1989	1990	1991	1992	1993 <i>Estimate</i>	1994 <i>Projection</i>
Output						
			<i>(Percentage change)</i>			
GDP at constant prices	3.7	1.6	-0.5	-9.6	1	-8
Industrial output	3.6	1.8	1.8	-12.3	-8.3	na
Agricultural output	-4.3	6.3	-5.2	-7.3	-0.7	na
Prices and wages						
Retail prices (annual average)	0.7	3.1	82	528	1,312	1,500
Retail prices (end-year)	na	na	169	787	927	600
Wholesale prices	2.1	7.2	147.3	2,700	1,970	na
Wages (annual average)	6.4	11.2	51.1	612	na	na
Government sector						
			<i>(In per cent of GDP)</i>			
General government balance ²	-0.9	-1.1	-3.6	-13	-15.7	-10
General government expenditure	35.9	46.1	52.7	46.5	50.5	na
External data						
			<i>(In millions of US dollars)</i>			
Current account ³	na	na	na	-238	-400	na
Trade balance ³	na	na	na	-235	-462	na
			<i>(In per cent of GDP)</i>			
Trade balance vis-à-vis countries outside the former Soviet Union	-1.2	-3.6	-2.5	-3.3	-10.4	na
Trade balance vis-à-vis other former Soviet republics	-11.4	-11.4	1.4	-9.4	1.2	na
Exports to countries outside the former Soviet Union	5.2	3.5	3.9	46.3	15.6	na
Exports to former Soviet republics	27.8	25.2	30.9	29.5	32.4	na
Imports from countries outside the former Soviet Union	6.4	7.1	6.4	49.5	26.0	na
Imports from former Soviet republics	39.2	36.6	29.5	38.9	31.2	na
Memorandum items						
			<i>(Denominations as indicated)</i>			
Population (in millions, end-year)	20	20.5	20.9	21.3	22	22.5
Unemployment rate (in per cent of the labour force, end-year) ⁴	0	0	0	0.1	0.2	na
Industry's share of GDP (per cent)	26.0	23.8	31	32.7	29.8	na
Agriculture's share of GDP (per cent)	42.3	44.3	45	38.9	34.9	na
GDP (in billions of roubles)	30.7	32.4	61.5	416.9	4,617.2	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	2,600	na	na

¹ Data for 1989-93 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1994 should be treated with the same caveats as apply to official estimates and forecasts, as discussed in Chapter 11. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for the first half of 1994.

² In the narrow version of the budget the deficit was 5 per cent in 1993. The larger deficit quoted here includes unbudgeted import subsidies and extrabudgetary funds.

³ Consolidated balance of transactions with both former Soviet republics and countries outside the former Soviet Union.

⁴ Officially registered unemployed.

⁵ PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

11. Macroeconomic forecasting in transition

This chapter presents macroeconomic forecasts for 1994-98 from a number of sources. Before the more detailed discussion of these forecasts, we note in Section 11.1 below that forecasters have found it very difficult in the past to predict developments in the transition economies accurately. Section 11.2 gauges the extent to which selected forecasters expect the macroeconomic performance in the region to change. Lastly, Section 11.3 highlights problems of interpretation, referring to the imprecision of past projections and the problem that most forecasters aim to predict what will at some stage be the “officially estimated outturn” rather than “what would be the correct estimate of the outturn, after adjusting for inadequacies in official data”. Comprehensive sets of EBRD forecasts for the region have not previously been published but Appendix 10.1 in this Report includes EBRD forecasts for 1994. We also intend to publish short-term forecasts in future editions of the *Transition Report*. The accuracy of these forecasts will be subject to analysis in next year’s Report alongside the forecasts of other institutions.

11.1 A comparison between forecasts and outturns

This section compares outturns for 1993 with forecasts prepared in the spring of 1993 by PlanEcon, the Vienna Institute for Comparative Economic Studies, the Organisation for Economic Cooperation and Development, the International Monetary Fund, the World Bank, the United Nations, the European Commission and JP Morgan.¹ Tables 11.1-11.7 contain the numerical comparison between forecasts and outturns for GDP, unemployment and inflation.² The applied data on out-turns are from the EBRD’s database as reflected in Appendix 10.1.

Output

How well did the forecasters predict last year’s growth in real GDP? The answer is given by Table 11.1 which includes an estimation of the average unweighted difference between outturns and forecasts – “the average error”³ – taking into account all collected predictions made by the mentioned institutions. The average error on forecasts for countries in eastern Europe and the Baltic

region was +1 percentage point. The implication is that growth in this group of countries was *underestimated*. Meanwhile the slowdown of the decline in the CIS was *overestimated*, as reflected in an average error on forecasts for CIS countries of -2.3 percentage points.

The forecasters erred badly on their predictions for individual countries. Thus the average absolute value of the errors⁴ came out at a considerable 3.7 percentage points for observations on eastern Europe and the Baltic countries, 5.5 for the CIS and 4.2 for the entire set of forecasts.

Within the set of observations for eastern Europe and the Baltics, only outcomes for Estonia, Hungary, Latvia and Lithuania were below expected levels. In some other cases, expectations were surpassed by a wide margin. For all the forecasters included in our survey Albania and Romania performed much better in 1993 than expected.

For the CIS countries, the sharp declines in Armenia, Georgia, Moldova and Tajikistan exceeded the forecasts. The contraction in Azerbaijan, Kyrgyzstan, Russia, Turkmenistan and Ukraine was roughly within the predicted range, while Belarus, Kazakhstan and especially Uzbekistan performed better than expected. It should be noted in this context that Turkmenistan is the one country for which the EBRD estimate of the outturn differs markedly from official data. Official estimates show positive growth in 1993 in excess of 7 per cent. While the forecasts for Turkmenistan fit well with the most recent EBRD estimate, they were poor forecasts for the officially estimated outturn. This example highlights the difficulty of deciding on a standard against which the forecasters’ performances can be measured. We return to this issue at the end of this chapter.

Inflation and unemployment

Table 11.2 focuses on inflation. It shows that price stabilisation in 1993 was pursued less successfully than expected in Ukraine, Romania and, albeit on a much more moderate scale, in the Czech Republic and Hungary. Albania, Bulgaria and Slovenia performed better than predicted.

¹ See the EBRD’s *Annual Economic Outlook*, September 1993, for an earlier discussion of such forecasts. Unfortunately, a serious error occurred in Table 5.2 (page 108) of that document, where the output growth forecasts for 1993 attributed to the Vienna Institute for Comparative Economic Studies (WIIW) were their forecasts for 1994. We apologise to the WIIW and are glad to publish the correct figures in Table 11.7.

² Due to methodological, administrative and political measurement problems, some of which we discuss below, the actual outturns are estimates, too. They vary over time and across different sources. The estimates for the 1993 outturns which we use here are taken from our own database. The original sources, with few exceptions, are publications from the national authorities, the International Monetary Fund, the World Bank, OECD, PlanEcon and the Institute of International Finance.

³ The *average error* represents a measure of the bias of the forecasts. The *average error* in PlanEcon’s forecasts points to a small overestimation (-0.7) for eastern Europe and the Baltics, but this is due to a considerable overestimation of growth in the Baltics. Growth in eastern Europe excluding the Baltics was underestimated.

⁴ The *average absolute error* is defined as the mean of the absolute value of the differences between forecasts and outturns across all countries and all forecasters. It represents a measure of the dispersion of forecasts around actuals.

