

Transition report 1999

Ten years of transition

**Economic transition
in central and
eastern Europe,
the Baltic states
and the CIS**

**Transition and economic
performance**

**The state and economic
reform**

**Enterprise response
to reforms**

Country assessments



European Bank
for Reconstruction and Development

Guide to readers

Country groupings

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

Central and eastern Europe	Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic and Slovenia
Commonwealth of Independent States	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan
Baltic states	Estonia, Latvia and Lithuania
Countries of operations	The EBRD's member countries in central and eastern Europe, the Baltic states and the CIS

Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development	IFC	International Finance Corporation
BIS	Bank for International Settlements	IFI	international financial institution
BOT	build-operate and transfer	ILO	International Labour Organisation
CEFTA	Central European Free Trade Agreement	IMF	International Monetary Fund
CIS	Commonwealth of Independent States (which includes as full or associate members all countries of the former Soviet Union, except the Baltic states)	IPO	initial public offering
		IOSCO	International Organisation of Securities Commissions
CMEA	Council for Mutual Economic Assistance (former)	JSC	joint-stock company
CPI	consumer price index	MEBO	Management-employee buy-out
CSFR	Czech and Slovak Federal Republic	MFN	most-favoured nation: GATT principle that gives a country tariff treatment equal to the lowest rate generally offered to other countries
EC	European Community	na	not available
ECE	Economic Commission for Europe	OECD	Organisation for Economic Cooperation and Development
EFTA	European Free Trade Area	OTC	over-the-counter
EIU	Economist Intelligence Unit	Phare	Poland and Hungary: Aid for Economic Restructuring (EU)
EU	European Union	PPP	purchasing power parity
FCSM	Federal Commission for Securities Market	RPI	retail prices index
FDI	foreign direct investment	SMEs	small and medium-sized enterprises
FSU	former Soviet Union	SOEs	state-owned enterprises
FYR	former Yugoslav Republic	Tacis	Technical Assistance for CIS Countries (EU)
G-7	Group of 7 (Canada, France, Germany, Italy, Japan, UK and USA)	T-bill	Treasury bill
GATT	General Agreement on Tariffs and Trade	UN	United Nations
GDP	gross domestic product	USAID	United States Agency for International Development
GDR	global depositary receipt	VAT	value added tax
GNP	gross national product	WTO	World Trade Organisation
IAS	international accounting standards		

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Ten years of transition

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Foreword

Faced with great uncertainty, the people of central and eastern Europe, the Baltic states and the Commonwealth of Independent States (CIS) showed great courage and resolve in their struggle to overcome the legacy left behind by the old regime. In the decade since the fall of the Berlin Wall, they have gained wide-ranging political and economic freedoms. Today, most goods and services are produced by the private sector and are exchanged in markets. Free and fair elections have been held in most countries, and political and civil liberties have begun to take root. However, the promise of good governance and economic prosperity remains unfulfilled in many countries. The experience has demonstrated that the process of transition from the command to the market economy is complex and long and that the upheavals and stress can be severe.

This *Transition Report*, a special issue within an annual series, takes stock of developments in transition over the past decade. While the countries of central Europe and the Baltic region have moved steadily towards the standards and performance of developed market economies, elsewhere the transition has been stunted by slow and uneven reforms and by persistent weaknesses in the institutions that support markets and private enterprise. The transition is not necessarily a steady march forward; there have been and will be setbacks and crises along the way. It has a long way to go, even in more advanced countries.

The EBRD seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in all 26 of its countries of operations. It does this as a participant investor with a private sector focus. It works with its partners on projects that are financially sound and advance the transition, and that would be unlikely to emerge or to function well without its participation. For the EBRD to perform this task effectively, it needs to analyse and understand the complex process of transition and to share the Bank's analyses with its partners, other investors and policy-makers in the region. The EBRD's *Transition Reports* take therefore an investment perspective on the transition. They focus on both the climate for investment and the contribution that investment shaped by market forces can make to the transition and to overall economic performance.

The analyses in this and previous Reports have consistently pointed to two broad patterns across the region. First, progress in market-oriented reform has been more rapid and sustained in the countries adjacent to the European Union, including central Europe and the Baltic states, than in countries further south and east. As was demonstrated by the repercussions from the crisis in Russia last year, countries such as Hungary and Poland showed impressive resilience in the face of heightened uncertainty over economic prospects in emerging markets. These economies have

benefited from a sound investment climate and from policy stability fostered by the prospect of accession to the European Union. In south-eastern Europe and in the CIS, on the other hand, slower and more uneven reforms, combined with repercussions of the crisis in Russia and, more recently, the conflict in Kosovo, have created a more challenging environment for investment.

A second pattern that has emerged in the first decade of transition is an inherent imbalance in reforms, which is a characteristic even of more advanced transition economies. Some aspects of a market economy can and have been created quickly, in particular through market liberalisation and privatisation. However, developing the institutions and behaviour required for well-functioning markets and private enterprise takes much longer. The promotion of effective institutions, such as government structures, laws and regulations and the sound behaviour of governments, enterprises and financial institutions lies at the heart of the challenge of transition as it enters the next decade.

The structure of this *Transition Report* follows from its purpose: to understand the dynamic process of market reforms in transition economies and the key requirements for a successful transition. It focuses on the impact of initial conditions, early reform choices and the political process, all of which can have powerful consequences for the direction of future reforms and for aggregate economic performance (see Parts I and II). This analysis helps to identify the transition traps that have entangled reforms in some countries and the characteristics of countries that have pressed ahead steadily with reforms. Central to this analysis is an assessment of how reforms have reshaped the relationship between the state and enterprises. The analysis shows that the initial hope that liberalisation and privatisation would create the foundation for improved governance and would transform the relationship between the state and firms has not been fully realised. The impact of these reforms on the quality of governance depends strongly on the extent to which states are subject to "capture" – or undue influence – by private interests. The Report also breaks new ground in its detailed analysis of the factors for success at the level of individual enterprises, both existing ones and potential new firms (see Part III). The competitive process of market entry, innovation and growth at the enterprise level ultimately holds the key to a successful transition and rising living standards.

Part of the analysis of the Report presents the results of a major new Business Environment and Enterprise Performance Survey undertaken by the EBRD in collaboration with the World Bank. Covering over 3,000 enterprises in 20 transition economies, the survey asked senior managers about the characteristics of their firms, about the business environment in which their firms operate, and about their restructuring and growth performance.

While this *Transition Report* takes the form of a special issue, previous Reports have each had a special theme. These themes have developed a close analysis of the transition and the forces shaping its progress, together with an examination of the policies that foster the development of the institutions and behaviour that is required to support the functioning of markets and private enterprise. It is important, therefore, to consider the Reports as a series in which each edition, including this special issue, is not only complete in its own right but also inter-related and cross-referenced to previous editions.

The special themes of the previous *Transition Reports* have been:

- 1994 – Institutional reform and economic openness;
- 1995 – Fixed investment and enterprise development;
- 1996 – Commercial infrastructure and contractual savings institutions;
- 1997 – Enterprise performance and growth; and
- 1998 – Financial sector in transition.

This year's *Transition Report* draws from and builds on this previous work.

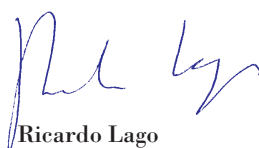
This Report argues that the way to improve governance and the investment climate is to strengthen simultaneously the capacity and the accountability of the state. This requires the promotion of

domestic constituencies for reform with the power to break the grip that vested interests hold on the transition in many countries. The last decade has shown that liberalisation and privatisation alone are not enough to generate such constituencies. Political and economic competition is vital to pressure the government to provide essential public goods and to encourage firms to restructure and innovate rather than to rely primarily on state support. The process of competition is therefore central to the development of institutions that are able to support markets and private enterprise. Importantly, the Report argues that promoting the formation and growth of small and medium-sized enterprises (SMEs) and opening the market to foreign competition are core elements of an effective strategy for transition economies to reach their full potential.

The assessments and views expressed in this *Transition Report* are not necessarily those of the EBRD. The responsibility for them is taken by ourselves on behalf of the Office of the Chief Economist. While we have attempted to be as up to date as possible, the “cut-off” date for most of the information in the Report is September 1999.



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8 October 1999

Executive summary

Chapter 1: Ten years of transition

The fall of the Berlin Wall in November 1989 was an occasion for hope. It also inspired a sense of euphoria and triumphalism, and – for some – a belief that the transition to a market economy and democratic society would be simple and short. But ten years of experience has demonstrated that the transition is complex and long and that the upheavals and stresses can be harsh. The transition is not a steady march forward; there have been and will be setbacks and crises along the way. But the disappointed hopes of some should not be allowed to overshadow the remarkable achievements over the past ten years. Most output in the region is now exchanged in a market system and produced by the private sector. Free and fair elections in most countries have led to democratic changes of government.

Taking stock of developments over the first decade of reform, Chapter 1 emphasises the need to complement liberalisation and privatisation with the development of institutions and behaviour that support the functioning of markets and private enterprise. This requires a strategy to strengthen simultaneously the capacity and the accountability of the state by empowering domestic constituencies with a stake in the process of reform. Liberalisation and privatisation are not enough to promote these constituencies. Political and economic competition are essential. The hope and challenge for the second decade lie with the democratic process, the entry and expansion of new private firms and continuing international integration.

Part I: Transition and economic performance

Chapter 2: Progress and patterns in transition

Over the past decade, two broad patterns in transition have emerged. In the more advanced countries, rapid liberalisation and sustained macroeconomic stabilisation have laid the basis for gradual institutional change. These changes have been driven by the demand from enterprises and voters and have been shaped by the process of European integration. In the less advanced countries, progress in liberalisation and privatisation has been slow and uneven and stabilisation has been jeopardised by the persistence of soft budget constraints. The business environment for new enterprises also remains deeply flawed.

Two issues dominate the second decade of transition. First, the less advanced countries in south-eastern Europe and the CIS need to redouble their efforts to complete liberalisation and lay the basis for macroeconomic stability. In this task, they face serious challenges, confronted with unfavourable legacies from the previous regime's central planning and the need for significant structural change to introduce free markets. To help ease this constraint, governments should reduce obstacles to the growth of new private enterprises, which can provide new employment opportunities and reduce the costs of adjustment. Second, the

process of institutional change in response to demands from the private sector cannot be taken for granted. The state must play a strong and leading role in developing market institutions. Transforming the state remains a pressing challenge for all the transition economies.

Chapter 3: Macroeconomic performance and prospects

The variation in reforms across countries is mirrored in their macroeconomic performance over the first decade of transition. The severity of initial structural and macroeconomic imbalances has not only influenced the depth of the initial recession in the transition process but also affected the political feasibility of rapid reforms. Even among countries with unfavourable starting points, however, there is clear evidence that rapid liberalisation and stabilisation, as well as progress in small-scale privatisation, have yielded significant benefits in terms of stronger growth in output.

For liberalisation and stabilisation to be sustained, they must be complemented with institutional changes that support markets and private enterprise. The chapter reviews recent cases of reform reversals caused by the lack of underlying structural change in the enterprise and financial sectors. These flaws have also impeded reform of public finances and undermined fiscal stability. Over the medium term, the transition economies are, in principle, well-placed for rapid growth because of their high level of skills and their potential for rapid improvements in productivity following the introduction of new technologies. This potential has begun to be realised in part of the region, primarily in central and eastern Europe. The main challenge for the south and east of the region is to break out of the vicious cycle of policy instability and poor governance.

Chapter 4: Structural change in transition

A crucial link between progress in transition and growth in output is structural change. Economic reforms were widely expected to lead to substantial reallocation of resources, rectifying the distortions inherited from central planning. While causing temporary economic and social upheaval, this reallocation would underpin the subsequent recovery. A structure of economic activity comparable to market economies has been achieved more rapidly in countries that have quickly liberalised markets and trade than in those with gradual and uneven levels of reform.

The pace of structural change has differed widely in various areas in the economy. Although the adjustment in employment across sectors has been uniform and swift, regardless of the pace and durability of reforms, other areas have been much more sensitive to the extent of progress in reform. These include the reorientation of trade towards the international economy, the development of the private sector and the expansion of key infrastructure services, which are all fundamental to high growth. If structural change is to

give rise to growth, reforms aimed at strengthening these sectors should be a priority. The chapter also shows that the financial sector – which is necessary for growth and stability over the long term – has so far shown little development in response to financial reforms. Regulatory practice will have to be strengthened and competition in finance needs to be promoted if this sector is to support the transition in the next decade.

Part II: The state and economic reform

Chapter 5: The politics of economic reform

Within the constraints provided by differing initial conditions, the political environment has been the major factor influencing policy choices during the first decade of transition. It is commonly believed that successful reform requires a stable, strong government of technocrats committed to reform, but the experience of the last ten years of transition has contradicted this view. A high degree of political competition, rather than a government insulated from electoral pressures, has promoted reform in many countries. This has partly been achieved by weakening the power of vested interests to gain influence over government and to distort reforms.

Four key political factors influencing successful and consistent reforms are identified. First, deposing the old elite at the initial stages of transition has been instrumental in promoting economic reforms, which have not only fostered markets and private enterprise but also weakened the strongly vested interests from the previous regime. Second, the degree of social cohesion around the goals of transition at an early stage is critical for sustaining the reform process through the inevitable pains of adjustment and the change of governments. Third, to maintain the momentum for reforms, it is essential to constrain the power of vested interests to block reforms that threaten to undermine their gains from only partial reforms and distorted markets. Finally, the incentives associated with external alliances can encourage governments to take difficult policy choices and to undertake institutional reforms. The chapter provides a cross-country comparison of the relationship between the structure of the political system and economic reforms, and analyses in detail the politics of privatisation in several less advanced countries.

Chapter 6: Governance in transition

One of the main goals of transition has been to transform the role of the state in the economy – to persuade it to adopt a form of governance based on support for markets and private enterprise rather than plans and commands. Yet despite the considerable achievements in liberalisation and privatisation in the first decade of transition, the quality of economic governance varies widely across the region, as revealed by the survey of over 3,000 enterprises in 20 countries – the Business Environment and Enterprise Performance Survey – which was undertaken for this Report.

Surprisingly, this variation is not a direct result of the extent of economic reforms that have been adopted. In fact, enterprises in both the most advanced and least advanced countries tend to have relatively favourable assessments of the quality of their governance, while those in countries with partial reforms report a higher level of governance problems. A key to explaining different assessments of governance across the region lies in the extent to which the state is subject to “capture” – or undue influence – by vested interests. The survey provides a unique opportunity to measure and compare the extent of state capture across the region and to investigate its effects on the overall quality of governance.

The survey also shows that the initial hope that privatisation would create the foundation for improved governance and transform the ties between the state and firms has not been fully realised. The impact of privatisation on the quality of governance depends strongly on the extent of state capture. Firms in transition economies continue to interact with the state in a complex web of costs and benefits that differs across countries and types of firms. Enterprises spend considerable resources in lobbying state officials, paying bribes and adjusting to state interference. In return, they receive benefits in the form of subsidies, soft finance, tax advantages and the tolerance of arrears. A key challenge remains the effective “depoliticisation” of firms through further market reforms and measures to constrain state capture by private interests.

Part III: Enterprise response to reforms

Chapter 7: Competition, enterprise performance and the investment climate

A successful transition must unlock and encourage deep restructuring, innovation and growth by enterprises, but in many countries economic reforms have yet to yield strong responses. This chapter examines how reforms influence the performance of firms, using data from the enterprise survey. Importantly, the analysis considers differences in reforms both at the country level, in terms of the pervasiveness of soft budget constraints and assessments of the investment climate, and at the level of enterprises themselves, in particular the degree of competition faced by firms and their origin and ownership.

The analysis reveals the strong influence of competition and hard budget constraints on deep restructuring and product innovation and concludes that these initiatives contribute significantly to the growth of firms. Growth tends to be recorded much more rapidly in new private firms than in other types of firms, even after allowing for their relatively small size. However, firms that operate in countries with unfavourable investment climates tend to grow more slowly. The analysis underscores therefore that competition, hard budget constraints and a favourable investment climate are vital for the restructuring and growth of enterprises.

Chapter 8: Market selection and the role of SMEs

New private firms tend to grow more rapidly than other types of firms. The emergence and growth of these firms occurs most strongly if the market “playing field” is level. One indicator of the strength of the process of market selection in the enterprise sector is the extent to which firms with increasing productivity grow and those with falling productivity decline. An analysis of this process reveals sharp differences among transition economies.

The survey reveals that the main obstacles to the growth of SMEs are anti-competitive practices and corruption, followed by taxes and business regulations. A priority for the next decade of transition is to embrace competition policy that focuses on reducing barriers to business start-ups, introducing measures to combat corruption and crime and hardening the budget constraints on declining industrial enterprises.

Chapter 9: Restructuring large industrial enterprises

The restructuring of existing enterprises remains one of the greatest challenges of the transition. Progress in liberalisation and privatisation has been extensive in the past ten years, but enterprise restructuring – particularly in the industrial sector – has not. The mix of reforms adopted by many transition economies has led to rapid industrial downsizing in terms of employment and capacity, but it has not led to quality investment and the development of new products and production methods. A combination of political, fiscal and social constraints has made the task much more difficult than anticipated and the reforms adopted in many countries have been ineffective.

The way forward remains challenging. Changes in ownership and management will be crucial to break up the vested insider interests and to initiate deep restructuring. The chapter reviews various options that could be used to attract strategic outside investors, including debt forgiveness, creditor-led restructuring, “ring-fencing” in joint ventures, and the hiring of external management expertise.

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Annex 9.1: Recent trends in revealed comparative advantage

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Ten years of transition

Chapter 1

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Ten years of transition

The fall of the Berlin Wall in November 1989 was a time of hope. It was also a time of euphoria and triumphalism, leading some to believe that the process of building market-oriented economies, democratic societies and good governance could be simple and short. Some thought that the dynamism and efficiency of the market system would lead inexorably to rapidly rising living standards and strong economic growth. But the experience has demonstrated that the process of transition from the command to the market economy is complex, difficult and lengthy. The dislocations and stresses can be profound and severe. The transition is not a steady forward march, or a linear process; there have been and will be setbacks and crises along the way. It has a long way to go.

The naivety of some of the early hopes and expectations must not, however, be allowed to obstruct recognition of the remarkable changes over the past ten years. Most goods and services are produced by the private sector and are exchanged in markets. Democratic systems have been established rapidly; fair and free elections in most countries have led to the democratic change of governments. The political process has shown real robustness in the face of crises and hardship. Strong and continuing commitment to market reform and democratic processes has been shown across the political spectrum and has been maintained across changes of government. There is little likelihood of a return to the old political structures. These achievements are fundamental landmarks of the twentieth century.

The common challenge of establishing a market system from a command economy, however, diverted attention from the many and basic differences between the countries of the region at the outset of transition. This may in turn have led to an assessment of prospects which was overly uniform. Economic structures, history (including the history of reforms), geography, resource endowments, culture and indebtedness all varied sharply across the countries of the region at the outset of transition. The countries of the Commonwealth of Independent States (CIS) had lived under central planning for 70 years, while for others it was imposed after the Second World War. Some, such as Hungary and Poland, had experimented with reforms prior to the 1990s. Countries have also differed greatly in the policies pursued. As a result of these fundamental differences in both initial conditions and policies, the experience across countries over the past decade has varied enormously. Indeed, it is this variation that, in large part, provides the foundation of the lessons drawn from the first decade of experience.

The contrasts between the largest country of central and eastern Europe and the Baltic region (CEE), Poland, and the largest country of the CIS, Russia, are striking and instructive. Poland has shown a strong and steady emphasis on liberalisation and macroeconomic stability, together with a measured and controlled approach to privatisation and to building the financial sector.¹ Russia, in contrast, has also liberalised and privatised but its macroeconomic policy has been haphazard, its privatisation deeply flawed and its financial sector poorly regulated, fragile and corrupt. Poland's economy has grown strongly since 1992. Russia's economy has declined in every year except 1997, with the nascent economic growth in that year smothered by the traumatic events of 1998.

Lessons from such contrasts have to be treated carefully, particularly in relation to the starting points, but the differences tell us a great deal about the process of transition. This *Transition Report*, like its predecessors starting from 1994, provides an analysis of, and draws lessons from, the comparative experience of the 26 countries of the region that are members of the EBRD. The assessment in this Report looks back on a full decade of transition and forward to the challenges ahead. One clear and basic lesson stands out: a strong, effective and committed transition is both feasible and yields substantial and sustainable rewards.

1.1 Key challenges

The experience of ten years and 26 countries is long and broad enough for us to draw clear conclusions in a way which would not have been possible four or five years ago. For example, in 1995 Vaclav Klaus, then Prime Minister of the Czech Republic, could speak of the transition in his country being over. The Governor of the EBRD for the United States was looking forward at the London Annual Meeting of that year to the privatisation of the EBRD in the not-too-distant future, when its work on promoting the transition would be essentially complete. At the 1996 Sofia Annual Meeting of the EBRD there was much talk of "graduation" of countries from the transition process. The stock markets in the region boomed in 1996 and 1997 and interest rates for foreign borrowing were falling sharply.² Some were suggesting in 1996-97 that Russia and other countries in the CIS, having started reforms two or three years after CEE, were about to follow them in realising sustained growth.³ But the last two or three years have brought strong and sobering lessons. It is now even more clear that institutional and behavioural underpinnings of the transition in much of the region are weak and that this weakness creates difficult and long-term challenges.

¹ Like any polity, particularly one undergoing fundamental change, Poland's reforms have not been without controversy. Further, one should not depict a totally controlled and planned process. The transition cannot take such a form. It will inevitably be a step-by-step approach, learning from experience at each stage.

² Indeed, some were moved to begin warning publicly about excessive exuberance (see, for example, speeches by the then President of the EBRD in the spring and summer of 1997 and the *Transition Report* 1997, Chapters 1 and 7).

³ For example, see Fischer, Sahay and Vegh (1997).

This *Transition Report* lays special emphasis on institutional, political and behavioural issues and their interaction with economic performance. The passage of time has not only shown their importance, but has also allowed more systematic collection of evidence than was possible for earlier *Transition Reports*. The evidence now shows clearly that the central lesson of transition is that markets will not function well without supporting institutions,⁴ a state that carries through its basic responsibilities and a healthy civil society. This Report provides an analysis of the problems created by institutional and governmental failure for entrepreneurship and investment by firms. It emphasises strongly the importance of institutions, especially those supporting open competition, if privatisation and liberalisation are to lead to strong economic performance. Moreover, the forms of liberalisation and privatisation will themselves have a profound influence both on institutional development and the behaviour of enterprises. Institutional development itself strongly influences and is influenced by behaviour. Therefore, at the heart of this Report and of the lessons of transition are the interactions between these elements: liberalisation and privatisation, development of institutions that support markets and private enterprise, and the behaviour of participants.

Based on this analysis, the Report emphasises the importance of creating an environment that fosters a vigorous response by enterprises to reforms if strong growth is to be promoted and living standards are to be raised. The sharp declines in living standards that have occurred in some parts of the region have not only caused great stress but have also undermined confidence in reforms.

Institutions and behaviour

While institutional questions have been central to the *Transition Reports* from the beginning,⁵ we are recognising increasingly the importance of behavioural issues and how behaviour interacts with institutions. The empirical analysis of key examples of social capital and behavioural issues is central to several of the chapters that follow (see, for example, Chapters 2, 6, 7 and 8).⁶ Whereas the term “institution” refers largely to organisations and rules (see Box 1.1), behaviour concerns the actions and attitudes of individuals and groups within these arrangements. Institutional arrangements which may appear sound from a formal or written perspective (for example, legislation) may be undermined by patterns or codes of behaviour which prevent them from functioning effectively. In this sense, behaviour is not only influenced by institutions but also provides a social foundation of institutions.

In focusing on behaviour, the term social capital can also be useful. This is distinguished from human capital, which is about skills.

Social capital may be defined in terms of: voluntary compliance with established laws, trust, cooperative behaviour and basic codes of conduct.⁷ By using the language of capital, we emphasise both that it can be enhanced or eroded and that it can complement other factors of production, such as physical and human capital. Defined in this way, social capital can be seen to be fundamental to the development of institutions. Furthermore, appropriate institutions can preserve and foster social capital. With weak social capital, physical capital is misused, destroyed or misappropriated and human capital can be wasted and diminished.

Manifestations of weak social capital include: bureaucratic interference of various kinds, especially harassment by the tax authorities; behaviour by those involved in the judiciary which undermines its effectiveness; corruption and other deficiencies in law and order; and unsound or dubious business practices, including asset-stripping and poor corporate governance.⁸ While the term social capital is not prominent in the chapters that follow, it is used here as a summary term that captures behavioural aspects of institutional change, governance and the investment climate, which are the concepts used in subsequent chapters.

There are a number of possible explanations for the patterns and codes of behaviour (and thus social capital) across countries and over time. The degree of exposure to Western market culture and principles prior to the start of transition has probably influenced the extent to which market-supporting institutions have become easily accepted in the transition economies. The cultural and geographical proximity of CEE to western Europe has clearly helped in this regard. The pre-communist market economies of Hungary and the Czech Republic were fairly advanced and rivalled their neighbours in western Europe. The people of Poland and Hungary had much greater opportunities to travel and interact with western Europe than did those under communist regimes further east. In these two countries, partial market reforms were also introduced before the 1990s, which may have provided some useful experience with market behaviour.

Several transition economies had been established nation states prior to communist rule. Others had never existed as independent nations. Moreover, the process of achieving independence generated social cohesion in the early period after liberation in much of the former group. In central Europe and the Baltic states, there was a sense of liberation and a common endeavour in the building of a new society. However, in some countries, independence brought to the fore unresolved ethnic tensions and national aspirations. Frequently, they led to violent conflicts with devastating

⁴ Examples of institutions are tax and regulatory administrations and legal arrangements governing business life. See Box 1.1 for a discussion of definitions.

⁵ Indeed, the opening chapter of the first *Transition Report* defines transition as: “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 of goods and resources, and the ownership incentive and reward structures that institutions embody, that characterise the difference between a command and market economy”. See *Transition Report* 1994, p. 4.

⁶ The term “social capital” is used here as a summary term that captures behavioural aspects of institutional change, governance and the investment climate, which are the concepts used in these chapters.

⁷ Definitions of social capital vary across authors but the one proposed here covers most of the key elements. Some authors also refer to behavioural elements in terms of “social norms” (Elster (1989)). Fukuyama (1995) uses the term values, particularly in discussing the East Asian experience of development and growth. The term “informal institutions” is used by Raiser (1997). Putnam (1992) uses the term social capital somewhat more narrowly. For a valuable discussion of institutions in economic analysis, see North (1991).

⁸ The interaction between institutional development and social capital may also be seen in the development of township and village enterprises (TVEs), which have driven the strong growth in China over the last 15 years. The TVEs depend strongly on cooperative behaviour within the township or village (which may have a population of several thousands). This cooperation has a strong social basis in extended families and relationships and in cooperative agriculture (which in turn is based on the strong interdependencies associated with the patterns of irrigation). See Hussain, Stern and Stiglitz (1999).

Box 1.1

What are “institutions”?

The term “institution” is often used in economic analysis, but rarely subject to formal definition. The absence of a commonly accepted and precise use of language reflects in part the application of the term to a wide range of political, social, economic and legal arrangements. It is therefore important to set out at the beginning of this Report how the term has been and is used in the *Transition Reports*.

The *Oxford Dictionary of Current English* defines institution in the following ways:

- “the act or instance of instituting”;
- “a society or organisation founded especially for religious, educational, or social purposes”; and
- “an established law, practice or custom”.

At this level of abstraction, an institution is thus something within a society that serves to guide or to organise human activity and behaviour.

The *Transition Reports* have sought to give a practical meaning to the term institutions in the context of transition economies. In particular, Chapter 1 of the *Transition Report 1994* argued that the basic elements of a market economy could be taken to be the following:

- **Enterprises and households** – they are responsible for decisions concerning production and consumption. Such decisions are taken in response to incentive structures embodied in the allocation of ownership rights, as well as the rules and regulations constraining economic behaviour.
- **Markets** – they are the means by which goods and resources are exchanged between enterprises and households and determine both economic opportunities and competitive pressures.
- **Financial institutions** are crucial players in the integration of transactions over time; in particular, the channelling of savings and investment, the organisation of payments and the enforcement of financial discipline.
- **The role of the state** – in a market economy, the state plays a crucial role in the functioning of enterprises and households, markets and financial institutions, including the provision of legal and regulatory structures that govern economic behaviour and the system of taxation to support the provision of these and other public services.

All four elements involve institutions that fall broadly within the dictionary definition of institutions. And given the definition of institutions and its practical application to transition, it is clear that transition is in its essence a process of institutional change and adaptation. The centrally planned economy was built around the institutions of state orders,

annual and medium-term planning, state-ownership of the means of production, administered prices and a monobank system. It therefore differed fundamentally from a market economy in all its basic institutional elements.

There are, however, important distinctions that can be drawn among the various dimensions of reforms, both in terms of the feasible timing of their implementation and their consequences for behaviour. Liberalisation and privatisation are reforms that involve the withdrawal of the state from direct participation in economic activity and that can be implemented quickly. As the *Transition Reports* have shown, these reforms have now been largely implemented in most countries in the region, although the manner of their implementation has varied widely. These reforms were the necessary steps towards establishing the institutions of a market economy in the place of those of central planning. However, they were not sufficient to ensure that markets and private enterprise function well.

The decentralised behaviour of households, enterprises and financial institutions are governed by complex sets of rules that in most market economies are broadly accepted by the population and adhered to for the most part voluntarily. The withdrawal of the state in transition economies from direct control of production and exchange has been accompanied by an effort to establish the appropriate laws and regulations and to create systems of taxation, thereby replacing direct state involvement with a system of guidelines, rules and practices and supporting activities for a market economy. However, for these formal rules to become embedded in the actual behaviour and practices of households, enterprises and financial institutions, strong leadership by government is required to set the right examples and understanding is needed of how the rules contribute to collective welfare. These deeper institutional changes inevitably require time for learning and adjustment. As the *Transition Reports* have shown, progress along these dimensions of transition has been much more gradual than that of privatisation and liberalisation.

A distinction is therefore often drawn in the *Transition Reports* between liberalisation and privatisation, on the one hand, and the deeper institutional reforms of enterprises, markets and financial institutions, on the other. All are aspects of institutional change in transition, but the speed and complexity of the changes differ widely. A distinction is also drawn (see the text) between institutions and behaviours. Much of the Report deals with the crucial and often subtle interactions between: (i) liberalisation and privatisation, (ii) development of institutions that support markets and private enterprise, and (iii) behaviour. While the three basic elements are intimately related, the analysis of their inter-relationships is crucial to an understanding of the development of the transition. It is therefore important to maintain the conceptual distinction between them.

effects: Nagorno-Karabakh, the Caucasus region of Russia, the secessionist movements in Georgia, the de facto split of Moldova, the civil war in Tajikistan and the turmoil in much of the former Yugoslavia, including most recently the tragic events in Kosovo.

The extent to which the *nomenklatura* retained much of their power in terms of control over political systems, line ministries, enterprises and natural resources following the break-up of the communist regimes also differed across the region in the CIS. In most Central Asian countries, for instance, the new leaders were the communist party bosses prior to independence. This was not likely to have encouraged trust by the population in government or the rule of law or belief in a new beginning. It also gave those groups most resistant to fundamental economic and political reforms the power to block measures that would have weakened their economic and political position.

The development of institutions and of behaviour depends strongly on history and culture. An emphasis on the importance of these issues implies, therefore, that from the historical and cultural differences in the region, one should expect very different paths of transition to emerge. However, it would be a mistake to suggest that transition paths are rigidly and inexorably determined by history, geography, culture and other initial conditions. Institutions and behaviour can be influenced by policy. Policy is of crucial importance. Indeed, one of the key lessons of the experience of transition is that sound economic policies and careful attention to building institutions are essential to sustaining strong and robust economic performance.

The experience of the transition has also demonstrated clearly that the events and decisions of the first few years are fundamental. The vested interests and institutions established in these years

exerted a profound influence on the opportunities and choices that followed. Furthermore, these decisions have powerful implications for the development of social foundations for well-functioning markets and private enterprises. A cohesive attempt to create a new society can build these foundations. However, cynical plundering by those in special positions will destroy them – the lesson for behaviour will be towards banditry and theft rather than responsibility, creativity and investment.

The importance of policy and early decisions for the development of institutions and behaviour is clearly illustrated by the comparison of the Russian and Polish liberalisation and privatisation programmes and the events that followed. In Russia, the early liberalisation of prices was patchy and inconsistent and offered scope for enrichment by the few who had access to levers of power.⁹ The privatisation process, and particularly the notorious loans-for-shares scheme of 1995,¹⁰ offered scope for further concentration of wealth and income through manipulation by those who had benefited from the defects of the liberalisation earlier in the decade. Together, flawed liberalisation and privatisation left enormous power in the hands of a few oligarchs. These vested interests had little incentive to press for reforms which could establish a level playing field for competitors, which could lower barriers to entry and to new initiatives, and which could improve corporate governance. In Poland, by contrast, the rapid and extensive liberalisation of prices and trade, combined with a more measured and controlled privatisation process, led to a much more open environment, allowed many small and medium-sized firms to emerge (either as start-ups or spin-offs) and promoted stronger corporate governance.

This comparative experience shows (in contradiction to an argument commonly advanced early in the transition) that liberalisation and privatisation will not, *per se*, automatically lead to a demand for institutions to support well-functioning markets. However, liberalisation and privatisation policies that take careful account of the importance of competition and corporate governance will indeed set in train processes that reinforce these two key elements of a well-functioning market economy.¹¹

Transition and social developments

Weaknesses in transition manifest themselves not only in poorer economic performance, but also in heavier social burdens. These have been particularly severe in Russia and Ukraine. Annex 1.1 examines in detail evidence on social developments in the region.

The most striking social development has undoubtedly been the loss of life as represented by the higher age-specific mortality rates and the decline in life expectancy in several countries of the region. In 1997, life expectancy in both the CIS and the Baltic states was lower than the level recorded in 1989. The declines have been stronger for males than females. In Russia, male life expectancy decreased from 64.2 years in 1989 to 57.6 years in 1994 and had recovered only to 60.9 years in 1997.