Table 11.1 GDP growth in 1993
(in per cent) ¹

<i>Eastern Europe and the Baltic states</i>																
	Actual ²	PlanEcon forecast	PlanEcon error ³	Vienna Institute forecast	Vienna Institute error ³	OECD forecast	OECD error ³	EU forecast	EU error ³	UN forecast	UN error ³	JP Morgan forecast	JP Morgan error ³	Average absolute error ⁴	Average error ⁵	Range of forecasts ⁶
Albania	11	3.0	8.0											8.0	8.0	
Bulgaria	-4.2	-4.6	0.4	-7	2.8	-4	-0.2	-6	1.8	-8	3.8			1.8	1.7	4.0
Croatia	-3.2			-10	6.8									6.8	6.8	
Czech Republic	-0.3	-1.3	1.0	-3	2.7	0	-0.3					0.5	-0.8	1.2	0.7	3.5
Estonia	-7.8	-4.4	-3.4	6	-13.8									8.6	-8.6	10.4
Hungary	-2.3	1.7	-4.0	-1	-1.3	0	-2.3	0	-2.3	0	-2.3	-0.5	-1.8	2.3	-2.3	2.7
Latvia	-11.7	-4.3	-7.4											7.4	-7.4	
Lithuania	-16.2	-7.1	-9.1											9.1	-9.1	
Poland	3.8	5.0	-1.2	2	1.8	2	1.8	2	1.8	2	1.8	1.9	1.9	1.7	1.3	3.1
Romania	1	-5.1	6.1	-8	9.0	-9	10.0	-6	7.0	-6	7.0			7.8	7.8	3.9
Slovak Republic	-4.1	-7.2	3.1	-6	1.9	-7	2.9							2.6	2.6	1.2
Slovenia	1	1.5	-0.5	-1	2.0									1.3	0.8	2.5
<i>Average absolute error</i>			4.0		4.7		2.9		3.2		3.7		1.5	3.7		3.9
<i>Average error</i>			-0.6		1.3		2.0		2.1		2.6		-0.2		1.0	
<i>Commonwealth of Independent States</i>																
Armenia	-20	-9.4	-10.6											10.6	-10.6	
Azerbaijan	-13	-13.4	0.4											0.4	0.4	
Belarus	-11.6	-14	2.4	-14	2.4									2.4	2.4	0.0
Georgia ⁷	-40	-10.2	-29.8											29.8	-29.8	
Kazakhstan	-12	-16.1	4.1	-14	2.0									3.1	3.1	2.1
Kyrgyzstan	-17	-15	-2.0											2.0	-2.0	
Moldova	-14	-7.7	-6.3											6.3	-6.3	
Russia	-12	-10.9	-1.1	-15	3.0									2.1	1.0	4.1
Tajikistan ⁷	-28	-17.7	-10.3											10.3	-10.3	
Turkmenistan	-8	-8.7	0.7											0.7	0.7	
Ukraine	-14	-13.9	-0.0	-12	-2.0									1.1	-1.1	1.9
Uzbekistan	1	-9.6	10.6											10.6	10.6	
<i>Average absolute error</i>			6.5		2.4									5.5		2.0
<i>Average error</i>			-3.5		1.4										-2.3	
<i>Former Soviet Union (CIS plus the Baltic states)</i>																
	Actual ²	PlanEcon forecast	PlanEcon error ³	Vienna Institute forecast	Vienna Institute error ³	World Bank forecast	World Bank error ³	IMF forecast	IMF error ³	UN forecast	UN error ³			Average absolute error ⁴	Average error ⁵	Range of forecasts ⁶
Former Soviet Union	-12.4	-11.7	-0.7	-14	1.6	-5	-7.4	-12.0	-0.4	-14.0	1.6			2.3	-1.1	9.0

¹ All forecasts in this table were published or reported to EBRD in June/July 1993.

² Here "actuals" represent the most recent official estimates of outturns in 1993, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance, except in the case of Turkmenistan for which the 1993 "actual" is an EBRD estimate.

³ What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

⁴ The number at the bottom of this column is calculated as the mean of all the absolute values of the errors shown in this table (i.e. it is not a simple average of the errors in this column).

⁵ The number at the bottom of this column is calculated as the mean of all the errors shown in this table (i.e. it is not a simple average of the errors in this column).

⁶ For the countries where more than one forecast is available, this column shows the difference between the highest and the lowest of the forecasts.

⁷ For Georgia and Tajikistan, "forecasts" and "actuals" refer to growth in real NMP rather than growth in real GDP.

Table 11.2 Inflation in 1993
(change in the average consumer price level in per cent) ¹

Table 11.2 Inflation in 1993 (change in the average consumer price level in per cent) ¹										Eastern Europe and the Baltic states				
	Actual ²	PlanEcon forecast	PlanEcon error ³	Vienna Institute forecast	Vienna Institute error ³	OECD forecast	OECD error ³	EU forecast	EU error ³	UN forecast	UN error ³	Average absolute error	Average error	Range of forecasts
Albania	85	120.0	-35.0									35.0	-35.0	
Bulgaria	72.8	50.0	22.8	90	-17.2	90	-17.2	58	14.8	97	-24.2	19.2	-4.2	47.0
Czech Republic	20.8	11.5	9.3	15	5.8	16	4.8					4.0	6.6	4.5
Hungary	22.5	19.0	3.5	20	2.5	21	1.5	15	7.5	12	10.5	5.1	5.1	9.0
Poland	35.3	35.0	0.3	43	-7.7	40	-4.7	32	3.3	36	-0.7	3.3	-1.9	11.0
Romania	256.1	180.0	76.1	210	46.1	165	91.1	90	166.1	101	155.1	106.9	106.9	120.0
Slovak Republic	23	30.0	-7.0	24	-1.0	20	3					3.7	-1.7	10.0
Slovenia	32.3	30.0	2.3	61	-28.7							15.5	-13.2	31.0
Commonwealth of Independent States														
Belarus	1,188			1,000	188							188	188	
Kazakhstan	1,517			1,000	517							517	517	
Russia	896	773	123	1,000	-104					241	655	294	225	759
Ukraine	4,735			1,200	3,535							3,535	3,535	

¹ All forecasts in this table were published or reported to EBRD in June/July 1993.

² Here "actuals" represent the most recent official estimates of outturns in 1993, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance, except in the case of Turkmenistan for which the 1993 "actual" is an EBRD estimate.

³ What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

Table 11.3 Unemployment 1993
(in per cent of the labour force, end-year) ¹

<i>Eastern Europe and the Baltic states</i>										
	Actual ²	PlanEcon forecast	PlanEcon error ³	OECD forecast	OECD error ³	EU forecast	EU error ³	Average absolute error ⁴	Average error ⁵	Range of forecasts ⁶
Albania	17.5	15.0	2.5					2.5	2.5	
Bulgaria	16.4	16.6	-0.2	16	0.4	14	2.4	1.0	0.9	2.6
Czech Republic	3.5	5.8	-2.3	6	-2.5			2.4	-2.4	0.2
Hungary	12.1	13.9	-1.8	17	-4.9	15	-2.9	4.8	-3.2	3.1
Poland	15.7	14.9	0.8	17	-1.3	16	-0.3	1.2	-0.3	2.1
Romania	10.2	13.0	-2.8	14	-3.8			3.3	-3.3	1.0
Slovak Republic	14.4	15.0	-0.6	17	-2.6			1.6	-1.6	2.0
Slovenia	14.5	14.5	0.0					0.0	0.0	
<i>Average absolute error</i>			1.4		2.6		1.9	1.9		1.8
<i>Average error</i>			-0.6		-2.5		-0.3		-1.2	

¹ All forecasts in this table were published or reported to EBRD in June/July 1993.

² Here "actuals" represent the most recent official estimates of outturns in 1993, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.

³ What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

⁴ The number at the bottom of this column is calculated as the mean of all the absolute values of the errors shown in this table (i.e. it is not a simple average of the errors in this column).

⁵ The number at the bottom of this column is calculated as the mean of all the errors shown in this table (i.e. it is not a simple average of the errors in this column).

⁶ For the countries where more than one forecast is available, this column shows the difference between the highest and the lowest of the forecasts.

For unemployment, relatively few forecasts are available. This probably reflects a low demand for such forecasts. In the preparation of our 1993 publication we were able to identify unemployment forecasts only from PlanEcon, the OECD and the European Commission. Table 11.3 shows that unemployment in eastern Europe has risen slightly less than expected by these institutions, particularly in Romania and Hungary.

The accuracy of forecasts from different institutions

The data we have compiled allow us also to make a comparison across forecasting institutions. This is carried out in Tables 11.4-11.7 which show the errors made on forecasts for Bulgaria, Hungary, Poland and Romania (these countries are referred to below as EE4). It should be noted that the comparison presented in this section is based on very limited information, namely that conveyed by forecasts and outturns for only one year. Well founded comparisons, based on a statistically adequate set of

Table 11.4 Comparison of growth forecasts for EE4

Institution	PlanEcon	Vienna	OECD	EU	UN
Average absolute error	2.9	3.7	3.6	3.2	3.7
Average error	0.3	3.1	2.3	2.1	2.6

Table 11.5 Comparison of growth forecasts for EE3

Institution	PlanEcon	Vienna	OECD	EU	UN
Average absolute error	1.9	2.0	1.4	2.0	2.6
Average error	-1.6	1.1	-0.2	0.4	1.1

observations, will become feasible only several years from now. Readers are encouraged to interpret the results below as tentative evidence on which improvements may be expected in future years.

The measures computed in Table 11.4 point to PlanEcon's growth forecasts as the best in terms of precision and bias. PlanEcon was considerably more optimistic than the other institutions and underestimated the (unweighted) average growth rate by only 0.3 percentage points.

However, these data are heavily influenced by large errors (representing under-estimation) on all forecasters' predictions for Romania. When the sample is reduced to observations for Bulgaria, Hungary and Poland (EE3), the comparison looks as shown in Table 11.5.

For these three countries, the OECD's forecasts were clearly the most accurate. An equivalent comparison based on observations for the Czech Republic, Hungary and Poland would rank growth forecasts from the OECD and JP Morgan above those from PlanEcon and the Vienna Institute. The EU and UN, which continued during the first half of 1993 to make predictions for the CSFR rather than for the two newly independent successor states, cannot be included in this comparison.

Table 11.6 shows a similar comparison with respect to inflation. All forecasters underestimated the (unweighted) average inflation rate in the EE4 group of countries. The Vienna Institute provided the most accurate forecasts, with a bias of 6 percentage points and an average absolute error of 18 percentage points.

The result in Table 11.6 is largely driven by the generally unforeseen developments in Romania. We therefore show in Table 11.7 the comparison of inflation forecasts for the EE3 group of countries which excludes Romania. On this basis, no clear ranking emerges; for all forecasters, the average absolute error falls within the range of 8-12 percentage points.