The sources of increases in mortality seem to be largely stress-related (as shown by the prevalence of causes such as heart disease, strokes, alcohol-related problems, suicides and accidents). But the decline in life expectancy has not been uniform across the region. While showing declines in the CIS and the Baltic states, life expectancy in the more advanced transition countries has improved since 1989. The decline in life expectancy in the CIS has been mainly due to increases in the age-specific mortality rates for adults over 40. In Central Asia the rise in age-specific mortality rates appears to be less severe, perhaps because local (often informal) social support networks appear to be stronger than in Russia and Ukraine.¹²

Income inequality and poverty have also increased in many parts of the region. Before the transition began, the centrally planned economies enjoyed a relatively egalitarian distribution of income,¹³ compared with developing economies and with industrialised market economies. During the transition, however, income differentials¹⁴ have widened considerably and in a number of countries the degree of inequality, as measured by the Gini coefficient,¹⁵ now approaches that of the most inequalitarian countries. This is most notably the case in Russia, where inequality is now comparable to that in some of the most unequal Latin American countries. Macroeconomic instability has been a major factor behind the increase in income inequality in Russia, reflecting the vulnerability of people on public pensions and transfers to inadequate indexation.¹⁶

1.2 The structure and findings of the Report

The structure of the Report follows from its purpose: to understand the dynamic process of market reforms in transition economies and the keys to a successful transition. It focuses on the impact of reforms on aggregate economic performance and on the political process, both of which can have powerful “feedback” effects on the path of future reforms. This analysis helps to identify the transition traps that have entangled reforms in some countries and the characteristics of countries that have pressed ahead steadily with reforms and have realised their economic benefits.

⁹ Liberalisation of some aspects and controls but not others in certain markets granted enormous scope for the awarding of special privileges and for arbitrage.

¹⁰ The earlier phase involved the privatisation of small firms and the voucher scheme.

¹¹ The importance of the form of privatisation for corporate governance was, however, highlighted in early *Transition Reports*, specifically in Chapter 4 of *Transition Report 1994* and Chapter 8 of *Transition Report 1995*.

¹² Infant mortality rates, the deaths of infants (less than 1 year old) per 1,000 live births, have improved in most of the region, except for Russia where they worsened considerably in 1993 and where recent improvements have been small.

¹³ As Atkinson and Micklewright (1992) showed, however, one must take care not to exaggerate the degree of equality that existed in the pre-transition period.

¹⁴ As emphasised in earlier *Transition Reports* (see, for example, *Transition Report 1996*, Annex 2.1), measurement problems in this area can be very difficult. However, the changes are so dramatic that they would appear strongly from most treatments of the issues that arise.

¹⁵ The Gini coefficient is derived from the cumulative distribution of incomes across the population, ranked by per capita incomes – the so-called Lorenz curve. It may be defined as one-half of the mean difference between any two observations in the income distribution divided by average income.

¹⁶ The correlation between inflation and the Gini coefficient in Russia is demonstrated in a recent paper by Gavrilenko (1999).

The Report breaks new ground in its detailed analysis of factors for success at the level of individual enterprises, both existing ones and potential new firms. Market entry, deep restructuring, innovation and growth at the firm level ultimately hold the key to a successful transition and rising living standards. Part of the analysis of the Report presents the results of a major new Business Environment and Enterprise Performance Survey undertaken by the EBRD in collaboration with the World Bank. The survey covered over 3,000 enterprises in 20 transition economies, asking their senior managers about the characteristics of their firms, about the business environment in which their firms operate and about their restructuring and growth performance (see Annex 2.1 to Chapter 2 for a brief description, and Chapters 6, 7, 8 and 9).

The Report has three parts. Part I (Chapters 2 to 4) examines progress in transition and economic performance over the past ten years, focusing on patterns of reform and their relationship to macroeconomic performance and to the changing structure of economic activity. Part II of the Report (Chapters 5 and 6) analyses how political factors have shaped the pattern of market reforms and how these reforms have changed the relationship between the state and enterprises. Particular emphasis is placed on economic governance, corruption and bureaucratic interference in enterprises. Part III (Chapters 7 to 9) examines how enterprises have responded to reforms, including the innovation and growth of existing firms and the process of market selection in which viable firms expand and start-up and non-viable firms contract and close.

Transition and economic performance

Over the past decade, two broad patterns in transition have emerged (see Chapter 2). In more advanced countries, rapid liberalisation, comprehensive small-scale privatisation and sustained macroeconomic stabilisation have laid the basis for steady and successful, albeit gradual, institutional change. These changes have been driven by the demands from enterprises and voters and have been shaped by the process of European integration. In less advanced countries in south-eastern Europe and the CIS, progress in liberalisation and privatisation has been slow or uneven and stabilisation has been jeopardised by the persistence of soft budget constraints. This variation in patterns of reform reflects in part relatively unfavourable legacies from central planning in some countries, such as the heavily distorted structure and location of industry in Russia, and their implications for the economic and social costs associated with the introduction of market reforms. However, some transition economies with difficult starting points, such as the Baltic states and Poland, have shown the political resolve to implement comprehensive reforms successfully.

The variation in reforms across countries is mirrored in their macroeconomic performance over the first decade of transition (see Chapter 3). Performance has varied with the severity of the initial structural and macroeconomic distortions, which not only have influenced the depth of the initial transition recession, but also have affected the political feasibility of reforms. Yet even among countries with relatively unfavourable starting points, there is clear evidence that comprehensive liberalisation and stabilisation (including the hardening of budget constraints), as well as progress in small-scale privatisation, have yielded significant

benefits in terms of stronger output growth and lower inflation. For liberalisation and stabilisation to be sustained, however, they must be complemented with development of supporting institutions. Chapter 3 reviews recent reversals and relates them to the lack of underlying structural change in the enterprise and financial sectors. These flaws have, in turn, impeded reform of public finances and weakened fiscal balances.

A crucial link between progress in transition and output growth is structural change (see Chapter 4). An analysis of structural change in transition economies reveals that those countries that have liberalised markets and trade more quickly have adjusted the composition of their economic activity towards that of comparable market economies more rapidly than slow and uneven reformers. The pace of structural change along its many dimensions, however, has differed widely. The reorientation of trade to the international economy, development of the private sector and expansion of key infrastructure sectors – all fundamental to high growth – have been particularly sensitive to reforms. However, financial intermediation – which is necessary for growth and stability over the long term – has, for the most part, so far responded only weakly to financial reforms.

The state and economic reform

Within the constraints created by initial conditions, the political structure and environment have been major determinants of policy choices throughout the first decade of transition (see Chapter 5). The change from the old elite where this occurred in the initial stages of transition was instrumental in promoting economic reforms that not only fostered markets and private enterprise but also that weakened the strongly vested interests of the previous regime. In these cases, the degree of social cohesion in favour of reform was critical in sustaining reforms through the inevitable pains of adjustment and the turnover of governments. While liberalisation and privatisation can serve to weaken the economic and political position of opponents of reform, it should be recognised that they can also be undertaken in deeply flawed ways that create powerful new vested interests. These can block further reforms and promote a popular backlash against the initial measures. External incentives, such as the prospect of integration into the European Union or membership in the World Trade Organization, can exert a powerful influence on policy choices. However, for reforms to be sustained they must generate a strong domestic constituency in support of their continuation.

While a primary goal of transition was to transform the role of the state to provide economic governance based on support for markets and private enterprise, the considerable achievements of liberalisation and privatisation in the first decade of transition have not eliminated arbitrary state interference in enterprises (see Chapter 6). In some countries, there is evidence from the Business Environment and Enterprise Performance Survey that poor economic governance is associated with the extent to which the state is “captured” by powerful vested interests. The survey also shows that the initial hope that privatisation would substantially change the state’s role in firm-level decision-making has not fully been realised. Although ownership has been largely shifted from the state to the private sector, firms continue to interact with the

state over a complex web of costs and benefits that differs across countries and types of firms. Firms spend considerable resources in lobbying state officials, paying bribes, and adjusting to state interference. In return they receive benefits in the form of subsidies, soft finance, tax offsets and tolerance of tax arrears.

Enterprise response to reforms

A successful transition must unlock and encourage innovation and growth by enterprises, but in many transition economies reforms have yet to yield strong responses (see Chapter 7). The Business Environment and Enterprise Performance Survey provides valuable insights into the reasons. There are important differences in reforms at both the country level – in terms of the prevalence of soft budget constraints and quality of the investment climate – and at the level of enterprises themselves, in particular the intensity of competition that they face and their form of ownership. The analysis of the survey reveals a strong influence of competition on deep restructuring and product innovation and that these actions by firms contribute significantly to their real growth. The extent to which budget constraints have been hardened and the quality of the investment climate also have a significant influence on the restructuring and growth of firms.

New private firms tend to grow more rapidly than do other types of firms. But they will grow and emerge most strongly where the market “playing field” is level, including the requirement for the exit of non-viable firms (see Chapter 8). One indicator of the dynamics in the enterprise sector is the extent to which firms with increasing productivity grow and those with falling productivity decline. An analysis of firm dynamics using the Business Environment and Enterprise Performance Survey reveals sharp differences among transition economies with respect to this indicator. The survey also reveals that the main obstacles to small and medium-sized enterprises (SMEs) are anti-competitive practices and corruption, while soft budget constraints are associated with the sustained operation of firms with declining productivity. A priority for the next decade of transition is to embrace a competition policy focused on reducing barriers to business start-ups and introducing measures to combat corruption and crime as well as hardening the budget constraints on declining industrial enterprises.

The restructuring of large industrial enterprises remains one of the most vexing challenges of transition (see Chapter 9). When transition began, it was widely believed that enterprise restructuring would require two types of reforms: liberalisation and privatisation. Ten years on, progress in these reforms has been extensive, but enterprise restructuring – particularly in the industrial sector – has not. A combination of political, fiscal and social constraints has made the task much more difficult than had been anticipated and the reforms adopted in many countries have so far been ineffective. Necessary reforms include improvements in the investment climate to foster the entry and growth of new private firms – to create new employment opportunities and competition – and reform of the social safety net to reduce resistance to restructuring, to facilitate labour mobility and to harden budget constraints. Ownership and management change can also be instrumental in breaking up entrenched insider interests and in initiating restructuring and innovation. There are a number of practical strategies

that governments can adopt to attract strategic investors, including privatisation of the state’s residual shares and “ring-fencing” new joint ventures with strategic investors.

The analyses of this *Transition Report* and those of previous years yield several lessons that can guide the response to the challenges of the second decade of transition:

- First, transition will be a long and difficult process. If the rewards to transition are to be realised and popular support for the process is to be retained, it is vital to learn from the experience of the first ten years of transition – to identify the factors for success and for failure – and to maintain and deepen commitment to reforms.
- Second, while conditions at the start of transition have exercised an important influence and continue to do so, there are crucial policy choices that can and must be made. There are a number of countries in the region that have defied difficult initial conditions and have achieved real successes. In contrast, several countries have been unable to sustain liberalisation and stabilisation, largely because of the persistence of soft budget constraints and of serious weaknesses in the enterprise and financial sectors and in the public finances.
- Third, building institutions that support markets and private enterprise remains a fundamental challenge of transition, but establishing the appropriate laws and regulations is not sufficient. They must be embodied in the social norms, practices and behaviours of both government and the private sector – institutions need social capital and social foundations. The experiences of the first ten years of transition point to the ways in which both formal institutions can be built on firm foundations and social capital accumulated. Of particular importance are: (i) the experiences of liberalisation and privatisation, (ii) the demands for good governance from entrepreneurs and civil society, and (iii) the forces of competition. In particular, economic and political competition can help to direct the demand for institutions in ways that underpin rather than undermine the market economy.
- Fourth, it must be recognised that new firms are the driving force behind economic growth in transition economies and that concerted efforts should be made to create an even playing field for their birth and expansion. Their success is also vital to the restructuring of old enterprises and the hardening of their budget constraints, particularly in the industrial and agricultural sectors, and for building a strong domestic constituency in support of market reforms.

1.3 The way forward

The four lessons above provide strong guidance on how best to respond to the challenges of the second decade of the transition. The importance of promoting the formation and growth of new enterprises and SMEs cannot be over-emphasised. A successful transition must also provide opportunities for restructuring, innovation and expansion by all enterprises and this process of adaptation to the market requires a favourable climate for investment. These two core elements of a strategy for the second decade of transition are examined in turn.

Creating the conditions for new enterprise formation and growth

SMEs in market economies and those in transition are a key source of growth and innovation and they impart flexibility to economies undergoing structural adjustment. By bringing capitalism “close to the people” – into their neighbourhoods and homes – they are at the heart of the economic, political and social transition. A vibrant SME sector can enhance the commitment to democratic societies and the rule of law. SMEs are also an important source of competition. By broadening the private sector, they counter concentration of economic power and can thereby reduce the extent of rent-seeking. Policies for promoting SMEs are central to a successful transition.

Despite the potential benefits that they bring, SMEs have so far received much less attention from governments than larger enterprises, which have been in extensive need of restructuring. Business start-ups and SMEs, by virtue of their limited resources and political influence, often operate on an uneven playing field. Complex tax systems and administrative burdens, corruption, anti-competitive practices, and access to finance are the principal impediments to SME formation and to their participation in the formal economy. The institutional infrastructure – which supports SME information and legal and training needs in most mature market economies – remains largely ineffective. Most banks are reluctant to finance SMEs because of perceived high transaction costs and a lack of accurate financial information. These financing problems can also be found in industrialised market economies, but they are particularly pronounced in transition economies given the inexperience of banks and the brevity of credit histories.

An effective strategy to promote SMEs in the region must simultaneously tackle the three “pillars” of: (i) finance, (ii) improvements in the business environment, and (iii) the strengthening of SME support networks.¹⁷

Finance

An effective strategy would support and strengthen financial intermediaries with the potential to reach SMEs and with the commitment to develop SME finance into a core part of their business. These will often be banks with wide branch networks or a regional basis, such as savings and cooperative banks.¹⁸ External support can make valuable contributions. However, the corporate governance structure of savings and cooperative banks must permit a clear commercial orientation. Today, they often suffer from political interference, poor management and weak balance sheets.

Business environment

The main burden of responsibility for the business environment rests with governments. It is necessary to identify obstacles to small business development and to design and implement policies

and processes based on best practice examples. Important needs for assistance exist, in particular, for authorities at regional and local level.

Support networks

As in finance, support requirements are often specific to stages in a small business development cycle, including: how to transform ideas into business plans and how to find partners for expansion. The goal must be a support network that assists small businesses in “helping themselves”, whatever the nature of the challenge. Chambers of commerce and business associations often play this important role in mature market economies. This capacity must still be built in most transition economies. Organisational partnerships with chambers of commerce in industrialised market economies are one of the ways to achieve this.

Creating the conditions for private investment

There cannot be a vigorous supply-side response to reforms and sustained growth without a large rise in investment. Public money, foreign or domestic, will play only a subordinate role in this process. The vast majority of investment will have to be by the private sector. Governments throughout the region must do still more to create the conditions under which the private sector will invest. These conditions include:

- laws that protect property rights, and that are market-oriented, transparent and effectively enforced;
- a tax system that raises resources but which is designed and administered in a way which does not discriminate against success and honesty;
- fair and robust competition, including the removal of barriers to market entry, the imposition of financial discipline on firms and the enforcement of bankruptcy;
- a framework for the sound corporate governance of firms, including protection of the rights of minority shareholders and creditors; and
- administrative practices that minimise the scope for corruption and cronyism, and that ensure the predictability and stability of the business environment.

Progress in these areas is primarily the responsibility of governments. Without a sound policy, legal and administrative framework, the private sector cannot fulfil its role, and without determined government action, interventions by external sources of assistance will remain largely ineffective.

1.4 Conclusions: the role of the IFIs

The donor community and the international financial institutions (IFIs) can support reforms through loans, policy dialogue and tech-

¹⁷ The EBRD’s new strategy for promoting SMEs is built on these three pillars. An active supporting policy by governments is essential if SME promotion is to be effective and sustainable. Outside actors can complement such a policy but cannot hope to substitute for it. An effective, integrated approach covering the different dimensions of the SME-enabling environment must be coordinated with governments and external sources of support working together with common goals.

¹⁸ The main focus should be on debt instruments, since this is the area in which the broadest immediate benefits can be obtained. However, a comprehensive approach should also cover equity funds, which, while reaching fewer companies than many debt facilities, provide a highly intensive and hands-on form of support.

nical assistance. In some parts of the region, the prospect of progressive integration into European and North Atlantic structures can provide (and has in fact provided) a vision to motivate and direct the drive for reform. The aim should be a coordinated approach that builds on the respective strengths of the different IFIs and bilateral donors.

What is the role of the IFIs in the second decade of transition? The importance of IFIs and bilateral aid as sources of funds is decreasing – as it has in other emerging markets – while private capital flows have been rising. A central challenge for the IFIs is therefore to find ways of fostering the transition through expanding opportunities for the private sector, to view the private sector as a prime vehicle for the achievement of development goals. The IFIs can respond to this challenge both by working with governments to create the conditions for the right kind of market-oriented growth and by becoming participant investors, working directly with the private sector. These two approaches are complementary and can be characterised as “top-down” and “bottom-up”.

The first embodies some of the more traditional IFI roles. It involves promoting macroeconomic stability and ensuring the provision of the necessary physical, institutional, legal and regulatory infrastructure. In the transition economies, these are areas associated with the activities of the IMF and World Bank, and all continue to be important for market-oriented growth.