Table 11.6 Comparison of inflation forecasts for EE4

Institution	PlanEcon	Vienna	OECD	EU	UN
Average absolute error	26	18	29	48	48
Average error	26	6	18	48	35

Table 11.7 Comparison of inflation forecasts for EE3

Institution	PlanEcon	Vienna	OECD	EU	UN
Average absolute error	9	9	8	9	12
Average error	9	-8	-7	9	-5

11.2 Prospects

Short term – 1994

Table 11.8 shows updated forecasts for 1994 (as published or reported to the EBRD in June/July/August 1994). The forecasts from all institutions included in this table, as well as in the EBRD forecasts presented in Appendix 10.1, are characterised by optimism concerning the growth potential of the economies in transition. Growth rates are generally expected to increase in 1994 by several percentage points compared with 1993. According to PlanEcon's forecasts, only Albania, Belarus, Turkmenistan, Ukraine and Uzbekistan will see the growth rate fall in 1994 (in Albania's case this still implies a very strong economic expansion). The EBRD forecasts add Azerbaijan and Romania to this group of countries.

The gap between growth rates in eastern Europe and the CIS is expected to widen. This is reflected in the contrast between an (unweighted) average growth forecast for 1994 of 3 per cent for east European and Baltic countries, and a negative 9 per cent for the CIS countries. For the CIS countries, the equivalent average weighted by the countries' GDP would be a substantially greater number as the average forecasts for the two largest CIS countries, Russia and Ukraine, are, respectively -11 per cent and -20 per cent. The Baltic states look set to match the significantly positive growth rates forecast for the most successful east European economies. The summary table in Appendix 10.1 includes weighted averages of the EBRD forecasts for growth in 1994 (using observations of national GDP as weights); growth is expected to increase for the group of countries in eastern Europe and the Baltic states from 1 per cent in 1993 to 3 per cent in 1994, and to fall marginally in the CIS from a negative 12 per cent in 1993 to a negative 13 per cent in 1994.

The forecasters tend to believe that in 1994 almost all east European and Baltic countries will be members of the club of "growth countries", which in 1993 included only Albania, Poland, Romania, Slovenia and Uzbekistan. On average, the east European and Baltic economies are

Table 11.8 GDP-Growth forecasts for 1994
(in per cent) ¹

<i>Eastern Europe and the Baltic states</i>																	
	PlanEcon forecast	PlanEcon exp ch ²	Vienna Institute forecast	Vienna Institute exp ch ²	OECD forecast	OECD exp ch ²	EU forecast	EU exp ch ²	UN forecast	UN exp ch ²	IMF forecast	IMF exp ch ²	JP Morgan forecast	JP Morgan exp ch ²	Average forecast ³	Average exp ch ⁴	Range of forecasts ⁵
Albania	9.6	-1.4													9.6	-1.4	
Bulgaria	1.4	5.6	-2	2.2	0	4.2	0.5	4.7	-0.4	3.8			-1.9	2.3	-0.4	4.5	3.4
Croatia			-3	0.2											-3.0	0.2	
Czech Republic ⁶	4.8	5.1	2	2.3	2	2.3	2.5	2.8			2.5	2.8	2.4	2.7	3.0	3.4	2.8
Estonia	5.9	13.7													5.9	13.7	
Hungary ⁶	5.5	7.8	2	4.3	1	3.3	2.0	4.3	0.0	2.3			0.4	2.7	2.0	4.7	5.5
Latvia	3.0	14.7													3.0	14.7	
Lithuania	1.7	17.9													1.7	17.9	
Poland ⁶	6.0	2.2	4	0.2	4	0.2	2.5	-1.3	4.2	0.4	4.5	0.7	4.5	0.7	4.8	0.5	3.5
Romania	3.8	2.8	-2	-3.0	0	-1.0	1.4	0.4	1.2	0.2					0.9	-0.3	5.8
Slovak Republic ⁶	3.9	8.0	2	6.1	0	4.1	-3.1	1.0			0	4.1			0.6	5.5	7.0
Slovenia	5.3	4.3	3	2.0											4.2	3.2	2.3
<i>Average</i>	4.6	7.3	0.8	1.8	1.2	2.2	1.0	2.0	1.3	1.7	2.3	2.5	1.4	2.1	2.7	5.5	4.3
<i>Commonwealth of Independent States ⁷</i>																	
Armenia	11.8	31.8													11.8	31.8	
Azerbaijan	-4.3	8.7													-4.3	8.7	
Belarus	-19.0	-7.4													-19.0	-7.4	
Georgia	-13.2	26.8													-13.2	26.8	
Kazakhstan	-11.5	0.5													-11.5	0.5	
Kyrgyzstan	-6.9	10.1													-6.9	10.1	
Moldova	-3.1	10.9													-3.1	10.9	
Russia	-11.2	0.8	-10	2	-10	2							-14	-2	-11.3	0.7	4.0
Tajikistan	-8.1	19.9													-8.1	19.9	
Turkmenistan	-11.5	-3.5													-11.5	-3.5	
Ukraine	-20.3	-6.3	-20	-6											-20.2	-6.2	0.3
Uzbekistan	-7.1	-8.1													-7.1	-8.1	
<i>Average</i>	-8.7	7.0	-15	-2	-10	2							-14	-2	-8.7	7.0	2.2

¹ All forecasts in this table were published or reported to EBRD in June/July/August 1994 (see also the references at the end of this chapter).

² "Exp ch" refers to the expected change in the forecasted variables measured in percentage points, i.e. it is calculated as the difference between the rate forecasted for 1994 and the actual rate in 1993.

³ The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

⁴ The number at the bottom of this column is calculated as the mean of all the expected changes shown in this column.

⁵ This column shows the difference between the highest and the lowest of the forecasts.

⁶ The IMF expects growth in central European countries in transition in aggregate of 1.8 per cent for 1994.

⁷ For the former Soviet Union as a whole (CIS plus the Baltic countries), growth in 1994 has been forecast by the UN at -9.3 per cent, by the World Bank at -7 per cent, and by the IMF at -9.8 per cent.

expected to increase their growth rates by 5-6 percentage points (see the items "exp ch" in Table 11.8).

All these forecasts should be interpreted with great caution. One reason for this is the relatively large errors produced last year. A second reason is the variability of the new predictions across forecasting institutions. The range of the forecasts (i.e. the difference between the most optimistic and the most pessimistic available forecast) may be taken as an indication of the expected reliability of the forecasts for a particular country. The increase in the average range for eastern Europe from 3.9 percentage points in 1993 (Table 11.1) to 4.3 in 1994 (Table 11.8) does not indicate any improvement in the reliability of the forecasts.

Taking the example of Poland, which was so successful in 1993, the growth forecasts range from 2.5 to 6 per cent (Table 11.8). A similar picture is found for most other countries. For Hungary, the forecasts range from 0 to 5.5

per cent. This variation is remarkable, considering that these are short-term forecasts made in the spring of 1994 for the same year.

The 1994 forecasts of unemployment show an expected increase of more than 2 percentage points, on average (see Table 11.9). Especially in the Baltic states, unemployment could become a destabilising factor if the predicted sharp increase materialises. Hungary is the only country expected to see its unemployment rate fall. As noted in Chapter 10, this expectation for Hungary reflects to a large degree revisions to eligibility rules for unemployment benefits.

Optimism is evident in the short-term inflation forecasts (see Table 11.10). All countries in eastern Europe are expected to see a decline in their inflation rates. However, no country (with the possible exception of the Czech Republic) is expected to come close to price stability.

Table 11.9 Unemployment forecasts for 1994
(in per cent of the labour force, end-year) ¹

	<i>Eastern Europe and the Baltic states</i>									
	PlanEcon forecast	PlanEcon exp ch ²	Vienna Institute forecast	Vienna Institute exp ch ²	OECD forecast	OECD exp ch ²	EU forecast	EU exp ch ²	Average forecast ³	Range of forecasts ⁵
Albania	17.6	0.1							17.6	0.1
Bulgaria	16.3	-0.1	18	1.6	17	0.6	15.8	-0.6	16.8	0.4
Czech Republic	4.2	0.7	4	0.5	5	1.5	5.5	2.0	4.7	1.2
Estonia	5.0	2.4							5.0	2.4
Hungary	11.1	-1.0	12	-0.1	11	-1.1	12.6	0.5	11.7	-0.4
Latvia	9.5	4.2							9.5	4.2
Lithuania	4.0	2.6							4.0	2.6
Poland	16.1	0.4	17	1.3	16	0.3	16.8	1.1	16.5	0.8
Romania	14.3	4.1	12	1.8	13	2.8	16.1	5.9	13.9	3.7
Slovak Republic	15.6	1.2	16	1.6	16	1.6	14.0	-0.4	15.4	1.0
Slovenia	14.4	-0.1	15	0.5					14.7	0.2
Average	11.6	1.3	13.4	1.0	13.0	1.0	13.5	1.4	11.8	1.5
<i>Commonwealth of Independent States</i>										
Russia	3.5	2.4	3	1.9					3.3	2.4
Ukraine	4.5	4.1	2	1.6					4.5	4.1
Average	4.0	3.3	2.5	1.8					3.9	3.3

¹ All forecasts in this table were published or reported to EBRD in June/July/August 1994 (see also the list of references at the end of this chapter).

² "Exp ch" refers to the expected change in the forecasted variables measured in percentage points, i.e. it is calculated as the difference between the rate forecasted for 1994 and the actual rate in 1993.

³ The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

⁴ The number at the bottom of this column is calculated as the mean of all the expected changes shown in this column.

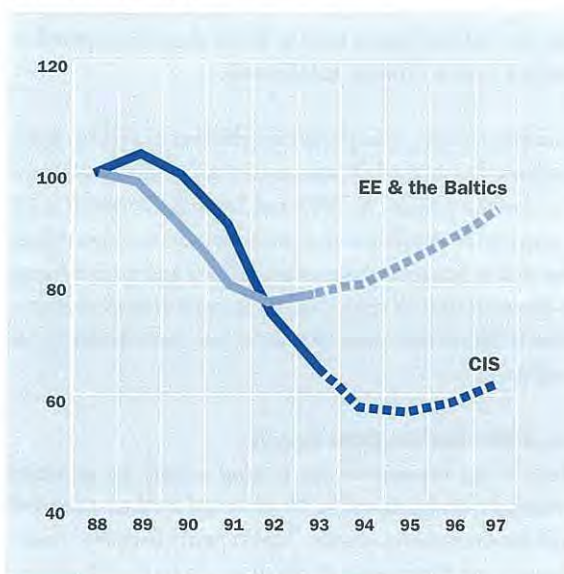
⁵ This column shows the difference between the highest and the lowest of the forecasts.

The medium term – 1995-98

Available predictions for 1995 (see Tables 11.11 and 11.12) and PlanEcon's forecasts for the years to 1998 (as presented in their half-yearly publications) suggest a continued divergence of growth paths in the medium term. PlanEcon expects growth in eastern Europe and the Baltic states to be around 4.5-6 per cent per annum starting in 1994 but foresees further stagnation/declines in Russia and Ukraine in 1994-95. This is broadly consistent with the IMF's expectation. PlanEcon expects a rebound in Russia from 1996 onwards, with growth rates of 5-6 per cent per annum; they expect an equivalent pick-up in Ukraine, beginning in 1997.

The widening of the gap between the output levels in eastern Europe and the Baltic states on the one side, and the CIS on the other side in 1994-95 is depicted in Chart 11.1. The forecasts imply that eastern Europe will achieve its pre-reform production levels by 1997 whereas the CIS will fail to reach pre-reform levels of output for a long time. However the Chart assumes that the decline in CIS-output between 1988 and 1993 is measured accurately by official statistics. In reality the decline may well, as noted in Chapter 10, have been substantially smaller than these statistics would indicate.

Table 11.13 quotes inflation forecasts for 1995. It reflects the same dichotomy as the growth forecasts, with price stabilisation being more advanced in eastern Europe and

Chart 11.1: Development in real GDP 1988-97
(index: 1988=100) ¹

¹ The figures used for 1988-93 are from the EBRD's internal database and are consistent with the numbers presented in Appendix 10.1. The weights used to aggregate country-specific observations were national estimates of 1992-GDP at average exchange rates prevailing in 1992. The figures used in the chart for 1994 represent the EBRD's forecasts (as reflected in the summary table in Appendix 10.1). Data used in the chart for the period 1995-97 represent a rough approximation of the scenario foreseen by PlanEcon; the chart assigns to eastern Europe 5 per cent growth in each year of this period, and to CIS -1 per cent in 1995, +3 per cent in 1996 and +5 per cent in 1997.

Table 11.10 Inflation forecasts for 1994¹

<i>Eastern Europe and the Baltic states</i>																
	Actual 1993 ²	PlanEcon forecast	PlanEcon exp ch ³	Vienna Institute forecast	Vienna Institute exp ch ³	OECD forecast	OECD exp ch ³	EU forecast	EU exp ch ³	UN forecast	UN exp ch ³	IMF forecast	IMF exp ch	Average forecast ⁴	Average exp ch ⁵	Range of forecasts ⁶
Albania	85	28	-57											28	-57	
Bulgaria	73	89	16	80	7	75	2	65	-8	52	-21			72	-0	37
Czech Republic	21	9	-12	10	-11	11	-10	10	-11	9	-12	10	-11	10	-11	2
Estonia	90	46	-44											46	-44	
Hungary	23	16	-7	22	-1	19	-4	18	-5	20	-3			19	-4	6
Latvia	109	35	-74											35	-74	
Lithuania	390	70	-320											70	-320	
Poland	35	28	-7	30	-5	30	-5	27	-8	24	-11	27	-8	26	-7	6
Romania	256	140	-116	180	-76	170	-86	150	-106	120	-136			152	-104	60
Slovak Republic	23	14	-9	16	-7	16	-7	17	-6			14	-9	15	-8	3
Slovenia	32	19	-13	20	-12									20	-13	1
<i>Average</i>	103													45	-58	16
<i>Commonwealth of Independent States⁷</i>																
Russia	896	310	-586	300	-596	450	-446							353	-543	150
Ukraine	4,735	813	-3,922	700	-4,035									757	-3,979	113

¹ All forecasts in this table were published or reported to EBRD in June/July/August 1994.

² Here "actuals" represent the most recent official estimates of outturns for 1993, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon, and the Institute of International Finance.

³ "Exp ch" refers to the expected change in the forecasted variables, measured in percentage points, i.e. it is calculated as the difference between the rate forecasted for 1994 and the actual for 1993.

⁴ The number at the bottom of this column is the mean of the average forecasts in the column.

⁵ The number at the bottom of this column is the mean of expected changes shown in this column.

⁶ This column shows the difference between the highest and the lowest of the forecasts.

⁷ The IMF forecasts inflation for the former Soviet Union as a whole at 457 per cent in 1994.

the Baltics than in the CIS countries. This is reflected in average expected inflation rates for 1995 of around 23 per cent for eastern Europe and the Baltic states, as opposed to 268 per cent for Russia and Ukraine.

In order to derive a projection for inflation in 1995 or later, the forecaster not only has to predict the economic changes but also the policies in 1995 and beyond. Clearly, it is an extremely demanding task to make predictions more than one year in advance of monetary policies and price reforms in the countries in transition. This implies that medium-term inflation forecasts have to be interpreted with great caution.

11.3 Methodological issues

Most of the forecasters are relying mainly on informal techniques and judgement. More formal methods are used only for consistency checks. This is partly because econometrics and time-series methods are inapplicable where radical changes in structure, ownership, behaviour and statistical reporting effectively destroy the relevance of historical data for projections of the future. A more formalised approach to forecasting will only be applicable when long post-reform time-series begin to emerge.

Forecasting errors of the order of magnitude shown above might suggest that range forecasts would be preferable to the point forecasts that are reported by all institutions

included in this survey (as well as by the EBRD in the country tables in Chapter 10). It may not seem meaningful to announce a growth forecast of, say, 1.3 per cent when the average projection error exceeds 4 percentage points. A range forecast or a central projection accompanied by a confidence interval could be used to indicate the reliability attached by the forecaster to each prediction and would help users make a macroeconomic risk assessment. Evaluations of macroeconomic risks are clearly of great importance for both investment and policy decisions and should ideally form part of the forecasts.

However, there are also costs associated with range forecasts. Most importantly, deriving country-specific confidence intervals for the forecasts requires either a long historical track record of forecasting errors or an in-depth knowledge of the methodology which underlies national statistics. In addition, the use of ranges, together with the forecasters' explanations of them, would add to the amount of information which the user would have to digest.

Table 11.1 indicates a relatively good forecasting accuracy for countries where price stabilisation and market-oriented transition are well entrenched, where the bulk of associated structural shocks are events of the past, and where progress on statistical methodology is comparatively advanced. In particular, the errors on growth forecasts for the Czech Republic, Poland and Slovenia were relatively small. It

Table 11.11 GDP growth in 1995
(in per cent) ¹*Eastern Europe and the Baltic states*

	PlanEcon forecast	Vienna Institute forecast	OECD forecast	EU forecast	UN forecast	JP Morgan forecast	Average forecast ²	Range of forecasts ³
Albania	8.1						8.1	
Bulgaria	5.4	-1	0	1.5	0.4	0.2	1.1	6.4
Czech Republic ⁴	6.3	3	5	4.0		4.4	4.5	3.3
Estonia	7.3						7.3	
Hungary ⁴	6.1	1	2	3.0	2.5	0.6	2.5	5.5
Latvia	7.2						7.2	
Lithuania	4.9						4.9	
Poland ⁴	5.4	4	3	2.5	4.1	4.7	4.0	2.9
Romania	5.0	0	1	2.1	1.1		1.8	5.0
Slovak Republic ⁴	3.3	1	2	1.0			1.8	2.3
Slovenia	5.3	4					4.7	1.3
Average	5.8	1.7	2.2	2.4	2.0	2.5	4.4	3.8

Commonwealth of Independent States ⁵

Russia	0.6	-5	-2			-8	-3.6	8.6
Ukraine	-4.9	-5					-5.0	0.0
Average	-2.2	-5	-2			-8	-4.3	4.4

¹ All forecasts quoted here were published or reported to EBRD in June/July/August 1994.