The second approach represents territory that has been less well explored by the IFIs but that is represented, for example, by the EBRD and International Finance Corporation. It builds on the understandable reluctance of governments to provide sovereign guarantees for IFI loans, which stems both from the pressures on public finances and from a growing understanding of the importance of imposing financial discipline to demonstrate appropriate and strong responses by enterprises and financial institutions to market reforms. These considerations mean that the IFIs must find ways of operating that catalyse the private sector growth in ways which support broader development goals.

An effective way for the IFIs to operate is to become participants in the investment process. Central to the private sector's interest in such a partnership is the ability of the IFIs to manage certain types of political risks in business environments where the institutional framework for markets and private enterprise have yet to develop fully.¹⁹ Partnership with the private sector implies that IFIs must, in important respects, act and think like the private sector, observe market disciplines and be entrepreneurial and flexible partners responding to shifting opportunities and constraints of the market. The challenge is to combine such an approach with the active pursuit of IFI public policy objectives.

There are three principles that should govern the activities of IFIs in this area. At the EBRD, they are termed sound banking, “addi-

tionality” and transition impact. Closely related to the transition criteria is the promotion of sound environmental practices, a principle strongly grounded in the EBRD's mandate.²⁰

Sound banking principles

The financial return to the IFI should be commensurate with the risk. Sound market-oriented development cannot be promoted by investments that are commercially unsound. By ensuring their projects are financially sound and viable, IFIs set an example and establish important standards in accounting, disclosure and corporate governance. Working in collaboration with donor governments, technical assistance can also be used to help overcome market failures and to promote the development of sound business practices and skills. The rigorous application of these principles also ensures the financial health of the institution itself.

Additionality

The participation of the IFIs can encourage the private sector to operate in areas or in ways in which it would not otherwise be ready to do. The privileges enjoyed by IFIs allow them to bring project preparation and risk mitigation facilities “to the table”. These advantages should not allow them to displace private funding or provide an unfair competitive advantage to their private partners. By ensuring that the price of their funding and resources is closely related to the market, they can ensure that their participation does indeed work to expand markets and opportunities rather than displace other investors.

Transition impact

For the EBRD, transition impact is more than an operating principle, it is its basic purpose. If the investment projects supported by IFIs are to facilitate private sector development, they should be appraised in relation to their influence both on the investment climate – discussed above – and on the ability of enterprises and financial institutions to respond to it. Each IFI has to develop methods that focus on its own mandate. For the EBRD, this is the promotion of the transition process, but similar methods can be developed for other objectives.

The public and private sector projects supported by IFIs can have a number of qualitative characteristics that serve to advance private sector development, or, in the language of the EBRD, that have a transition impact. These impacts should be on the key foundations of a market economy:

- markets themselves
- institutions and policies that support and promote markets
- market-based conduct, skills and innovation.

These have been the principles that have guided the EBRD in its assessment of the transition impact of its projects. Their importance has been powerfully demonstrated by the experience of ten years of transition, as analysed in this *Transition Report*.

¹⁹ IFI “local knowledge”, technical assistance and project finance expertise are also important.

²⁰ Environmental issues are closely related to those of transition for a number of reasons, including both the heavy environmental legacy of the old economic system and the political contribution of market-based approaches to environmental problems.

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Annex 1.1: Social developments in transition

The transition over the past ten years has been a period of social upheaval in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS). The disappearance of rationing and shortages, the increase in the quality and choice of products, and the new opportunities for private initiative have improved living standards for many people across the region, but others have suffered severe reductions in their standard of living and some have experienced acute poverty.

This annex examines several aspects of the standard of living in transition economies and shows how developments have differed not only across the region but also across gender, age and social groups.¹ Perhaps the starkest result and the most disconcerting is the substantial increase in mortality (particularly among adult males) in many countries of the CIS. While mortality rates have begun to fall in recent years, their dramatic increase in the first phase of transition was a striking indication of the social upheaval that many people have suffered. An examination of the incidence of poverty reveals that the poor are concentrated among households with many children and among those who are dependent on state benefits. Governments will be challenged in the coming years to provide an environment where opportunities for these groups are generated and to design social “safety nets” that are affordable and well-targeted at the same time.

This special focus on social developments during the transition’s first decade is important for three main reasons. First, social developments are significant in their own right. The health of people, their education and the degree of social, racial or gender discrimination that they face all have a direct impact on people’s livelihood. Second, when people are denied access to basic health and education services, their human capital remains underdeveloped and the economy’s production potential cannot be fully realised. Third, adverse social developments, including an increase in destitution of some groups or individuals, can severely undermine the social fabric of a society. The social tensions created by widespread poverty and increases in economic inequality can discredit market reforms in the eyes of the public.

Although many social statistics, such as mortality rates, school enrolment and literacy, may be more accurately measured than monetary indicators of income and wealth, there is an important proviso on the quality of these data in transition economies, particularly regarding changes over time. While vital statistics were generally accurately measured under communism, political considerations may have led to data manipulation to improve headline statistics, such as infant or maternal mortality rates. They may even have led to outright suppression of sensitive evidence. Moreover, statistical recording was greatly hampered during the violent conflicts that engulfed the former Yugoslavia, the Caucasus

and Tajikistan during the past decade. Comparisons across countries should be treated with care under these circumstances. While the evidence presented in this annex should be viewed with some caution, it consistently points to a similar conclusion. There can be no doubt that the transition has been associated with a heavy social burden on the people of many countries in the region.

Health in transition

A basic indicator of the health of people in any society is their life expectancy at birth. Across the world, people in relatively wealthy societies tend to live longer, although there is considerable variation among countries, depending on, among other factors, the extensiveness or effectiveness of public health care. Before the transition, life expectancy in the region by and large compared favorably with the level in market economies with similar income levels. For instance, in 1980 life expectancy in CEE averaged 70 years, which was significantly higher than the levels achieved in most of Latin America or East Asia. In the former Soviet Union, life expectancy in 1980 was 68 years, although it varied considerably across republics (see Table 1.1.1).

Since 1989, life expectancy data show diverging trends across the region. Five distinct groups may be distinguished. The first group comprises the countries of central Europe (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia). In these countries, life expectancy has increased since 1989 to an average of 73 years. The second group comprises Albania, Bulgaria, Croatia, FYR Macedonia and Romania. Life expectancy in this group has remained roughly constant. The third group contains the three Baltic states and Russia, where life expectancy declined precipitously during the first four years of transition, but has recovered partially since then. The fourth group is made up of the other countries of the western CIS (Belarus, Moldova and Ukraine) but also includes Kazakhstan. This group has experienced a continuous decline in life expectancy since 1989. The fifth group contains the remaining countries of Central Asia and the Caucasus, where data are patchy, but overall little change in life expectancy is indicated.

Average life expectancy is a summary indicator of health, which combines the effect of different mortality rates across age groups and gender. Looking more closely at the factors that have led to the diverging trends in life expectancy reveals that one major factor has been the change in adult male mortality rates (see Chart 1.1.1). In Russia, male life expectancy declined by six years between 1989 and 1994, and approximately half of this decline was due to higher death rates of males aged 35-64.² In the Baltic states as well as in the western parts of the CIS and in Kazakhstan, adult male mortality rates similarly experienced a dramatic increase during the first years of transition. Although female

¹ The analysis builds strongly on the detailed examination of social developments in transition economies by UNICEF’s International Child Development Centre (ICDC) in Florence. Since 1993, the ICDC has produced six annual Regional Monitoring Reports, each covering a special topic such as education, health, gender and poverty. The ICDC has also collected a wide range of social statistics on the region, available through their TransMONEE database, on which this annex heavily relies. Readers are referred to the ICDC’s web site at www.unicef-icdc.org for more information.

² See McKee (1998).

mortality rates were lower and have increased by less, the loss of life among women has also been severe. In Russia and Kazakhstan, female life expectancy fell by over three years in 1989-94. In Belarus, Moldova and Ukraine it has declined by over two years since the start of transition.

Recent research reveals that a high proportion of additional deaths among males during the transition can be attributed to the rising incidence of cardiovascular diseases, accidents and violence.³ The concentration of excess deaths in these categories helps to uncover some of the socio-economic causes of the rise in mortality and highlights the important role of stress and social upheaval in addition to economic deprivation. While dietary habits and reduced calorie intake among the poor may have increased morbidity, the concentration of excess male deaths in the categories listed above is better explained by psychological stress. None of the existing studies finds that the declining quality of health services has had a significant impact on mortality rates, although its impact on the well-being of those in need of medical treatment may nonetheless be substantial.

A particularly conspicuous aspect of changes in mortality during transition is the relationship with changes in alcohol consumption. In the western CIS and the Baltic states in particular, the psychological stress related to rapid economic change seems to have led to an increased incidence of excessive drinking, which in turn may have led to the rising number of deaths from injuries, violence and cardiovascular disorders.⁴ The significance of alcohol seems to be confirmed by the fact that the anti-alcohol campaign of Gorbachev during the mid-1980s resulted in a very notable improvement in male life expectancy by almost three years between 1980 and 1985.

The much smaller increases in mortality in the Caucasus and in Central Asia indicate the potential role of social support systems in mitigating the effects of economic upheaval. In particular, the stronger family ties and informal support arrangements in these countries may have cushioned the impact of rising unemployment and rapid structural change on male mortality rates. A recent study by UNICEF finds that higher male mortality rates in the 40-49 years age group have coincided with a higher incidence of divorce and family break-ups in the Baltic states and the western parts of the CIS than in the Caucasus and in Central Asia.⁵ Another study focusing on regional differences in mortality rates in Russia finds that the degree of trust in local government and the level of civil engagement by the local population were negatively associated with mortality rates.⁶ In general terms, social capital may cushion the impact of economic recession and structural change on individuals' livelihood, demonstrating another aspect of its important contribution to a successful transition (see Chapter 1).

Table 1.1.1

Life expectancy at birth – selected transition economies and emerging markets, 1980-97

(Number of years)

	1980	1985	1989	1993	1997
Central and eastern					
Europe and Baltic states¹					
Albania	70.0	71.2	72.5	71.3	71.7
Bulgaria	71.0	–	71.8	71.1	70.7
Croatia	70.4	–	71.8	–	72.5
Czech Republic	70.4	71.0	71.7	72.7	73.9
Estonia	69.0	70.0	70.1	68.0	70.1
FYR Macedonia	70.1	–	–	–	72.5
Hungary	69.1	69.1	69.5	69.0	70.6
Latvia	68.8	70.0	70.1	67.6	69.2
Lithuania	70.0	70.5	71.5	69.0	71.2
Poland	71.2	71.1	71.0	71.6	72.7
Romania	69.2	69.8	69.5	69.6	69.0
Slovak Republic	70.4	71.0	71.0	72.4	72.7
Slovenia	71.4	71.6	72.7	73.3	74.7
<i>Average</i>	70.1	70.5	71.1	70.5	71.7
CIS¹					
Armenia	72.6	72.8	71.8	71.1	73.7
Azerbaijan	68.0	69.2	70.2	69.4	70.9
Belarus	70.8	72.3	71.6	69.0	68.5
Georgia	71.0	71.3	71.8	–	72.6
Kazakhstan	66.8	67.6	68.3	66.7	64.9
Kyrgyzstan	65.6	67.2	67.9	67.2	66.9
Moldova	65.6	65.3	68.8	67.4	66.5
Russian	67.3	67.8	69.2	65.2	66.9
Tajikistan	66.2	68.1	68.4	–	68.3
Turkmenistan	64.5	64.6	65.0	–	65.7
Ukraine	69.3	69.4	70.5	67.9	67.4
Uzbekistan	67.4	67.6	69.0	–	69.2
<i>Average</i>	67.9	68.6	69.4	68.0	68.4
Other²					
Argentina	69.6	68.2	71.6	–	73.1
Brazil	62.7	60.4	65.4	–	67.0
Korea, Dem. Rep.	66.8	62.3	65.5	–	63.0
Malaysia	66.9	62.6	70.5	71.3	72.0
Mexico	66.8	64.2	70.4	–	72.0
Thailand	63.6	66.5	68.4	–	68.8

¹ Source: TransMONEE database, UNICEF, 1999.

² Source: *World Development Indicators*, World Bank, 1999.

While the causes of the initial increase in mortality rates in Russia have been extensively investigated, much less conclusive evidence is available on the more recent improvement. To some extent, this may reflect the fact that people have learned to adapt better to the difficult economic circumstances.⁷ However, it may also be due to the possibility that the most marginalised groups died during the early 1990s, and their declining representation in the population therefore explains the apparent improvement.

³ For a collection of papers on the mortality crisis in Russia and other parts of the CIS, see the special issue of *World Development*, November 1998, in particular the papers by Shkolnikov et al., Kennedy et al. and Brainerd.

⁴ Excessive drinking as opposed to moderate regular alcohol consumption has been found to be associated with a higher incidence of cardiovascular disorders. See McKee (1998).

⁵ See UNICEF, ICDC, *Women in Transition*, Regional Monitoring Report No. 6, Florence, 1999.

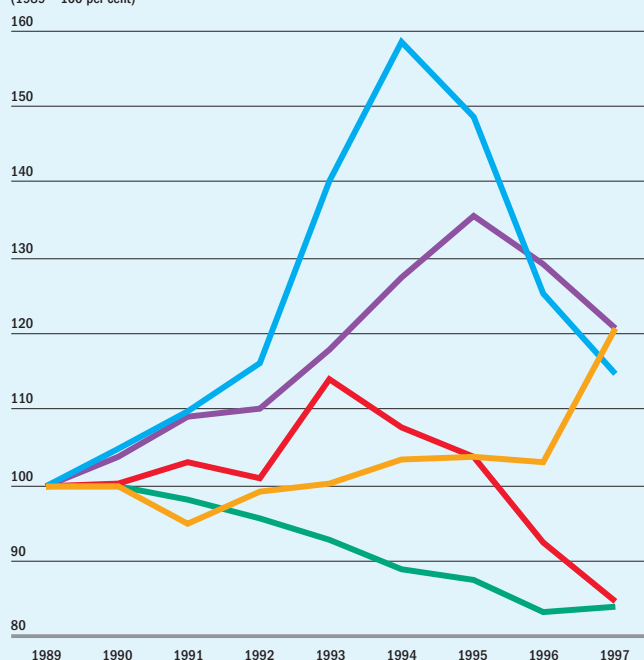
⁶ See Kennedy et al. (1998).

⁷ See Rose (1999).

Chart 1.1.1

Mortality rate among adult males (aged 40-59), 1989-97

Number of deaths per thousand
of relevant population
(1989 = 100 per cent)



Source: UNICEF, TransMONEE database, 1999.

Education in transition

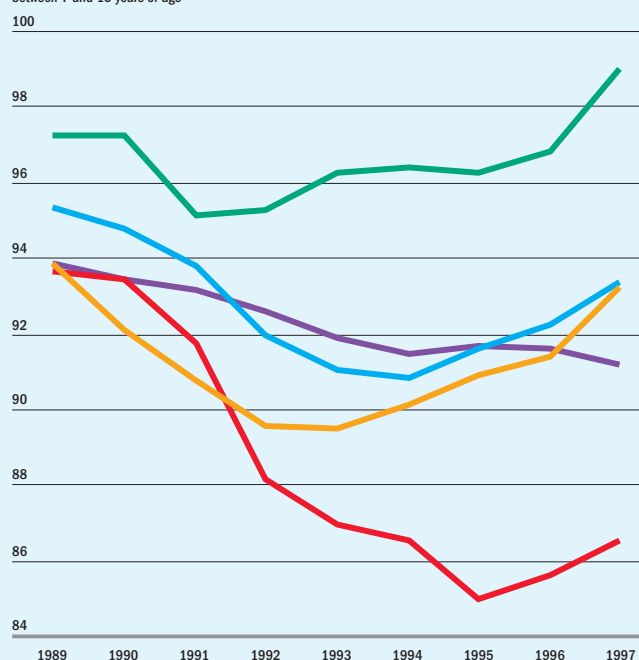
Education is fundamental to individual well-being and economic performance. Individuals can realise their potential only when they have affordable access to quality education, and economies can prosper only when their populations are well-educated. More broadly speaking, the investment that a society is willing to undertake in its young generation has a persistent influence on the standard of living of its population.

Centrally planned economies provided extensive and broad educational services.⁸ Basic education, lasting eight years, was compulsory, secondary school enrolment rates were high by international standards and adult literacy was almost complete. Moreover, the education system was evenly balanced between men and women. An extensive system of crèches and nursery schools provided day care for children below school age to support working women. Yet, this overall positive picture masks significant differences in access to education between the urban and rural population as well as among children with different social backgrounds. Moreover, while children in centrally planned economies were generally well-trained in factual knowledge, teaching put insufficient emphasis on forming skills that would allow children to acquire new knowledge and adapt to a changing environment.

Chart 1.1.2

Basic school enrolment rates (gross rates), 1989-97

Percentage of relevant population
between 7 and 15 years of age



Source: UNICEF, TransMONEE database, 1999.

The transition has brought further disparity in the access to quality education. The universal provision of basic educational services has been eroded in some countries as the costs to families of educating children have increased. Greater selectivity and competition in education has contributed to improving the services provided to the talented and better off, at the expense of children with average ability who are from less wealthy families. Moreover, an urban-rural divide seems to be appearing, which is jeopardising the educational achievements made under central planning.⁹

Chart 1.1.2 reveals that basic school enrolment ratios (covering children from the age of 7 to 15 years) increased in central Europe and followed a moderately U-shaped pattern in south-eastern Europe and the Baltic states. In the CIS, the chart draws a distinction between the relatively urbanised countries, such as Belarus, Kazakhstan, Russia and Ukraine, and those with a large proportion of the labour force still engaged in agriculture (the Caucasus, Moldova and Central Asia). While in the former, the decline in basic school enrolment rates was contained to around 3 percentage points, in the latter group, the combination of war and lack of adequate government funding has contributed to a precipitous decline in basic school enrolment rates.