² The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

³ This column shows the difference between the highest and the lowest of the forecasts.

⁴ Aggregate growth in central European countries in transition in 1995 has been forecast by the IMF at 3.5 per cent.

⁵ Growth in the former Soviet Union as a whole in 1995 has been forecast by the IMF and the World Bank at, respectively, 0.4 per cent and -2 per cent.

Table 11.12 Unemployment forecasts for 1995
(in per cent of the labour
force, end-year) ¹*Eastern Europe and the Baltic States*

	PlanEcon forecast	Vienna Institute forecast	OECD forecast	EU forecast	Average forecast ²	Range of forecasts ³
Albania	15.8				15.8	
Bulgaria	14.7	19	17	14.7	16.4	4.3
Czech Republic	5.2	5	7	5.7	5.7	2.0
Estonia	8.0				8.0	
Hungary	9.7	12	11	12.6	11.3	2.9
Latvia	13.0				13.0	
Lithuania	9.0				9.0	
Poland	15.8	20	15	16.5	16.8	5.0
Romania	12.8	14	15	18.6	15.1	5.8
Slovak Republic	14.4	16	16	13.1	14.9	2.9
Slovenia	13.0				13.0	
Average	11.9	14.3	13.5	13.5	12.6	3.8

Commonwealth of Independent States

Russia	9.0	4			6.5	5.0
Ukraine	12.5				12.5	
Average	10.8	4			9.5	5.0

¹ All forecasts listed here were published or reported to EBRD in June/July/August 1994 (see also the list of references at the end of this chapter).

² The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

³ This column shows the difference between the highest and the lowest of the forecasts.

Table 11. 13 Inflation forecasts for 1995
(change in the average consumer price level, in per cent) ¹

	PlanEcon forecast ²	Vienna Institute forecast	OECD forecast	EU forecast	UN forecast	JP Morgan forecast ²	Average forecast ³	Range of forecasts ⁴
<i>Eastern Europe and the Baltic states</i>								
Albania	16						16.0	
Bulgaria	67	60	40	23.8	39	35.0	44.1	43.2
Czech Republic ⁵	6.0	10	10	10.0		8.0	8.8	4.0
Estonia	15.0						15.0	
Hungary ⁵	13.6	20	17	15.0	15	20.5	16.9	6.9
Latvia	15.0						15.0	
Lithuania	30.0						30.0	
Poland ⁵	25.0	25	25	20.0	19	22.0	22.7	6.0
Romania	50	100	80	40.0	23		58.6	77.0
Slovak Republic ⁵	10	10	15	15.0			12.5	5.0
Slovenia	14	14					14.0	0.0
<i>Average</i>	23.8	34.1	31.2	20.6	24.0	21.4	23.1	20.3
<i>Commonwealth of Independent States ⁶</i>								
Russia	111	300	150			230	198	150
Ukraine	175	500					337.5	100
<i>Average</i>	143	400	150			230	268	125

¹ All forecasts listed here were published or reported to EBRD in June/July/August 1994.

² J P Morgan's forecasts refer to end-year inflation (i.e. the change in the price index from December to December).

³ The number at the bottom of this column refers to the mean of the average forecasts shown in the column.

⁴ This column shows the difference between the highest and the lowest of the forecasts.

⁵ Aggregate inflation for central European countries in transition for 1995 has been forecast by the IMF at 53.7 per cent.

⁶ Aggregate inflation for the former Soviet Union (CIS plus the Baltic countries) for 1995 has been forecast by the IMF at 83.2 per cent.

could be argued that this type of information could form the basis for country-specific confidence intervals. However, the advocate of this point of view would have to argue that equally small errors for Azerbaijan, Russia, Turkmenistan and the Ukraine were flukes that will not be repeated in subsequent years.

Another difficulty relates to the fact that estimates of outturns for past years change over time. The main original source of data on outturns for a particular country is the government or the central bank of that country. Governments in many transition economies are gradually adapting their statistical systems to a more market-oriented environment (this issue is explored in greater detail in Appendix 11.1). As a result, measured outturns for all the variables discussed above keep varying over time. In many cases, government statisticians continue to revise data for a particular year several years after completion of the period.

This must lead the forecasters to question which concept they are trying to forecast. Is it the "official outturn", or is it the forecasters' own estimates of the outturn? For purists it may be tempting to argue in favour of forecasting "what

will really happen" as opposed to "what will be captured in a soon-to-be-available official estimate". In practice, however, this is rarely done. Even forecasters who believe that the unrecorded shadow economy accounts for a substantial fraction of GDP will not attempt to take into account this judgement when they make their forecasts. Typically, the accuracy of forecasts is judged by the users soon after the events to which they relate, and this puts pressure on the forecasters to "get close to the official government view". Public sector institutions among the forecasters may also be subject to political pressure to limit the differences between their forecasts and projections prepared by the national authorities as the latter are, in many cases, shareholders and/or important customers of these institutions.

Questions about what is really the phenomenon that is being measured further complicates the use of forecasts in general and of range forecasts in particular. If the real objective of forecasters is to predict what will, at some future point, be the estimate sanctioned by national authorities, then particularly broad confidence intervals might be needed for those countries that are making the

greatest progress in their statistical methodology. This might erroneously convey the impression to the user that, in these countries, data are particularly unreliable and macroeconomic risks severe.

Clearly, many of the methodological problems we have discussed here apply also to the macroeconomic measurement and forecasting in Western countries. What this chapter has shown, however, is that the measurement and forecasting errors, as well as the underlying political and economic uncertainties, are of a much greater order of magnitude in transition economies than in well-entrenched market economies.

References:

Note that in addition to the references listed below we have relied on extensive communication by fax with some of the forecasting institutions quoted in this chapter.

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Wissels, Rutger (1994), *Prospects for Growth in Eastern Europe* (the author is Deputy Head of Unit for Eastern Europe, Directorate-General for Economic and Financial Affairs, European Commission, Brussels), Working Paper no. 15 (ed. E. Hochreiter), Oesterreichische Nationalbank, March 1994.

Appendix 11.1. Are growth estimates for eastern Europe too pessimistic?

Introduction

Most countries in eastern Europe have begun to improve the quality of production statistics by broadening the coverage of economic activity in new enterprises. Recent analyses of small-scale activity in Hungary and Poland point to a need to increase substantially official estimates of GDP-growth for the past four years.¹ Official GDP series do not yet incorporate these results but are likely to do so within the next few years.

However, very little has been done in eastern Europe to use information on consumption and investment to improve the quality of GDP-estimates. Noting the widening gaps in the Czech Republic, Hungary and Poland between estimates of production on the one side and of the use of goods and services on the other, this appendix argues that the official GDP estimates should be modified to incorporate information conveyed by indicators of domestic expenditure. This modification would substantially alter the estimated growth pattern.

What would happen to growth estimates for eastern Europe if output-based series were adjusted to account fully for small-scale private activity, and thereafter combined with currently available data on consumption, fixed investment and the foreign balance to produce a “compromise” series of real GDP estimates? In the sections below a numerical experiment indicates (very tentatively) for Hungary that the resulting revision to growth in real GDP would be negative for 1993 and positive for 1991-92. A similar mixed picture emerges for Poland. In the case of the Czech Republic, statistical-methodological improvements would be likely to produce substantial increases in recorded growth rates for the entire period of market-oriented transition.

Widening statistical discrepancies

Most statistical offices in Europe collect primary data on production, absorption and income from tax and customs offices and from surveys among producers and consumers. Primary data are subject to stochastic errors. As a result, the “initial estimates” of items in the national accounts will often violate definitional identities. In the initial rounds of estimation, the measure of “aggregate supply” (represented by the sum of imports and domestically generated value added) usually differs from “aggregate demand” (represented by the sum of consumption, fixed investment, stock-building and exports) although the “true” values of the two concepts are by definition identical.

While initial discrepancies of this nature are inevitable in all countries that are sophisticated enough to produce

independent estimates for output and expenditure, their magnitude appears to be particularly great in eastern Europe. Statisticians in Hungary and Poland are finding it increasingly difficult to identify the uses of recorded increases in production and imports. Their colleagues in the Czech Republic are struggling to find the output and inflows of goods from abroad that appear to have allowed absorption to rise. Published versions of the national accounts for these countries bury statistical discrepancies in the items for “stock-building”, which have therefore shown implausibly sharp fluctuations in recent years.

In principle, GDP can be measured not only on the basis of data on production and absorption but also as the sum of wages and profits. However, in most countries in eastern Europe statistics on profits are weak. In others, including Hungary, data on wages and profits are used (together with banking data on financial savings) to establish a national accounts estimate of consumption. In the latter case, data on wages and profits fail to provide an independent check on the production-based estimate of GDP. They may instead be viewed as part of the statistical material that is used to establish absorption data which may indeed be used to check the reliability of the production-based GDP-estimates.

Given the inconsistencies between data on production and absorption, which data series should the user of the national accounts trust? One possibility is to trust estimates for production and the foreign balance and ignore observations of domestic absorption, the precision of which is generally perceived to be inferior. This practice is followed by the governments in eastern Europe and by international agencies that are active in the region. This practice is unsatisfactory. Indicators of expenditure must be presumed to convey some usable information about underlying trends – otherwise it would make little sense for the statistical agencies to go through the effort to produce them in the first place. To the extent that they are seriously defective, it would make good sense for governments and foreign providers of technical assistance to give priority to solving this problem. The availability of good indicators for consumption and investment would strengthen the scope for consistency checks on output-based GDP-estimates and provide knowledge about the final destination of national production. The latter is crucial to policy makers.

How should estimates of output and expenditure be combined to produce “compromise data”?

The famous economist Richard Stone argued for decades that the information value contained in accounting identities should be fully utilised. It follows from Stone’s line of thinking that maximum statistical use should be

¹ See Arvey and Vertes (1994) and the Polish Centre for Economic and Statistical Studies (1993).

made of the definitional equality of production on the one side and domestic expenditure plus the foreign balance on the other, combined with the availability of separate output- and expenditure-based estimates for value added.

The essence of Stone's argument is captured in the following quotation: "Data are always incomplete and rarely consistent; different bodies of statistics are often collected by a variety of agencies which do not all make use of an agreed set of definitions and classifications; different methods of collection give rise to sampling and other errors of many kinds. In such a situation, an intimate knowledge of the available statistics is not enough; a strategy and a certain amount of courage are also needed. The strategy is required in order to extract the best possible quantitative description of the economy from the statistical data available. Of course there may be so few data and what there are may be of such poor quality that very little can be done; but that is not the usual case and much is lost if we are not willing to compare statistics from different sources and adjust them so as to bring about a consistent and therefore usable description of the economic process. The courage is required because the methods that must be adopted run counter to the statistician's ingrained dislike of tampering with basic data even when it is obvious that not all these data can be correct".²

As mentioned above, many statistical agencies in eastern Europe balance their national accounts by assigning to stock-building whatever value is required to equate the estimate of production plus imports to the estimated sum of exports and domestic demand (including stock-building). This is arguably worse than publishing unbalanced national accounts – it conveys the erroneous impression that all available information has been used to establish the best possible estimate of every item in the accounts. In practice this procedure sometimes generates absurd estimates for stock-building (up to +/- 10 per cent of GDP).

What would be the preferred solution? Ideally, statisticians with intimate knowledge of procedures underlying the primary data should first eliminate from initial estimates all presumed systematic biases. As an integral part of this process the statisticians should settle for a realistic initial estimate for stock-building. Given the experience in other countries, 0-1/2 per cent of the preceding year's GDP might in most cases be a sensible initial estimate for stock-building in the absence of direct observations.³ Annual

data for 1983-92 on the ratio between stock-building and GNP in France, Germany, Japan, United Kingdom and United States of America include only two observations in excess of 1 per cent, namely 1.1 per cent for the UK in 1988 and 2.1 per cent for the USA in 1984.⁴

After "de-biasing" the estimates, the next step is to ensure compliance with the relevant accounting identities. To do this properly, the statisticians must first assess the relative reliability of the initial estimates. To the extent the accounting constraints allow it, most of the required adjustment should be borne by the least reliable initial estimates. A possible measure of relative reliability is a set of "error variances" which the statisticians can derive from their subjective stipulation of 95 per cent confidence-intervals for each of the initial estimates (the procedure is illustrated numerically in the example below). For stock-building, the confidence interval should be confined to a range that is consistent with international experience (such as the 0-1/2 per cent of GDP suggested above). Champenowne, Meade and Stone recommended, as far back as in 1942, that information conveyed by error variances⁵ and initial estimates be combined to produce a balanced set of accounts using the principles of generalised least squares estimation.⁶

Estimates of GDP from the output side

Market-oriented transition has weakened the ability of statistical agencies in eastern Europe to monitor output developments. Until the transition began, production statistics were based on information from the largest state-owned companies. The devolution over the past four years of economic activity to myriad smaller, often private entities has forced a switch towards more cumbersome survey-based methods of data collection, similar to those applied in the West. In parallel with this, eastern Europe's statistical agencies have gradually been phasing out, especially from 1989 onwards, the Material Product System (MPS) – the national accounting system that was applied by centrally planned economies and which excluded many services (in the so-called "non-material sphere") from the measure of value added.

Since 1992, all countries in eastern Europe have ceased to produce estimates of net material product, the MPS concept of value added. Focusing on the principles laid down in the UN System of National Accounts (SNA), most of the regions' statistical agencies have taken steps to

² Stone (1976), pp. 9-10.

³ In the Danish preliminary national accounts, the starting assumption, prior to the balancing process, is always that stock-building is zero (Bartholdy, 1987).

⁴ According to the International Monetary Fund's International Financial Statistics, 1993.

⁵ Ideally, covariances between errors on initial estimates should also be taken into account. However, in practice little tends to be known about the relative magnitudes of covariances. Error covariances have been ignored in most practical cases in which the generalised least squares approach has been used to balance social/national accounting matrices.

⁶ Their proposal was presented in Champenowne, Meade and Stone (1942). See Bartholdy (1987) for a concrete algorithm and a practical application.

improve their ability to monitor the growing private sector, notably service units, in order to be able to incorporate them fully in the SNA-concept of value added.⁷

One of the results of the gradual methodological change has been frequent, and sometimes massive, revisions to national accounts estimates. Among the more extreme cases of this was a change in 1992 to Bulgaria's national accounts which reduced the official estimate of the decline in real value added between 1989 and 1991 by about 12 percentage points.

Revisions of similar orders of magnitude may be forthcoming in Poland. According to estimates from the Polish Research Centre for Economic and Statistical Studies (1993), a more comprehensive treatment of new private entities would lower the measured decline in real GDP between 1988 and 1992 from the previously estimated 18-20 per cent to only 5-10 per cent.

Hungary's statistical office has made allowances in official GDP estimates for the growing private sector, including in the "hidden economy", but research by Arvay and Vertes (1994) indicates that adjustments made to date have been inadequate. Arvay (1994) puts the required cumulative (upward) revision to official estimates of real GDP growth for the period 1990-1992 at about 4 percentage points.

The Czech Republic, which has done less to explore this issue, might well be the east European country in which the negative bias in official estimates of GDP growth is greatest. Official data on changes between 1990 and 1992 point to a drop in real GDP of 21 per cent and a decline in employment in enterprises with more than 25 employees of 26 per cent. In the same period measured unemployment rose by less than 2 per cent of the labour force. The comparatively small rise in unemployment is due in part to the fact that staff representing up to 1-2 per cent of the labour force lost eligibility for benefits and were forced off the unemployment register (OECD 1994). But what happened to the remainder of newly redundant workers? It is possible that some found work abroad but hardly more than a few per cent of the labour force. The remainder may have found work in the informal sector – work which is yet to be reflected in the national accounts. The latter presumption is supported by information gathered by the EBRD on the methodology underlying the Czech national accounts. Interviews with statisticians in the Czech Central Statistical Office indicate that large inventory write-offs undertaken by companies over the past two years may have been recorded as negative stock-building on the expenditure side, matched on the output side by an entry of the

same magnitude under "use of inputs", i.e. an entry which would artificially reduce the estimate of value added.⁸

Another source of underestimation of growth in the Czech Republic is the use of 1984 as the base year for the national accounts. This results in a comparatively low weight being given to the most dynamic sectors in the economy.

Estimates of expenditure components

Unfortunately, indicators of expenditure fail to support the hypothesis that currently available data on production tend to underestimate growth in all the east European countries. In fact, expenditure data for Hungary and Poland point in the opposite direction. This is possibly in part because expenditure data suffer from a negative bias, reflecting (a) the gradual shift in retail trade away from long-established outlets that tend to constitute the population underlying retail trade surveys, as well as (b) rising investment by small enterprises the activities of which is difficult to monitor. Knowledge of these statistical problems is in fact used by statisticians in eastern Europe as a basis for adjusting upwards the national accounts estimates for consumption and investment. However, even after these adjustments, measured growth in domestic demand (excluding stock-building) falls short in both Poland and Hungary of the measured increase in supply to the domestic market (represented by domestic value added minus the net foreign balance). In both countries, the statisticians attribute the remaining large gap between measured supply and recorded demand to stock-building, although further efforts to reconcile the estimates might be more appropriate. More details on statistical discrepancies in Poland, Hungary and the Czech Republic are provided in the following subsections.

Poland

Difficulties in matching estimates of output and expenditure have been particularly noticeable in Poland, where the official output-based estimate of GDP-growth for 1993 has been put at 4 per cent. National accounts data released by the Polish Central Statistical Office in June 1994 put the contribution to GDP growth from the foreign balance at a negative 2½ percentage points. Thus the estimated growth in supply for the domestic market (domestic value added plus the foreign balance) was 6½ per cent of 1992-GDP. Regarding consumption, average nominal monthly per capita expenditure grew in households of employees by about 44 per cent and in households of retired persons and pensioners by 51 per cent in the first nine months of 1993 (compared with the same period of 1992)⁹ according to the Polish *Monthly Statistical Bulletin*. This would be consistent with a volume

⁷ A description of differences between the concepts of value added in MPS and SNA is included in Marer et al. (1992); this description is based on material from United Nations (1977 and 1981). Boote (1990) provides a good overview of issues pertaining to the production of statistics under central planning.