⁸ A review of developments in education during transition is provided in the UNICEF, ICDC, *Education for All?*, Regional Monitoring Report No. 5, Florence, 1998, and Micklewright (1999).

⁹ See UNICEF, ICDC (1998).

Table 1.1.2

Estimated poverty headcount and poverty deficit in 1987-88 and 1993-95 based on household income

Country	Poverty headcount (%) ¹		Total number of the poor (mlns) ²		Shortfall as per cent of poverty line ³	Total poverty deficit as per cent of GDP ⁴	Poverty line (US\$ per month) ⁵
	1987-88	1993-95	1987-88	1993-95	1993-95	1993-95	1993-95
Central Europe	1.4	12	2.2	8.1	25	0.3	–
Czech Republic	0	<1	0.0	0.1	23	0.01	32
Hungary	1	4	0.1	0.4	25	0.2	57
Poland	6	20	2.1	7.6	27	1.4	51
Slovak Republic	0	<1	0.0	0.0	20	0.01	36
Slovenia	0	<1	0.0	0.0	31	0.02	73
South-eastern Europe	4	37	1.4	14.8	29	3.3	–
Bulgaria	2	15	0.1	1.3	26	1.1	30
Romania	6	59	1.3	13.5	32	5.4	28
Baltic states	1	29	0.1	2.3	33	3.1	–
Estonia	1	37	0.02	0.6	37	4.2	60
Latvia	1	22	0.03	0.6	28	2.3	58
Lithuania	1	30	0.04	1.1	34	2.9	26
Western CIS	2	52	3.5	112.1	39	4.8	–
Belarus	1	22	0.1	2.3	26	1.2	19
Moldova	4	66	0.2	2.9	43	7.0	13
Russia	2	50	2.2	74.2	40	4.2	21
Ukraine	2	63	1.0	32.7	47	6.9	21
Central Asia	15	66	6.5	30.7	47	9.8	–
Kazakhstan	5	65	0.8	11.0	39	9.2	23
Kyrgyzstan	12	88	0.5	4.0	68	64.4	16
Turkmenistan	12	61	0.4	2.4	40	7.7	33
Uzbekistan	24	63	4.8	13.3	39	12.4	11
Total transition	4	45	13.6	168.0	35	3.5	–
Comparators							
Brazil	33	–	48.3	–	44	4.4	–
Columbia	–	35	–	11.6	40	5.4	–
Ecuador	–	35	–	3.9	31	4.4	–
Paraguay	–	44	–	2.1	51	8.1	–
Malaysia	31	18	5.1	3.6	29	0.8	–
Turkey	31	–	16.7	–	33	3.8	–
United Kingdom	1	<1	0.6	0.5	–	–	–

Sources: Milanovic (1998), Table 5.1, pp. 68-9.

Notes:

The table is based on household budget surveys, collected by Milanovic. The poverty line is measured relative to household incomes, net of taxes and transfers. The results can change substantially when household expenditure data are used. See Milanovic (1998).

Data for regional country groups are sums for the total number of poor, and averages for the poverty headcount, the shortfall as per cent of the poverty line and the total poverty deficit as per cent of GDP.

¹ The poverty headcount is defined as the number of people falling below the poverty line, divided by the total population.

² The total number of poor people comprises all people with monthly income below the poverty line.

³ The average shortfall as per cent of the poverty line is defined as the average income of all people with monthly incomes below the poverty line, divided by the poverty line income. It measures the depth of poverty below the officially set poverty thresholds.

⁴ The total poverty deficit is calculated as the sum required to bring all people up to the poverty line. The poverty deficit will be higher, the more people are below the poverty line, and the larger the average shortfall as per cent of the poverty line.

⁵ The poverty line is based on national thresholds and converted using current exchange rates to the US\$. An international reference point is given by UNDP's poverty line for middle-income countries, set at US\$ 4 per day at purchasing power parity (PPP). See country tables at the back of this Report for estimates for 1995-97.

Poverty and income inequality

The review of developments in health and education suggests significant variation in the standard of living for people across the countries of the region. A similar observation can be made from an examination of data on poverty and income distribution (see also *Transition Report 1997*, Annex 2.2).

Monetary data on incomes in transition economies are difficult to interpret for a number of reasons.¹⁰ First, with dramatic changes in relative prices and widespread under-reporting of economic activity, it is very difficult to make precise estimates of changes in

real incomes during the transition. Second, measurements of poverty are faced with the problems of adjustment to different resource requirements for different individuals and social groups. The definition of a poverty line is to some extent always arbitrary. It should not be forgotten that there are substantial potential variations in income and consumption below such a line. Third, measuring the distribution of income poses considerable problems regarding the coverage of surveys, the unit of observation (households or individuals), and the measurement of income itself and its spending power.

¹⁰ A careful review of data issues for income measurement both before and during the transition is provided in Flemming and Micklewright (1999).

Bearing these issues in mind, the following two broad trends may be observed.

- The transition has been accompanied by an increase in the number of poor people in almost every country in CEE and the CIS. The increase has been largest in countries where real incomes have fallen most. Taking an international poverty line of US\$ 4 per day, measured at purchasing power parity (PPP) exchange rates, around 140 million people could be considered to be poor in 1995, 83 per cent of which were living in the CIS.
- Parallel to the rise in poverty, there has been a marked increase in income inequality. The increase has been pronounced in the countries of south-eastern Europe and the CIS, but much less so in central Europe. As a result, while income inequality in several CIS countries rivals the level in relatively unequal developing countries, income inequality in central Europe is more comparable to the much lower levels seen in continental western Europe.

Table 1.1.2 presents the headcount poverty rate, based on household incomes for a number of transition economies, for a year before the start of transition and a year in the mid-1990s as well as the total number of poor in each period. For the 1993-95 period, the national poverty line in current US dollars and the average shortfall to the poverty line are also given. In addition, the total cost of raising all the poor to at least the poverty line is calculated as a percentage of GDP. Although direct cross-country comparisons are complicated by the fact that the US dollar equivalent of national poverty lines differs, the table nonetheless highlights the significant variation in the incidence and depth of poverty across the region. It should be noted that in several countries, under-reporting of income is likely to have caused a severe upward bias to poverty rates estimated in Table 1.1.2. For instance, in Kyrgyzstan and Ukraine the poverty headcount is reduced from 88 per cent and 63 per cent to 46 per cent and 37 per cent respectively when household expenditure rather than income is used.

At an aggregate level, the increase in poverty may be attributed to decreases in average real incomes on the one hand and increases in income inequality on the other. While average real incomes initially declined in all transition economies, developments in income inequality have differed dramatically across the region. It is important to distinguish between changes in the distribution of earnings and changes in the distribution of household incomes (the latter typically include taxes and state benefits as well as non-monetary sources of income, such as own produce and payments in kind). Chart 1.1.3 reports the Gini coefficient of gross earnings for the pre-transition period and the latest available year.¹¹ Changes in distribution of earnings have clearly varied tremendously across the region (and the initial degree of inequality also differed). Data on the distribution of income are more patchy but support overall

the differences that emerge from Chart 1.1.3.¹² State benefits have done little to mitigate the increase in earnings inequality in the CIS (see below).

Whether poverty rates can be reduced during the next phase of transition depends on whether economic recovery can be achieved and sustained and on whether inequality will fall again. Regarding real incomes, the Russian case again provides a useful example. Chart 1.1.4 illustrates that the modest increases in disposable incomes in Russia during 1997 had little effect on the poverty headcount. However, their subsequent dramatic fall during 1998, especially following the crisis in August, led to a precipitous increase in the poverty headcount, from 23 per cent to 30 per cent in one month. During the same period, the Gini coefficient of the distribution of disposable income remained relatively constant, so that all the increases in official poverty can be attributed to the fall in real incomes. Some caution is required, however, because reported real incomes do not take into account the reduction in wage arrears following August 1998, so cash incomes may have declined by less.

Developments in inequality over the next decade of transition will depend on a variety of factors. One of the mechanisms that could cause increases in earnings inequality is the movement of workers from low-productivity, state sector jobs to higher-productivity, private sector jobs. As the proportion of workers in the private sector rises, however, earnings inequality would eventually fall, as productivity differences diminish.¹³ In the CIS, this process seems to have become stuck at a level where there are a few high-wage private sector jobs, but the majority of workers are employed in unprofitable and low-paying public sector or privatised enterprises. An eventual decline in inequality in this part of the region would depend therefore on advances in structural reform to create more private sector jobs.

The pattern of structural change is, of course, not the only factor influencing changes in earnings inequality during the transition. The distribution of wealth that has resulted from privatisation of productive assets and of the housing stock is likely to play an ever-increasing role in determining the distribution of earnings. Through its impact on an individual's capacity to borrow, the distribution of wealth may not only affect the distribution of earnings from capital assets but also have dynamic consequences for investment in human capital and therefore wage distribution.

The characteristics of the poor and social policy

Who are the poor? An answer to this question is clearly essential if social policy is to find an adequate response to the increase in inequality. The basic conclusion that may be drawn from existing studies is that the households most affected by poverty are those with many children, those headed by single parents, and those

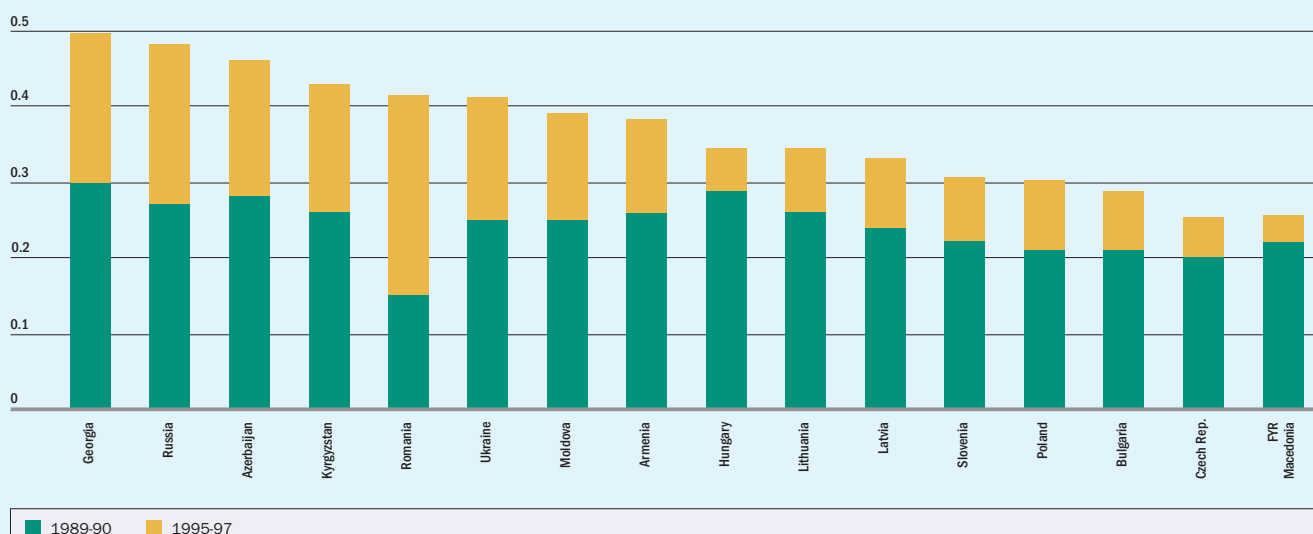
¹¹ The Gini coefficient is defined as one-half of the mean difference between any two observations in the income distribution divided by average income. Its value is zero for total equality, and one for a situation in which all income is concentrated in the hands of one individual.

¹² See Fleming and Micklewright (1999).

¹³ See Milanovic (1998) and Aghion and Commander (1999). In practice, earnings inequality has not declined anywhere in the region up until now, although it has stabilised in many countries.

Chart 1.1.3

Change in inequality, 1989-90 and 1995-97, selected transition economies

Gini coefficient of the distribution of earnings ¹

Source: UNICEF, TransMONEE database, 1999.

¹ The Gini coefficient is derived from the cumulative distribution of earnings across the population, ranked by per capita incomes. It is defined as one half of the mean difference between any two observations in the earnings distribution divided by average earnings.

dependent on state benefits, such as pensions, unemployment benefits and other forms of social support.¹⁴ The increasing incidence of poverty among children in transition economies is particularly worrying, as a deprived upbringing may reduce their chances of achieving a better standard of living in their adult life.

Recipients of state benefits have particularly suffered from imperfect indexation with inflation when the latter has been high as well as from the fiscal crisis in many transition economies, which has led to payment arrears.¹⁵ Yet, the poor include not just children, pensioners, single mothers and the unemployed – groups that are also strongly represented among the poor in many market economies. In most transition economies, a significant proportion of the poor consists of workers on low incomes. In Ukraine, for instance, 80 per cent of all workers earn a wage that is below the subsistence level. If a worker in this group is the only earner in a household of two, the household would fall below the poverty threshold.

The high incidence of poverty among workers in transition economies highlights the importance of education for escaping from poverty. Wage differentials between skilled and unskilled workers have tended to increase during the transition, and individuals with secondary and university education tend to be less represented among the poor than individuals with primary or vocational education. In south-eastern Europe and the CIS, providing quality education for all will require rebuilding an adequate fiscal revenue base to prevent real expenditures on education (and

health) from falling further. The creation of new private sector jobs will also be important, as this will provide individuals with an opportunity to make full use of their skills. Evidence from western Europe suggests that long spells of unemployment tend to erode this skills base and to make re-employment more difficult.

Regarding government assistance, it is generally believed that state benefits for households are more beneficial than subsidies to enterprises, and that broad-based taxes should be used rather than differential taxation. The evidence from the transition economies is again stark in contrasts. In much of the CIS, the state has remained tied to the enterprise sector, through explicit and implicit subsidies. In CEE, a relatively generous social safety net has been created and the use of producer subsidies has been greatly reduced. Moreover, in some CIS countries, even when there has been a system of social assistance, state benefits have not always gone to the most needy.¹⁶ According to one recent study on Russia, the increase in benefit entitlements and coverage after 1994 directly contributed to a higher incidence of poverty, because rising benefit arrears and imperfect indexation imposed a particular burden on poor households.¹⁷ By contrast, state benefits in the Czech and Slovak Republics have been generally successful in containing the increase in income inequality.¹⁸

Against the background of limited fiscal resources in the CIS and very high levels of payroll taxation in CEE, there have been increasing demands for improved targeting of social assistance.

¹⁴ For references, see *Transition Report 1997* and Milanovic (1998).

¹⁵ Gavrilov (1999) shows a strikingly close correlation between the Gini coefficient of household income and inflation in Russia.

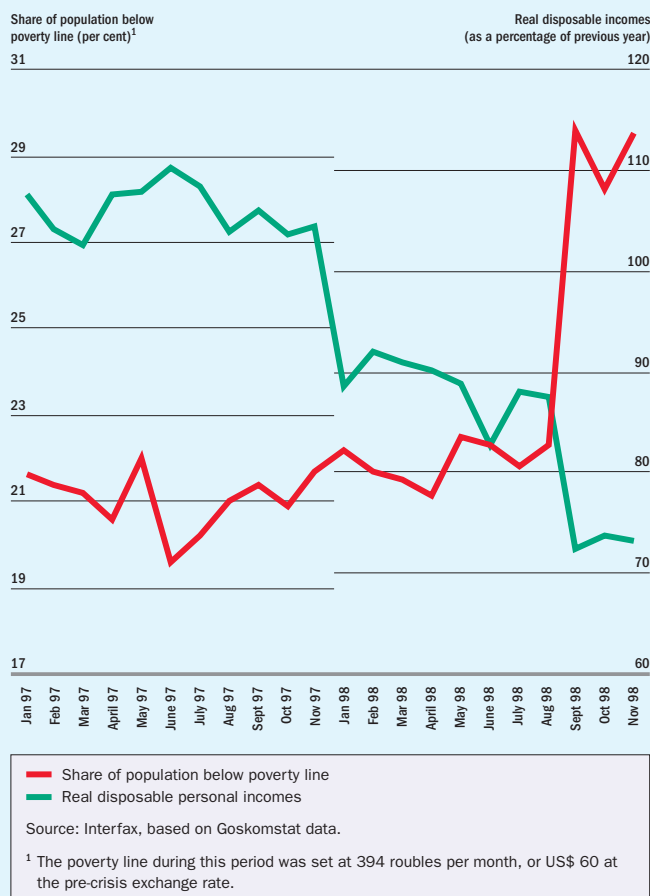
¹⁶ See, for instance, Commander, Tolstopiatenko and Yemtsov (1999) for the Russian case.

¹⁷ See Richter (1999).

¹⁸ See Garner and Terrell (1998).

Chart 1.1.4

Real incomes and poverty in Russia, 1997-98



Yet, how this is achieved in practice is not clear. International evidence suggests that universal entitlements at low levels tend to be far more efficient and less costly to administer than elaborate means-tested schemes.¹⁹ Moreover, means-testing effectively raises marginal tax rates for those at the bottom of the earnings distribution and may discourage the poor from entering the labour force. The inaccuracy of information regarding household incomes in the transition economies only serves to emphasise the difficulties with means-testing. One possible solution is to tie benefits to household characteristics, such as the number of children, as this information would be difficult to manipulate and easy to monitor. Similarly, public work schemes could be used as a self-selection device to target those in real need. The *mahalla* system in Uzbekistan provides an interesting case of decentralised benefit-targeting, which uses the knowledge available in a local community to select the needy.²⁰

Finally, it is important to stress the great human resilience in the face of immense changes across the region. Confronted with a deterioration in living standards, as indicated by the data in this annex, individuals have shown great resourcefulness in mobilising networks of friends and family for their mutual support. One of the

biggest challenges for government in the next phase of transition is to build on these informal networks to create a culture of public involvement and a degree of public support that could help the societies of the region to cope more effectively with the required large-scale adjustments.

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¹⁹ See UNDP (1999).

²⁰ See Coudouel, Marnie and Micklewright (1998). These authors also point to drawbacks of the system. While benefits overall are allocated to households in need, once selected to receive benefits the distribution of transfers among the recipients does not closely match criteria of economic need.



Part I

Transition and economic performance

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Progress and patterns in transition

Over the past decade, two broad patterns in transition have emerged. In more advanced countries, rapid liberalisation, sustained macroeconomic stabilisation and comprehensive small-scale privatisation have laid the basis for the gradual development of the institutions that are necessary to support markets and private enterprise. This development has been shaped by both the demand from enterprises and voters, on the one hand, and the strong incentives and guidance of European integration, on the other. In the less advanced countries, progress in liberalisation has been slow and uneven. Moreover, macroeconomic stabilisation in these countries has been jeopardised by the persistence of soft budget constraints for “old” enterprises and banks and by their continuing structural weaknesses, while the business environment for new private enterprises remains difficult.

This chapter analyses the factors that lie behind the patterns of reform observed after ten years of transition. This analysis consists of four main parts. The first two parts examine progress in liberalisation and macroeconomic stabilisation. This analysis reveals a striking degree of variation across transition economies, which is linked with the extent to which hard budget constraints have been imposed on enterprises. It also shows that, while the initial conditions in each country have had a significant influence on the extent and effectiveness of these reforms, policy choices have also been important. The third part examines progress in privatisation, emphasising the various objectives and constraints of medium- and large-scale privatisation and how the privatisation of state enterprises has not always led to a reduction in political intervention and an improved performance. In contrast, small-scale privatisation has been much easier to implement and its widespread implementation has helped to create a demand for effective market-oriented institutions. The fourth part examines the process of institutional change, focusing on the demand for market-oriented institutions and on the process through which they are established.

Before analysing the patterns of reform, however, the chapter examines recent reform developments and finds that the pace of overall progress in market reforms in the region over the past year has remained slow. The past two years have seen only gradual reform gains after a period of rapid progress up to 1997. One reason for this slowdown has been the widening disparity among countries, with continued reform progress in some countries offset by reversals in others. For example, the crisis in Russia in 1998 and its regional repercussions have contributed to setbacks in the liberalisation of prices and trade and in banking reform in a number of CIS countries. In contrast, Bosnia and Herzegovina and Romania have achieved significant reform advances over the past year, while Bulgaria has continued to build on its comprehensive reform programme initiated in 1997. A second reason for the slow overall progress in reform is the inherently gradual nature

of the developing institutions that support markets and private enterprise, as the tasks of liberalisation and privatisation become complete.

The chapter concludes by assessing the challenges of the second decade of transition and the need to improve the investment climate. This assessment emphasises that sustained liberalisation and stabilisation remains a challenge in a number of countries, particularly in south-eastern Europe and the CIS. The economic and social costs involved in adapting enterprises to market pressures lie at the root of the problem. One way to ease this constraint would be to reduce obstacles to the growth of new private sector companies, particularly by strengthening the economic governance provided by the state. The analysis in this chapter also emphasises that in countries where liberalisation and stabilisation have been sustained, the development of institutions that support markets and private enterprise has advanced steadily. However, it must be recognised that these institutions do not develop simply in response to demands from the private sector. The state must play a strong and leading role in developing well-functioning institutions. Given the varying constraints on the power of the state across the region, one way of ensuring institutional reforms is to open the country to the discipline of foreign competition and to increase its international integration.

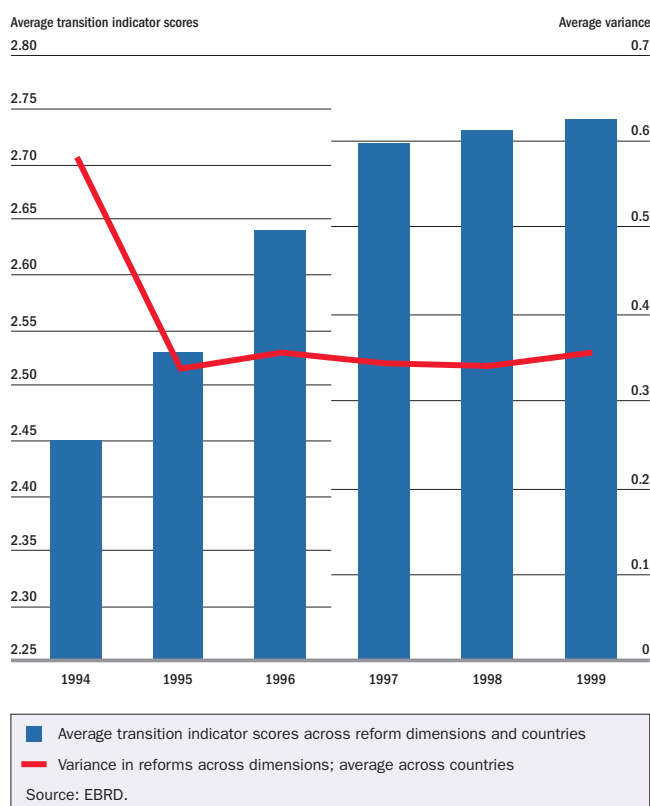
2.1 Transition indicators

The EBRD's *Transition Reports* have provided assessments of progress in transition for 26 countries of central and eastern Europe, the Baltic states and the CIS since the first Report was published in 1994. These assessments are made for a number of core aspects of reform that correspond with the main elements of a market economy – markets and trade, enterprises and financial institutions. Progress in each of these areas represents an improvement in how well markets, enterprises and financial institutions function. Progress is measured against the standards of industrialised market economies, recognising that there is neither a perfectly functioning market economy nor a unique end-point for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from the previous regime and 4+ represents a standard that would not look out of place in an industrialised market economy.

Within the broad categorisation of reforms, the transition indicators in Table 2.1 measure specific aspects of the transition process. On markets and trade, the indicators capture the liberalisation of prices, trade and access to foreign exchange as well as the extent to which utility pricing reflects economic costs. The indicators also assess the effectiveness of competition policy in combating market dominance and anti-competitive practices. On enterprises, the indicators measure the extent of small-scale and large-scale privatisation and of enterprise reforms, such as the elimination of

Chart 2.1

Average annual EBRD transition indicators and average variance across countries, 1994-99



production subsidies and the introduction of bankruptcy procedures and of sound corporate governance. On financial institutions, the indicators capture the extent to which interest rates have been liberalised and securities markets established. They also assess whether prudential regulations have been raised to international standards and if procedures exist for resolving the failure of financial institutions.

In addition to the core dimensions of transition that have been measured by each of the *Transition Reports*, this chapter has four annexes that summarise progress in other areas of reform. Annex 2.1 summarises the results of a major new Business Environment and Enterprise Performance Survey undertaken by the EBRD in collaboration with the World Bank. The survey asked over 3,000 enterprises in 20 countries about their perceptions of the investment climate in the country in which they operate.¹ Specifically, the survey asked the managers of local businesses about the obstacles they faced in the operation and growth of their firms. The questions focused on the nature of business regulation and taxation, corruption and crime, the judiciary, macroeconomic stability, finance and infrastructure. The survey complements the EBRD's transition indicators in two important ways. First, it provides a hands-on assessment by local businesses rather than by independent outside observers. Second, it expands the assessment of progress in transition by including the actual behaviour and practices of governments and judiciaries.

Annex 2.2 reports the results of the EBRD's legal transition survey of over 175 practising lawyers in 26 countries in the region. The Office of the General Counsel of the EBRD implemented and analysed this survey, which measures the extent and effectiveness of commercial and financial laws, with a particular focus on those laws and regulations that are fundamental to investment and financing decisions. They include company law, bankruptcy law and secured transactions law as well as banking and securities laws and regulations. The survey examines both the content of the law and the effectiveness of judicial enforcement. It therefore provides a valuable complement both to the EBRD's transition indicators and to the survey on the business environment and enterprise performance.

Annex 2.3 assesses progress in the development of commercial infrastructure. The analysis focuses on five sectors: electric power, railways, road transport, telecommunications and water. The infrastructure indicators focus on the areas of tariff reform, commercialisation (including private sector participation) and effective regulation. Annex 2.4 examines progress in environmental protection. It examines the progress of transition economies in adopting international treaties on the environment and in implementing environmental improvements in the area of energy efficiency.

2.2 Recent progress in transition

Chart 2.1 shows the overall transition indicator scores from 1994 to 1999, averaged across all countries of the region and all core dimensions of reform (markets, enterprises and financial institutions). This average provides a summary measure of overall progress in reform. It shows progress from 1994 to 1997 but a marked slowdown over the past two years. In 1999, 12 countries achieved net increases in their average transition indicator scores, while five registered declines and nine showed no change.

Countries that have achieved the greatest progress in reform over the past year include Bosnia and Herzegovina, Bulgaria, Romania and Tajikistan (see Chart 2.2 and the transition assessments) as they continue to catch up on long-delayed reforms. Tajikistan has achieved steady progress in small-scale privatisation and is preparing for full current account convertibility. Faced with major macroeconomic imbalances, Romania has redoubled reform efforts in the areas of privatisation and banking reform. It privatised over 1,000 small-scale enterprises in 1998 and, in May 1999, the National Bank of Romania withdrew the licence of Bancorex, a large and deeply troubled state bank with over 70 per cent of its total loans classified as non-performing. Bulgaria has continued to build on its comprehensive reform programme, which was initiated in the middle of 1997 with the establishment of a currency board. Over the past year, it has advanced significantly with small-scale privatisation, largely through management-employee buy-outs (MEBOs), and further liberalised its trade and foreign exchange regime. Bosnia and Herzegovina has achieved significant reform advances over the past year, including the reduction of internal barriers to trade between entities within the country and the adoption of a new banking law.

¹ The survey was undertaken as part of an EBRD Policy Studies project. The survey was designed in collaboration with the World Bank as part of its World Business Environment Survey initiative.

Table 2.1

Progress in transition in central and eastern Europe, the Baltic states and the CIS

Countries	Population (millions, mid-1999)	Private sector share of GDP in %, mid-1999 (EBRD estimate) ¹	Enterprises			Markets and trade			Financial institutions	
			Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	3.2	75	2	4	2	3	4	2	2	2-
Armenia	3.7	60	3	3+	2	3	4	2	2+	2
Azerbaijan	7.6	45	2-	3	2	3	3+	1	2	2-
Belarus	10.2	20	1	2	1	2-	1	2	1	2
Bosnia and Herzegovina	4.3	35	2	2	2-	3	3-	1	2+	1
Bulgaria	8.2	60	3	3+	2+	3	4+	2	3-	2
Croatia	4.5	60	3	4+	3-	3	4	2	3	2+
Czech Republic	10.3	80	4	4+	3	3	4+	3	3+	3
Estonia	1.4	75	4	4+	3	3	4	3-	4-	3
FYR Macedonia	2.0	55	3	4	2	3	4	1	3	2-
Georgia	5.4	60	3+	4	2	3	4	2	2+	1
Hungary	10.1	80	4	4+	3+	3+	4+	3	4	3+
Kazakhstan	14.8	55	3	4	2	3	3	2	2+	2
Kyrgyzstan	4.8	60	3	4	2	3	4	2	2+	2
Latvia	2.4	65	3	4	3-	3	4+	3-	3	2+
Lithuania	3.7	70	3	4+	3-	3	4	2+	3	3-
Moldova	4.3	45	3	3+	2	3	4	2	2+	2
Poland	38.8	65	3+	4+	3	3+	4+	3	3+	3+
Romania	22.4	60	3-	4-	2	3	4	2	3-	2
Russian Federation	146.7	70	3+	4	2-	3-	2+	2+	2-	2-
Slovak Republic	5.4	75	4	4+	3	3	4+	3	3-	2+
Slovenia	2.0	55	3+	4+	3-	3	4+	2	3+	3
Tajikistan	6.2	30	2+	3	2-	3	3-	1	1	1
Turkmenistan	4.9	25	2-	2	2-	2	1	1	1	1
Ukraine	50.7	55	2+	3+	2	3	3	2	2	2
Uzbekistan	24.2	45	3-	3	2	2	1	2	2-	2

¹ The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale

of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector", a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised.

Classification system for transition indicators¹

Large-scale privatisation

- 1 Little private ownership.
- 2 Comprehensive scheme almost ready for implementation; some sales completed.
- 3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
- 4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.
- 4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

Small-scale privatisation

- 1 Little progress.
- 2 Substantial share privatised.
- 3 Nearly comprehensive programme implemented.
- 4 Complete privatisation of small companies with tradable ownership rights.
- 4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Governance and enterprise restructuring

- 1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
- 2 Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
- 3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
- 4 Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level.
- 4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

Price liberalisation

- 1 Most prices formally controlled by the government.
- 2 Price controls for several important product categories; state procurement at non-market prices remains substantial.
- 3 Substantial progress on price liberalisation: state procurement at non-market prices largely phased out.
- 4 Comprehensive price liberalisation; utility pricing which reflects economic costs.
- 4+ Standards and performance typical of advanced industrial economies: comprehensive price liberalisation; efficiency-enhancing regulation of utility pricing.

Trade and foreign exchange system

- 1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
- 2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
- 3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.

- 4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.
- 4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Competition policy

- 1 No competition legislation or institutions.
- 2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
- 3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
- 4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
- 4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

Banking reform and interest rate liberalisation

- 1 Little progress beyond establishment of a two-tier system.
- 2 Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
- 3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
- 4 Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.

Securities markets and non-bank financial institutions

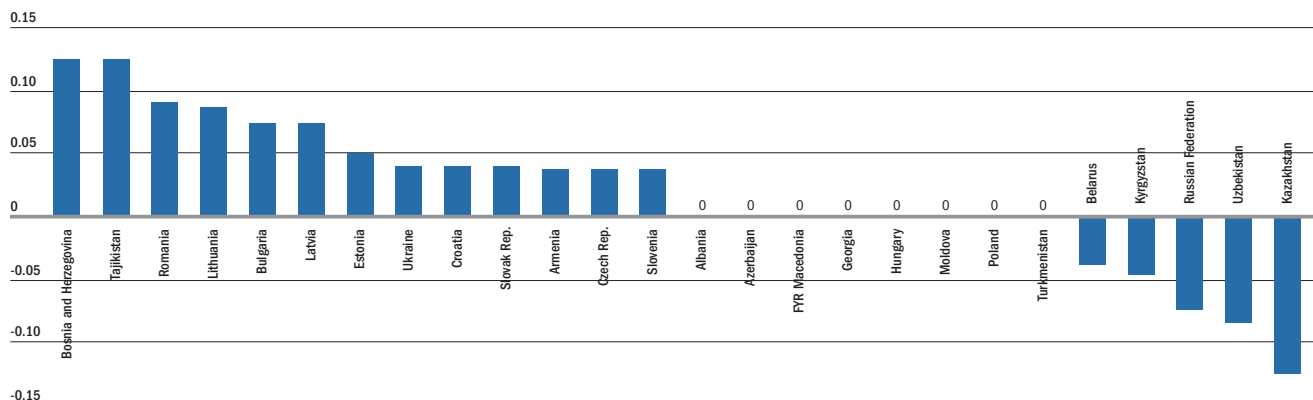
- 1 Little progress.
- 2 Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
- 3 Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.
- 4 Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation.
- 4+ Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation.

¹ The classification system is simplified and builds on the judgement of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the transition indicators at the back of this Report. The classification system presented here builds on the *Transition Report* 1994. To refine further the classification system, pluses and minuses have been added to the 1-4 scale since 1997 to indicate countries on the borderline between two categories. The classification 4* which was used up to and including 1996 has been replaced with 4+, though the meaning of the score remains the same.

Chart 2.2

Changes in transition indicators 1998-99

Change in average transition indicator scores 1998-99



Source: EBRD.

Latvia and Lithuania have also pressed ahead significantly with reforms over the past year. Both countries have applied to join the European Union and may soon be invited to enter into accession negotiations. Latvia joined the World Trade Organization in February 1999. It also tightened banking regulations as the National Bank of Latvia acted to resolve the insolvencies of a number of banks affected by the crisis in Russia. In Lithuania there was significant progress in the development of non-banking financial institutions with the privatisation of the dominant state insurance company and the establishment of private pension funds.

In other countries, progress in the development of institutions that support markets and private enterprise has been more gradual. Over the past year, Croatia, the Czech Republic, Estonia and Slovenia have each strengthened their banking regulations. In Croatia and Estonia new banking laws have given the central banks much stronger supervisory powers, including the authority to appoint administrators to oversee the restructuring or liquidation of insolvent banks. The Czech Republic has pressed ahead with the privatisation of three of the five largest state banks, while Slovenia has opened its banking market to the entry of foreign bank branches.