⁸ The Czech Central Statistical Office has confirmed in a letter to the EBRD that this treatment of stock write-offs may be pulling down the GDP growth estimates.

⁹ Source: *Monthly Statistical Bulletin*, Poland's Central Statistical Office, April 1994, p. 25.

increase of about 6 per cent for the former group and 11 per cent for the latter (using the consumer price index as deflator). Against this background, the national accounts estimate the growth in private consumption (which in 1992 represented 57 per cent of GDP) at 5½ per cent, absorbing about 3 percentage points of the estimated increase in real GDP. Public consumption is officially estimated to have risen by 3 per cent in real terms, which would absorb another ½ percentage point of the recorded growth in GDP. The Polish *Monthly Statistical Bulletin* points to an increase last year in nominal “investment outlays” of 10.6 per cent¹⁰ which corresponds to a decline in real terms of 16 per cent (after deflation by the producer price index). With investment accounting for about 17 per cent of GDP, this would represent a negative contribution to GDP-growth of almost 3 percentage points.

These developments in consumption and investment would leave supply for the domestic market equivalent to about 5½ per cent of GDP – i.e. more than the entire recorded growth in GDP – unaccounted for by recognisable developments in domestic demand components. One obvious contributor to the gap is that the quoted series on investment covers only large-scale enterprises. Aggregate investment, including outlays from small entities, is likely to have expanded more rapidly. Thus the most recent national accounts data put the real 1993-expansion in fixed investment at 3 per cent, despite the decline in recorded large-scale investment. This increase in capital outlays absorbs about ½ percentage point of the recorded GDP-growth (rather than the -3 percentage points estimated above) and reduces the unexplained gap between output and expenditure to about 2½ per cent of GDP. The June-release of national accounts data implicitly attributes this gap to stock-building. Both the estimate for stock-building and the assumed growth of investment in small enterprises appear at first sight implausibly large. There would appear to be a case here for the Polish statisticians to re-examine data for domestic production and the foreign balance instead of simply assigning statistical discrepancies to investment and stock-building. While some observers have indeed pointed to potential errors of measurement regarding the foreign balance, there appears to be great reluctance to use demand data as the basis for subjecting the output estimates to further scrutiny.¹¹

Hungary

Hungarian statistics are marred by similar problems. Preliminary national accounts for 1993 made available by the Hungarian Ministry of Finance in April 1994 (see Table 11.14) pointed to a decline in Hungarian real GDP of 2 per cent and a drop in the foreign balance of 9.7 per cent of GDP.¹² This implies an increase in real final domestic expenditure equivalent to 7.7 per cent of GDP. However, available expenditure indicators do little to support this picture. Measured retail trade at constant prices fell by ½ per cent, according to the Hungarian *Monthly Statistical Bulletin*. Taking into account a possible downward bias in these data due to under-recording of sales from informal outlets, and noting results of comparisons between data on personal income and financial savings,¹³ the national accounts statisticians put growth in private consumption at 2.5 per cent. The *Monthly Statistical Bulletin* points to an increase in nominal investment outlays of 17.5 per cent, which the national accounts statisticians have translated into a modest real increase of 1.3 per cent. Public consumption is thought to have grown by 2.5 per cent but has little weight in GDP. Thus there is little empirical evidence of a “demand-surge” to match the massive rise in supply which is indicated by data on production and trade. The preliminary national accounts for 1993 “solve” this problem by estimating stock-building residually at 3.3 per cent of GDP, up from -3.1 per cent of GDP the year before. The estimated massive swing in stock-building looks implausible. According to the *Monthly Statistical Bulletin*, industrial production grew by 4 per cent in 1993 while industrial sales grew by 2.9 per cent; i.e. industry was stocking finished goods to the tune of 1.1 per cent of sales. In agriculture, a sharp output contraction (caused by drought and structural production problems) is likely to have been accompanied by a rundown of stocks.

If the Hungarian estimate for stock-building is wrong, at least one of the other items in the national accounts is subject to a corresponding error. If data on production and foreign trade data are “right”, then this corresponding error relates to either consumption or investment which might have grown faster than assumed in the national accounts. However, other possibilities are that 1993’s swing in the balance of payments was less serious than hitherto thought or that production started growing later and less strongly than previously estimated.

It should be noted that Hungary’s statistics on wages, prices and employment lend more support to expenditure estimates than to the more favourable output-based

¹⁰ Source: *Monthly Statistical Bulletin*, Poland’s Central Statistical Office, April 1994, p. 112.

¹¹ The OECD (1994B) notes that “cross-border trade with Germany is thought to be significantly underestimated” (OECD 1994B p.116). However, as both imports and exports may be affected, this gives little hint of the sign of the error pertaining to the foreign balance.

¹² Note that these figures differ slightly from the revised official estimates prepared during the summer of 1994, which are the source of the GDP-series for Hungary that are quoted in Chapters 10 and 11.

¹³ In fact the estimate of consumption in nominal terms relies heavily on the computation from the income-part of the national accounts of the difference between net-of-tax income on the one side and the sum of financial savings and private housing investment on the other.

**Table 11.14 Hungary's Official National Accounts
as of April 1994 ¹**

	1990	1991	1992	1993 <i>Preliminary</i>
<i>(at fixed 1991-prices in billions of forint)</i>				
Output and imports	3,651.9	3,248.0	3,103.9	3,177.9
Domestically generated value added (GDP)	2,662.9	2,346.0	2,240.4	2,195.1
Imports of goods and non-factor services	989.0	902.0	863.5	982.8
Expenditure	3,651.9	3,248.0	3,103.9	3,177.9
Private consumption	1,700.6	1,605.4	1,570.7	1,588.0
Public consumption	297.3	289.3	286.0	293.2
Fixed investment	565.9	509.3	476.0	482.0
Stock-building	102.4	9.1	-69.0	72.0
Exports of goods and non-factor services	985.7	834.9	840.2	742.7
<i>(in per cent)</i>				
GDP growth ¹		-11.9	-4.5	-2.0

The source of data for 1991-1993 is national accounts tables released by the Ministry of Finance in April 1994. For 1990, the source is the Institute of International Finance's Hungary report from January 1994. The IIF report's growth rates for individual items were used to work backwards from the 1991 data, using stock-building for 1990 as a residual item.

¹ Note that revised figures released in the summer of 1994 pointed to a decline in real GDP in 1993 of 2.3 per cent, rather than the 2.0 per cent estimated in April.

**Table 11.15 GDP-estimates
for the Czech Republic**

	Absolute levels of GDP- components			Growth in GDP- components		Contributions to GDP growth	
	1991	1992	1993	1992	1993	1992	1993
	(in billions of Czech Krouna) at constant 1984-prices)			(percentage change)		(percentage points)	
Initial Estimate (Statistical yearbook, October 1993)							
Private consumption	192.7	214.1		11.1		2.2	
Public consumption	94.0	72.5		-22.9		-2.2	
Fixed investment	112.6	116.9		3.8		0.4	
Stock-building	16.6	-8.0				-2.5	
Foreign balance	16.2	6.0				-1.0	
GDP	432.1	401.5		-7.1		-3.1	
First Revision (December 1993 ¹)							
Private consumption	192.7	211.5		9.8		1.9	
Public consumption	94.0	90.5		-3.7		-0.4	
Fixed capital formation	112.6	116.9		3.8		0.4	
Stock-building	16.6	-27.0				-4.4	
Foreign balance	16.2	9.6				-0.7	
Exports of goods and services	233.7	253.2					
Imports of goods and services	217.5	243.6					
GDP	432.1	401.5		-7.1		-3.1	
Second Revision (April 1994 ²)							
Private consumption	191.8	209.3	212.5	9.1	1.5	4.0	0.8
Public consumption	94.0	89.6	90.6	-4.7	1.1	-1.0	0.2
Fixed capital formation	112.6	119.7	110.2	6.3	-7.9	1.6	-2.4
Stock-building	2.9	-24.3	-24.4			-6.3	0.0
Foreign balance	30.8	9.3	13.4			-5.0	1.0
Exports of goods and services	241.8	243.9	269.8	0.9	10.6	0.5	6.4
Imports of goods and services	211.0	234.6	256.4	11.2	9.3	5.5	5.4
GDP	432.1	403.6	402.3	-6.6	-0.3	-6.6	-0.3

¹ Source: Central Statistical Office in the Czech Republic: "Odhad tvorby a uziti hrubeho domaciho produktu 3. ctvrtleti 1993", December 1993.

² Source: Tables faxed from the Central Statistical Office to EBRD with the title "Hrubi donaci produkt Ceske Republiky".