The crisis in Russia and its regional repercussions have continued to place considerable pressure on reforms in several CIS countries. In Russia itself, the failure of the authorities to enforce the basic rights of creditors and of minority shareholders in the wake of the banking crisis represents a significant setback in the effectiveness of banking regulations. While considerable progress has been achieved in strengthening the legal framework for the resolution of banking troubles, the tolerance of asset-stripping from banks and the lack of protection afforded to bank creditors have seriously impaired the effectiveness of basic prudential regulations, such as capital adequacy requirements. A series of defaults by large corporations was also accompanied by the diversion of assets as controlling shareholders of troubled enterprises largely ignored the rights of creditors and minority shareholders.

Elsewhere in the CIS, the impact of the crisis in Russia has contributed to reversals in price and trade liberalisation. In Belarus existing price controls were further tightened and a ceiling on annual inflation was decreed. Kazakhstan and Uzbekistan adopted trade barriers in early 1999 against imports from neighbouring countries, including Kyrgyzstan and Russia, as well as from each other. While in Kazakhstan these measures are likely to be temporary, the commitment to market reforms in Belarus and Uzbekistan had already been weak.

In contrast to these reversals, achievements in trade and foreign exchange liberalisation have been preserved in the face of significant external pressures in the Balkans, as well as Moldova and the Caucasus. Albania and FYR Macedonia have sustained their progress in reform against the difficult background of the Kosovo conflict. To help ease historic tensions in the region and to promote integration into the European and broader international economies, the international community, led by the European Union, has proposed a Stability Pact for South-Eastern Europe (see Annex 3.2). Armenia, Georgia and Moldova have resisted the re-introduction of currency controls despite large exposures to Russian trade and considerable currency volatility. All three have stabilised their economies through a combination of fiscal consolidation and official external support from IMF adjustment loans.

2.3 Patterns of reform after ten years of transition

Two patterns of progress in reform emerge from the transition indicators after a decade of transition, as discussed in previous *Transition Reports*. One pattern is the clustering of countries by overall progress in reform within particular geographical sub-regions. The second is the persistent disparity between progress in liberalisation and privatisation, on the one hand, and in development of institutions that support markets and private enterprise – governance and enterprise restructuring, competition policy, banking reform and securities markets, and non-bank financial institutions – on the other. After a decade of transition it is now possible to provide a comprehensive analysis of these emerging patterns. This should help to identify key constraints to the implementation of reforms and to highlight the challenges for the next decade.

Chart 2.3 shows the average transition indicator score for countries grouped by sub-regional classifications, moving from the west to the east across the region as a whole. The downward sloping line depicts the average transition indicator score for each of the sub-regions. This line shows that the average score tends to decline the further east the sub-region lies. The chart also shows that the variation among countries within sub-regions increases from west to east. In particular, the average scores for countries in the central CIS and Central Asian sub-regions diverge widely.

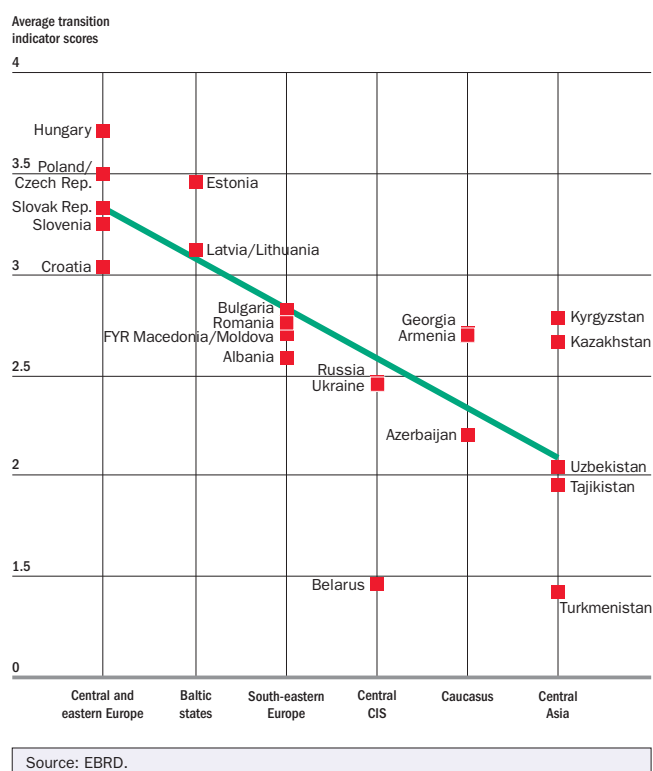
What factors lie behind the strong regional pattern of reform? At closer inspection, geographical proximity to the West is not the only feature that separates central Europe from the countries further east. In fact, there is a range of structural, political and geographical factors that distinguish the transition economies from each other. Many of these factors were present before reforms started and could have influenced subsequent progress in a number of ways. First, a high level of initial structural and macro-economic imbalances can encourage governments to delay implementing reforms because of the correspondingly large adjustment costs. Second, governments inheriting weak state institutions and facing a legacy of rigorous central planning can find it more difficult to implement reforms than governments with more effective state institutions in countries that had at least partial reform experience prior to the start of transition. Third, countries close to the European Union can benefit from the process of regional integration through the “demonstration effects” arising from trade with Western partners and through political cooperation.

Box 2.1 examines these initial conditions in more detail. It also presents a methodology for summarising the ways that countries in the region differed at the start of transition. A variety of factors – including the degree of industrialisation, the geographical orientation of trade, the extent of initial macroeconomic imbalances and the legacy of state institutions – determine a country’s starting position in the transition. Distinct clusters of countries emerge from this exercise, with central and eastern Europe at one end, the western CIS and the Baltic states in the middle and the Caucasus and Central Asia at the other end. The fact that these groups reflect far more than geographical location alone can be seen by the different starting points of neighbouring countries, such as Bulgaria and Romania or Armenia and Georgia.

While initial conditions have been important, they are not solely responsible for the pattern of reform. As can be seen from Chart 2.3 and the chart in Box 2.1, the Baltic states have achieved substantially greater reform progress than the countries of the western CIS despite beginning the transition from relatively similar starting points. Similarly, Poland has consistently ranked among the most advanced transition economies despite an initial position which, according to the analysis in Box 2.1, was very similar to the position in Romania. Other countries with similar starting points but contrasting reform patterns include Croatia and Bulgaria, and Kyrgyzstan and Uzbekistan. An analysis of this variation can provide additional clues to the factors influencing government policies during the first decade of transition. In particular, Chapter 5 examines the role of the political process in explaining the patterns of reform across transition economies.

Chart 2.3

Regional patterns of reform



Just as progress in reforms varies widely across countries, it also differs markedly across its key dimensions. Chart 2.4 depicts the discrepancy between overall progress in liberalisation and privatisation and development of institutions that support markets and private enterprise. This pattern was apparent even in 1994, when the EBRD first began to measure systematically progress in transition, and it has persisted since then. By their nature, liberalisation and privatisation are reforms that can be implemented relatively quickly. These reforms are relatively simple in the sense that they require governments to reduce their role in the economy by freeing prices from administrative control and by transferring the ownership of enterprises to private hands. However, for markets and private enterprise to function well, the state must take on important new roles to help establish the necessary supporting institutions. These institutional reforms inevitably take time to implement effectively because they require not only the enactment of new laws and regulations but also their broad acceptance and the capacity for rule enforcement.

Within the overall constraint of the time required to build the necessary supporting institutions in transition economies, important policy choices needed to be made with respect to the timing and process of liberalisation and privatisation. The main arguments for rapid progress on both dimensions was that this “shock therapy” would quickly establish functioning markets, force existing enterprises to restructure, and create the conditions for new business start-ups and therefore a strong demand for supporting institutions. The risks to this approach, however, were that downsizing of non-viable enterprises would take place more quickly than an increase in employment from new businesses.

Box 2.1

Initial conditions in transition economies

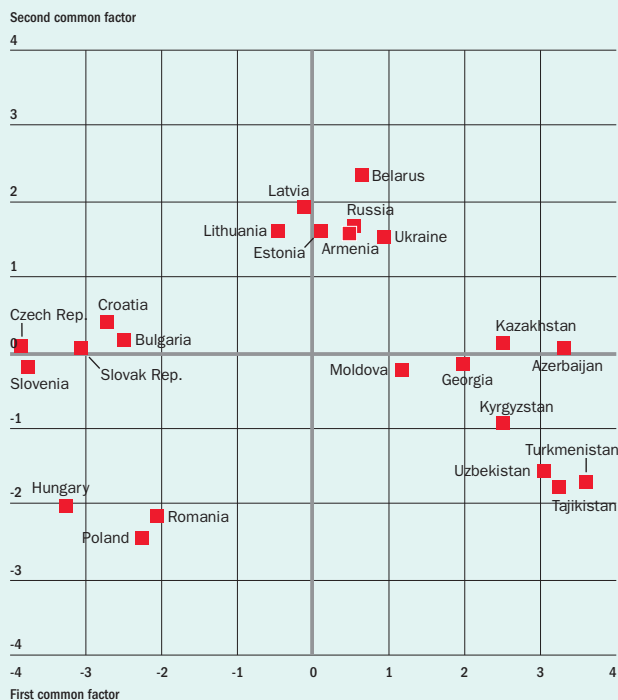
What were the key aspects of initial conditions in the transition economies? Central planning had a highly distorting effect on economic structures in central and eastern Europe and the Baltic states (CEE) and the CIS. Emphasis was placed on heavy industrialisation at the cost of underdeveloped services, and an excessive degree of specialisation was promoted within a closed trading block (see also Chapter 4). Private ownership and profit-oriented practices were largely absent across the region. However, the length of time under central planning differs widely. In CEE central planning was introduced only after 1945, making the transition process potentially easier than in the CIS, which experienced 70 years of central planning. Centrally planned economies also differed with respect to their macroeconomic policy framework, with some countries entering the transition with high, repressed inflation and external imbalances, whereas a few had maintained macroeconomic stability.

Aside from the effects of central planning, the countries of CEE and those at the periphery of the CIS had always differed fundamentally in terms of their levels of development. Central Europe had been among the wealthiest parts of the world prior to the Second World War, whereas Central Asia had hardly developed from a nomadic society. While these differences were narrowed during the socialist period, they remained considerable even when reforms were initiated throughout the region. Geographical location and endowments with natural resources also formed a clear distinction between the countries bordering the European Union to the west and the landlocked countries of Central Asia. Proximity to the EU was an important advantage in terms of access to markets and investment flows but also in terms of the proximity to modern democratic and business-oriented societies. Wealth in natural resources should have implied positive developments in trade for Central Asia and Russia as export prices, for energy in particular, approached world market levels. These resources were also an advantage in terms of attracting foreign direct investment. However, wealth in natural resources could also have negative implications for the willingness to reform, as political interest groups gaining access to resource rents could block a broader reform agenda (see Chapter 6).

By considering all of the elements of initial conditions, it is possible to construct an index of “distortions” and to relate it to progress in reform and economic performance during the transition. To do this, a weight has to be attributed to each element. The simplest approach would be to assign equal weights to each element, but this is clearly unsatisfactory. An alternative procedure – which has found widespread application in the social sciences – is to allow the data itself to generate the weights. The procedure, called factor or principal component analysis, is based on the correlations of all elements with each other. It generates so-called “common factors”, which may be interpreted as summary indicators of all the elements considered. Each country can be assigned a score for each common factor that can be used in cross-country comparisons.

In the chart, the results of such a factor analysis are presented. It shows the score achieved by each country on the first two common factors, explaining 43 per cent and 24 per cent of the total variation in initial conditions, respectively. The factor weights used to compute the factor scores for each country can be used to interpret the position of individual countries in the chart. The first common factor places large weights on the initial level of GDP, the distance to the EU, distortions in the allocation of employment, the period that a country spent under central planning and macroeconomic imbalances. It is therefore a combination of historical legacies dating back to the pre-socialist period and the nature of distortions that emerged under central planning. CEE differed from the CIS periphery along both dimensions.

Initial conditions in transition economies



Source: EBRD.

Note:

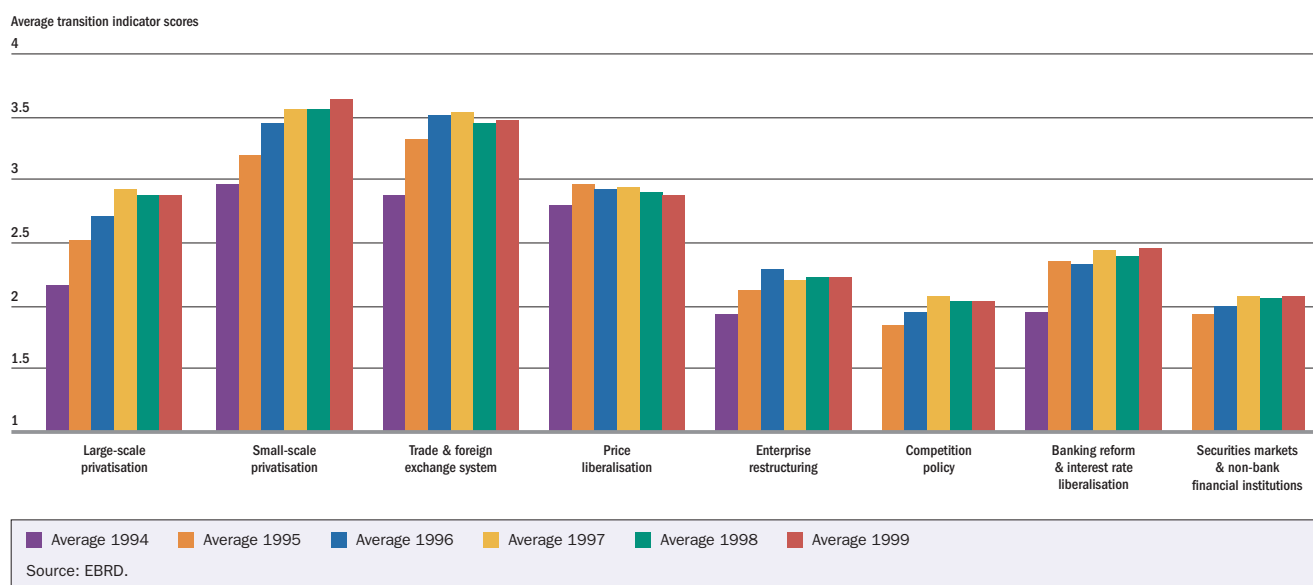
The common factors of initial conditions were computed using principal components analysis on the following set of variables: GDP per capita in 1989, at PPP exchange rates; pre-transition growth, where pre-transition refers to 1985-89 in CEE and 1987-91 in the FSU; a dummy for wealth in natural resources (ranging from 0 to 2); the share of the population living in urban areas; the distance between the country's capital and the EU (Brussels); the share of employment in industry, agriculture and services, all relative to market economy benchmarks; the value of trade with the CMEA over GDP in 1989; a measure of repressed inflation (derived from the difference between wage growth and productivity); the black market exchange rate premium in 1989; the years a country lived under central planning; the initial private sector share in GDP; a dummy for state capacity, set equal to 2 in all established nation states, 1 in all dominant states in a federation (Russia, the Czech Republic and former Yugoslavia) and 0 for all new CIS states and the Slovak Republic. For an explanation of the methodology of principal components see Box text. Most variables are from De Melo et al. (1997).

The second factor puts greater weight on trade dependence on the Council for Mutual Economic Assistance (CMEA), the initial private sector share in GDP, the importance of employment in agriculture and the level of urbanisation. Countries in CEE were distinguished from the western CIS by less trade dependence on the CMEA; Hungary, countries of former Yugoslavia and Poland were characterised by a larger initial private sector; and Poland and Romania were distinguished by the importance of agriculture in the economy. Central Asia was highly dependent on CMEA trade, but also had lower urbanisation rates and larger agricultural sectors than those in the western CIS, explaining its relatively similar scores compared with CEE. It should be noted that, while the emerging country clusters are clear, overall differences in the factor weights are not very large across dimensions. Rather, the different starting positions across the region reflect differences across the whole range of dimensions considered here.¹

1 This result stands in contrast to that of De Melo et al. (1997), which found stronger differences in factor weights between macroeconomic distortions on the one hand and structural distortions, or the “development overhang”, on the other. The analysis in this box builds largely on the Denizer, De Melo, Gelb data set, but with some important modifications. Over-industrialisation is measured by employment rather than by GDP shares and pre-transition growth is measured for 1985-89 for CEE but 1987-91 for CIS countries.

Chart 2.4

Average annual EBRD transition indicators by dimension



This possibility was a particular concern where initial structural problems were severe. The lack of market institutions would also pose a risk to macroeconomic stability and constrain growth until they became sufficiently developed.

An alternative reform path was the “gradualist approach” to liberalisation and privatisation. In principle, this approach would allow non-viable enterprises to cut back their operations and employment more slowly and therefore enable the new private sector companies to expand at the same rate as the decline of the state sector. This approach would also allow market institutions, which are necessary for macroeconomic stability and high growth, to develop in line with the growth in markets and private enterprise. The risks of this strategy were that a partially reformed economy would preserve rents and create powerful vested interests that would block further reforms.