Table 11.16 Revised "Initial" set of National Accounts for Hungary ¹

	1990	1991	1992	1993
			<i>Preliminary</i>	<i>Preliminary</i>
	<i>(at fixed 1991-prices in billions of forint)</i>			
Column difference	102.4	39.6	-10.4	158.7
Output and imports	3,651.9	3,278.5	3,162.5	3,264.6
Domestically generated value added	2,662.9	2,376.5	2,299.0	2,281.8
Imports of goods and non-factor services	989.0	902.0	863.5	982.8
Expenditure	3,549.6	3,238.9	3,172.9	3,105.9
Private consumption	1,700.6	1,605.4	1,570.7	1,588.0
Public consumption	297.3	289.3	286.0	293.2
Fixed investment	565.9	509.3	476.0	482.0
Stock-building	0.0	0.0	0.0	0.0
Exports of goods and non-factor services	985.7	834.9	840.2	742.7

¹ EBRD estimates. The underlying methodology is described in the text under the sub-heading "An empirical experiment".

Table 11.17 Assumed error margins in Revised Initial National Accounts for Hungary

(within which the "true" value of the item is assumed to lie with 95% probability)

*(generally in per cent of the initial estimate;
for stock-building in per cent of the initial GDP-estimate)*

Output and imports

Domestically generated value added	3.0
Imports of goods and non-factor services	3.0

Expenditure

Private consumption	6.0
Public consumption	1.0
Fixed investment	6.0
Stock-building	2.0
Exports of goods and non-factor services	3.0

Table 11.18 Assumed error variances in Revised Initial National Accounts for Hungary (estimated as one-quarter of the squared value of the absolute error margin ¹)

	1990	1991	1992	1993
Output and imports				
Domestically generated value added	1,595.5	1,238.3	1,129.4	1,084.2
Imports of goods and non-factor services	220.1	183.1	167.8	217.3
Expenditure				
Private consumption	2,602.9	2,319.6	2,220.4	2,269.6
Public consumption	2.2	2.1	2.0	2.1
Fixed investment	288.2	233.4	203.9	209.1
Stock-building	709.1	550.4	501.9	481.8
Exports of goods and non-factor services	218.6	156.8	158.8	124.1

¹ Based on the assumption that the error margin is normally distributed. Note that only the relative size of the error variances (as opposed to the absolute value of the variances) influence how large a part of the data adjustment will be borne by any particular item.

Table 11.19 Revised National Accounts for Hungary ¹

	1990	1991	1992	1993 <i>Preliminary</i>
<i>(at fixed 1991-prices in billions of forint)</i>				
Output and imports	3,619.0	3,266.5	3,165.6	3,217.6
Domestically generated value added	2,633.9	2,366.0	2,301.7	2,242.6
Imports of goods and non-factor services	985.0	900.5	863.9	974.9
Expenditure	3,619.0	3,266.5	3,165.6	3,217.6
Private consumption	1,747.9	1,625.0	1,565.6	1,670.1
Public consumption	297.4	289.3	286.0	293.3
Fixed investment	571.1	511.3	475.5	489.6
Stock-building	12.9	4.7	-1.2	17.4
Exports of goods and non-factor services	989.7	836.2	839.8	747.2
<i>(in per cent)</i>				
Revised estimate of GDP growth		-10.2	-2.7	-2.6
Original estimate of GDP growth		-11.9	-4.5	-2.0

¹ EBRD estimates. The underlying methodology is described in the text under the sub-heading "An empirical experiment".

estimates of GDP. The recorded increase in average industrial wages per employee in 1993 was about 26 per cent. Meanwhile producer prices rose 11 per cent, the official estimate of industrial output expanded by 4 per cent, and the recorded number of hours worked in industry fell 9 per cent in 1993. While this would indicate that unit labour costs and output prices rose at approximately the same rate, the implied increase in the productivity of industry – 14 per cent in one year – defies belief. It would appear likely that industrial employment fell less sharply than recorded while production grew more moderately than the official 4 per cent.

Czech Republic

Statisticians in the Czech Republic have also found it difficult to reconcile indicators of output and expenditure. Trade with the Slovak Republic, following the break-up of the CSFR, has been particularly difficult to monitor. Initially the clearing account used to settle trade with the Slovak Republic indicated a sharp drop in trade turnover. This was difficult to reconcile with the output-based estimates of GDP which pointed to a very minor drop in real value added. However, the gap between estimated output on the one side and domestic expenditure and the foreign balance on the other was largely closed by the recognition that substantial amounts of exports to the Slovak Republic had been financed through a drawdown by Slovak importers of deposits in Czech banks.

Nevertheless, the underestimate of Czech stock-building, as a result of the inclusion in this of write-offs of stocks of goods produced in previous years, is likely to have been a very substantial source of underestimation of both output

and expenditure. As long as these write-offs are growing faster than GDP, their erroneous treatment will lead to an under-recording of GDP-growth. The magnitude of the problem is indicated by the stock-building series for 1991–1993 (Table 11.15). According to the official national accounts published in December 1993, the ratio between stock-building and GDP amounted to 3.8 per cent in 1991, -6.7 per cent in 1992, and -11.2 per cent in the 12 months ending in September 1993. Revised accounts published in April 1994 produced dramatically different estimates for stock-building (third part of Table 11.15), in which nevertheless the changes from year to year remain remarkable: from +6.7 per cent of GDP for 1991 to -0.7 per cent for 1992 and -6.3 per cent for 1993. Suppose the write-offs of stocks produced in previous years cease in 1995. This would be likely to move stock-building back into the positive realm and take recorded GDP-growth to about +5 per cent, even in the absence of any underlying growth in the Czech economy.

Expenditure data should not be ignored

It may be particularly difficult in eastern Europe to monitor investment in the many new companies and to keep track of the shift in retail trade towards new informal outlets. Many western European statistical agencies also find demand more difficult to estimate than supply. However, even if demand data are less reliable than estimates of supply, this is not an argument for ignoring them, only for reflecting their weaker reliability in the weighting of data during the computation of a compromise GDP estimate. The section below illustrates the procedure that might be used to arrive at such a compromise estimate.¹⁴

¹⁴ A supporting point made by Janos Arvai in his comments on a draft of this article is that although estimates of gross output may be more reliable than estimates of demand components, it is less obvious that the same can be said for estimates of value added. The latter are subject to much greater uncertainty than production estimates as they represent the difference between measured output and sometimes rough estimates of intermediate input usage.

An empirical experiment

To illustrate the sensitivity of GDP-estimates to the choice of balancing principles, we shall attempt in this section to adjust Hungary's official national accounts in accordance with the principles that were first advocated by Champernowne, Meade and Stone (see the reference to their 1942 paper at the end of this chapter). The numerical experiment is based on very simple assumptions and should be viewed only as an illustrative exercise.

Starting from the official presentation in Table 11.14 of the national accounts at a high level of aggregation, the first step is to replace the official estimates for stock-building in different years by zeroes and to raise the estimates of value added to reflect the findings in the study by Arvay and Vertes (pointing to the need to increase estimated production to account more fully for growth in new small-scale enterprises). The result of this is shown in Table 11.16. For the purpose of the balancing process, we assume that this step eliminates any bias there might have been in the initial estimates.

We are now left with a gap between the estimates for output and expenditure. Following the recommendation of Champernowne, Meade and Stone, we set as the objective for the balancing exercise to remove the gap in accordance with the generalised least squares principles. For this purpose we proceed to attach 95 per cent confidence intervals to individual items (see Table 11.7). The corresponding "error variances" are shown in Table 11.18. It should be noted here that we have determined these error variances on very weak evidence. We have done this purely for illustrative purposes. Clearly the Hungarian statisticians are better placed to assess the error variances.

Under the assumption that all errors are uncorrelated, we now proceed to apply the generalised least squares formulas to arrive at a balanced set of accounts. In the simple one-column case presented here, the balanced estimates may be derived by simple distribution of the aggregate discrepancy on initial cell-estimates in proportion to their share of the sum of the error variances.¹⁵ The result is shown in Table 11.19. The last two lines in the table indicate (very tentatively) that real GDP growth may have been overestimated in 1993 and underestimated in previous years.

Concluding remarks

Data on consumption and investment are often forgotten in the discussion of production developments in eastern Europe. A possible argument against the use of expenditure-based GDP-estimates for eastern Europe is that they might be tainted by a large negative bias due to excessive reliance on information from state-owned institutions which represent an ever smaller share of the east European economies. However, the ideal response to this for national accounts statisticians is to assess the size of the bias and make the appropriate correction, even if this involves "tampering with data based on subjective judgements" – the national accounts statisticians are better placed to make these corrections than the users of the accounts.

Expenditure data should be actively used in the computation process which leads to establishment of official GDP estimates. This might, as illustrated in the example above, influence estimates of GDP-growth, possibly by as much as improvements in the coverage of new economic entities.

The only acceptable argument against taking account of expenditure data is that the latter may be so unreliable that they carry no information value at all. If indeed this argument can be substantiated, then responsible governments should give budgetary priority to improvements in the quality of demand data. This is not only because good demand data introduce a useful check on the supply series which governments use as a key indicator of policy-success, but also because it is crucial to know whether supply growth is matched on the demand side by increases in consumption or by rising investment.

¹⁵ This is a simple variant of the balancing algorithm presented in Bartholdy (1991).

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