After ten years of transition, it is possible to take stock of the actual reform paths observed in the transition economies. Chart 2.5 shows the pattern of liberalisation and privatisation versus development of supporting institutions from 1994-99, using the EBRD’s transition indicators. It reveals that countries have typically focused first on liberalisation and privatisation and that institutional reforms accelerated only once these reforms had been comprehensively implemented. In the chart, this pattern is depicted by the clustering of countries along an ascending curve. All of the countries lie below the 45-degree line, which denotes equal progress in both of these key areas of reform. Moreover, the chart shows that the countries closest to the 45-degree line are those that have advanced the least in all aspects of reform. Indeed, following some initial progress in liberalisation and privatisation, Belarus and Uzbekistan had reversed these reforms by late 1996 and have since moved backwards. None of the countries that have hesitantly undertaken liberalisation and privatisation have been able to move forward along the 45-degree line, which would have reflected balanced progress

in liberalisation and privatisation, on the one hand, and development of supporting institutions, on the other.

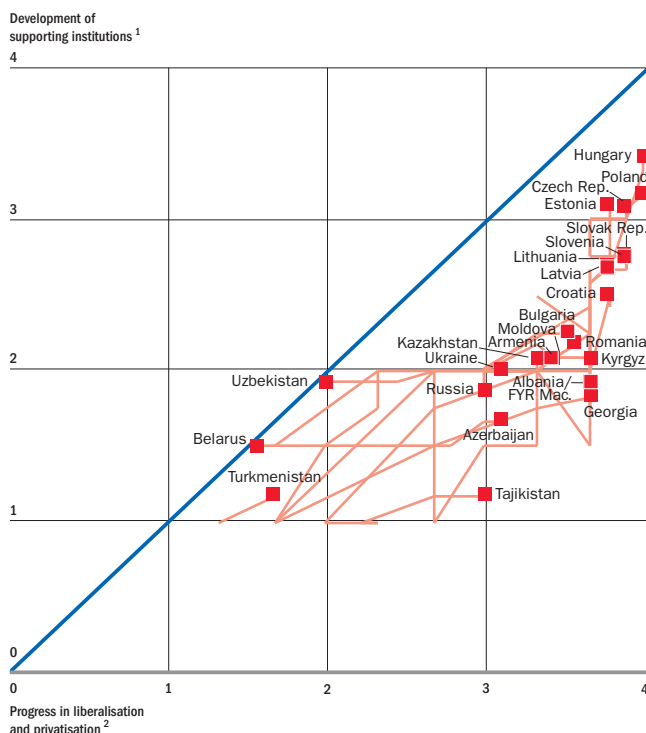
The above analysis suggests that the variation in liberalisation and privatisation remains considerable even after the first decade of market-oriented reforms. Moreover, countries have been able to reduce the imbalances between these reforms and the more time-consuming development of institutions that support markets and private enterprise only after sustaining their initial achievements. By contrast, a number of countries in recent years have experienced setbacks in reform as a result of severe macroeconomic imbalances that resulted from incomplete and flawed liberalisation and privatisation reforms. The next two sections examine the relationship between sustained liberalisation and macroeconomic stabilisation, focusing in particular on the extent to which governments have been able to effectively harden budget constraints.

2.4 Liberalisation

Despite the fundamental character of liberalisation, there remains remarkably wide variation across transition economies in the pace and extent of market liberalisation. The countries in central Europe and the Baltic region as well as Albania, FYR Macedonia and Kyrgyzstan liberalised domestic prices and abolished state orders very early in their transition. In addition, they have sustained these reforms. These countries also liberalised trade and access to foreign exchange, albeit slightly more gradually than they liberalised domestic markets. The relatively rapid “liberalisers” have maintained free markets for more than half of the period since transition began in their respective countries. Liberal markets can be defined as having an EBRD transition indicator score of 3- on price liberalisation (most prices free except for housing rents and infrastructure tariffs) and 4- on trade liberalisation (full current account convertibility). The proportion of years with liberal markets is defined as the number of years in which these two scores were reached scaled by the number of years since the start of transition.

Chart 2.5

Patterns of reform



¹ The development of supporting institutions denotes the unweighted average of transition indicators describing banking sector, non-banking financial institutions, competition policy, and enterprise reform and corporate governance.

² Liberalisation and privatisation denotes the unweighted average of transition indicators describing privatisation, price liberalisation and trade and forex liberalisation.

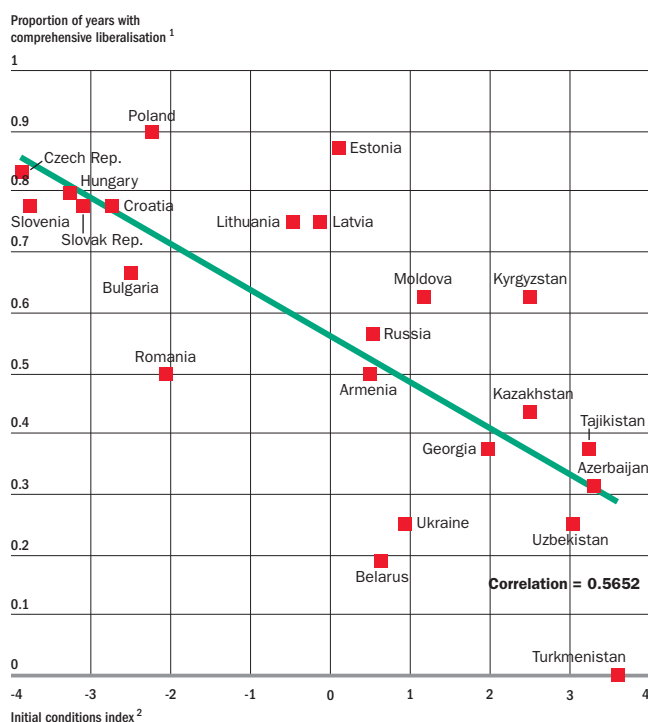
³ Transition indicators for competition and non-banking financial institutions have only been available since 1995.

The rapid approach to internal and external liberalisation stands in contrast to the more uneven and gradual liberalisation in Bulgaria, Romania and most of the CIS, particularly with respect to trade and access to foreign exchange. Among these countries, Bulgaria and Russia attempted to liberalise both domestic and external markets relatively early in the transition, but were unable to sustain fully these reforms in the face of mounting domestic and external imbalances. Both countries partially reversed liberalisation after three or four years, and Bulgaria has only recently restored the level of liberalisation that once prevailed. Romania and a number of CIS countries liberalised more gradually than Bulgaria. Among these more gradual reformers, Romania and Ukraine have also partially reversed these reforms. Belarus, Turkmenistan and Uzbekistan have yet to embark on comprehensive market liberalisation, and progress remains far from complete in Azerbaijan and Tajikistan. The gradual and uneven reformers have maintained liberal markets for less than half of the period since the start of transition.

To what extent does this variation reflect different starting points? Chart 2.6 shows that countries that benefited from a better starting position in terms of fewer structural and macroeconomic imbalances and a stronger state have tended to implement liber-

Chart 2.6

Sustained liberalisation and initial conditions



Source: EBRD.

¹ The proportion of years with comprehensive liberalisation is defined as the average of the number of years in which a country achieved a score of at least 3- on price liberalisation and 4- on foreign trade liberalisation, standing for complete price liberalisation excluding rents and utilities and full current account convertibility. This number of years is then divided by the length of transition in each country.

² The index of initial conditions is derived from factor analysis and represents a weighted average of measures for the level of development, trade dependence on CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory and state capacity. See Box 2.1 for details.

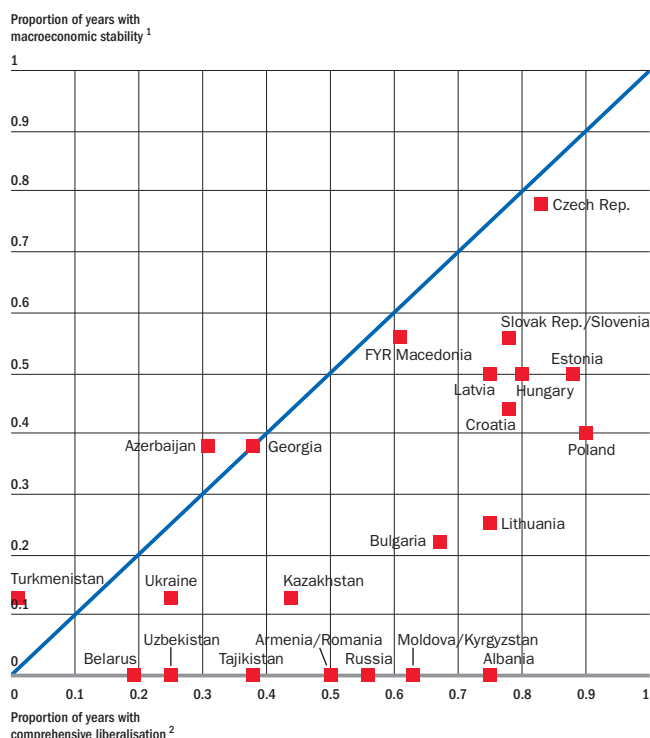
alisation more rapidly than their less advanced counterparts. However, a good starting position has not necessarily led to sustained liberalisation, nor has a difficult starting position prevented it. The positions of the Baltic states, Kyrgyzstan, Moldova and Poland above the downward sloping line in Chart 2.6, and of Belarus, Romania and Ukraine below it are strong evidence to support this claim.

2.5 Stabilisation

As with liberalisation, there is wide variation across the region in the pattern of macroeconomic stabilisation and the degree of financial discipline. Most countries experienced an outburst of inflation with the onset of transition, reflecting the pent-up macroeconomic imbalances in the waning years of central planning. The pace of the subsequent disinflation was remarkably fast across much of the region and most countries achieved moderate rates of inflation (below 30 per cent) by 1997. However, the strength of the fiscal foundations for sustaining this stabilisation has varied widely, with heavy reliance on official and market-based financing of sizeable fiscal deficits in several CIS countries, including Armenia, Kyrgyzstan, Moldova, Russia and Ukraine. Moreover, other countries have continued to use their banking sectors to transfer resources through inflationary soft lending to favoured

Chart 2.7

Comprehensive liberalisation and stabilisation



Source: EBRD.

¹ The proportion of years with macroeconomic stability is defined as the number of years since the start of transition in which a country had less than 30% inflation and a budget deficit below 5% of GDP, divided by the length of transition in each country.

² Comprehensive liberalisation is defined as the average of the number of years since the start of transition in which a country achieved a score of at least 3- on price liberalisation, and 4- on foreign trade liberalisation, standing for complete price liberalisation excluding rents and utilities and full current account convertibility. The number of years is again divided by the length of transition in each country.

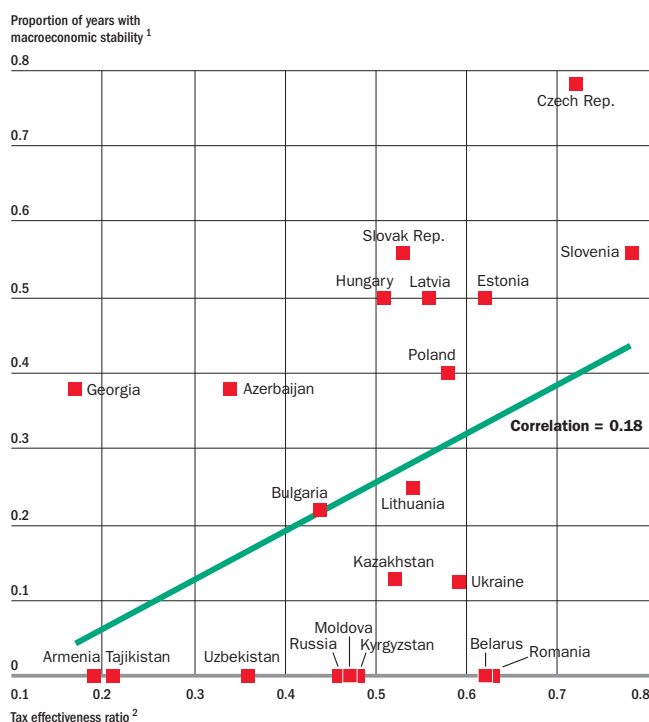
enterprises, as in Belarus and Romania, and have not yet reduced their inflation rates to moderate levels.

A measure of the strength of a country's macroeconomic stabilisation effort is the number of years since the start of transition with both a moderate rate of inflation (less than 30 per cent) and a sustainable fiscal deficit (less than 5 per cent of GDP). The inflation threshold reflects available empirical evidence on the level and volatility of inflation and its efficiency costs, while the fiscal threshold is consistent with a "rule of thumb" regarding the maximum fiscal deficit in an effective stabilisation programme. Countries in central Europe and the Baltic region have achieved this level of macroeconomic stability in almost half of the period since the start of transition. This stands in contrast to countries in south-eastern Europe, which have achieved this degree of stability in only a quarter of the period since the start of transition, and those in CIS, which have largely failed to cross this threshold.

While there is some overlap between the countries that sustained macroeconomic stabilisation and liberalisation through the first decade of transition, Chart 2.7 shows that many countries have

Chart 2.8

Tax effectiveness and stabilisation



Sources: EBRD staff calculations. Tax effectiveness data from Schaffer and Turley.

¹ The proportion of years with macroeconomic stability is defined as the number of years since the start of transition in which a country had less than 30% inflation and a budget deficit below 5% of GDP, divided by the length of transition in each country.

² Tax effectiveness is defined as the ratio of actually collected social security tax contributions over the total economy-wide payroll, divided by the statutory payroll tax rate. For example, for a total collection 6% of payroll and a statutory rate of 10% payroll tax, the effectiveness ratio would be 0.6.

been unable to sustain both reforms. For example, while achieving significant progress in liberalisation, Kyrgyzstan and Moldova have been much less successful in stabilisation. The same is true for Russia and to a lesser extent for Kazakhstan, which have had liberal markets for about half of the period since transition began but not a single year with macroeconomic stability, as defined by the inflation and fiscal deficit thresholds.

One reason for the failure to liberalise and to stabilise successfully at the same time is the difficulty of adapting public finances to the requirements of a market economy and of imposing hard budget constraints on enterprises. Liberalisation leads to the rapid erosion of the state's old (notional) tax base in the state enterprise sector, which is faced with adverse shifts in relative prices and increased competition from new private firms and imports from abroad. Stabilisation requires the government to cut subsidies to these enterprises and to accept the costs of economic restructuring.² While most countries have reduced substantially budgetary subsidies to producers in the transition,³ those that have experienced setbacks in stabilisation during the first decade of transition have often tolerated the emergence of alternative forms of support for enterprises, such as tax arrears and non-payment of utility bills.

² On the development of fiscal imbalances during the transition, see also Chapter 3. On the challenges of restructuring state enterprises, see Chapter 9.

³ See Chapter 5 of *Transition Report 1997* and the transition assessments of this Report.

Table 2.2

Progress and methods of privatisation of medium-sized and large enterprises¹

	EBRD large-scale privatisation transition indicator score	Direct sales	Vouchers	MEBO ²
Central and eastern Europe and the Baltic states				
Albania	2	–	Secondary	Primary
Bosnia and Herzegovina	2	Secondary	Primary	–
Bulgaria	3	Primary	Secondary	–
Croatia	3	–	Secondary	Primary
Czech Republic	4	Secondary	Primary	–
Estonia	4	Primary	Secondary	–
FYR Macedonia	3	Secondary	–	Primary
Hungary	4	Primary	–	Secondary
Latvia	3	Primary	Secondary	–
Lithuania	3	Secondary	Primary	–
Poland	3+	Primary	–	Secondary
Romania	3–	Secondary	–	Primary
Slovak Republic	4	Primary	Secondary	–
Slovenia	3+	–	Secondary	Primary
Commonwealth of Independent States				
Armenia	3	–	Primary	Secondary
Azerbaijan	2–	Secondary	Primary	–
Belarus	1	–	Secondary	Primary
Georgia	3+	Secondary	Primary	–
Kazakhstan	3	Primary	Secondary	–
Kyrgyzstan	3	–	Primary	Secondary
Moldova	3	Secondary	Primary	–
Russia	3+	Secondary	Primary	–
Tajikistan	2+	Primary	Secondary	–
Turkmenistan	2–	Secondary	–	Primary
Ukraine	2+	Secondary	–	Primary
Uzbekistan	3–	Secondary	–	Primary

Source: EBRD.

¹ Progress in privatisation of medium-sized and large enterprises is measured by the EBRD's transition indicators. A score of 2 indicates that up to 25% of state-owned enterprise assets have been privatised, a score of 3 that up to 50% of these assets have been privatised.

² Management-employee buy-out.

This approach has not only allowed loss-making enterprises to continue operations, but has also impaired public finances and undermined macroeconomic stabilisation.

Chart 2.8 illustrates the relationship between the tolerance of tax arrears and macroeconomic instability, plotting the effectiveness of the social security tax regime in transition economies against the proportion of years they have achieved macroeconomic stability.⁴ Tax effectiveness is measured as the ratio of the actual yield for a particular tax to the notional yield, which is obtained by multiplying the statutory tax rate by the appropriate tax base (labour income for social security taxes). On average, countries with less effective tax regimes have achieved fewer years of macroeconomic stability, although there is significant variation around the trend line. This evidence suggests that the measure of tax effectiveness may be an indicator of the softness of budget constraints (see also Chapter 7). Moreover, it is important to recognise that there are other forms of soft budget constraints that can

weaken macroeconomic stability. For example, while Belarus and Romania have relatively effective tax regimes, their banking systems have been a significant source of enterprise support.

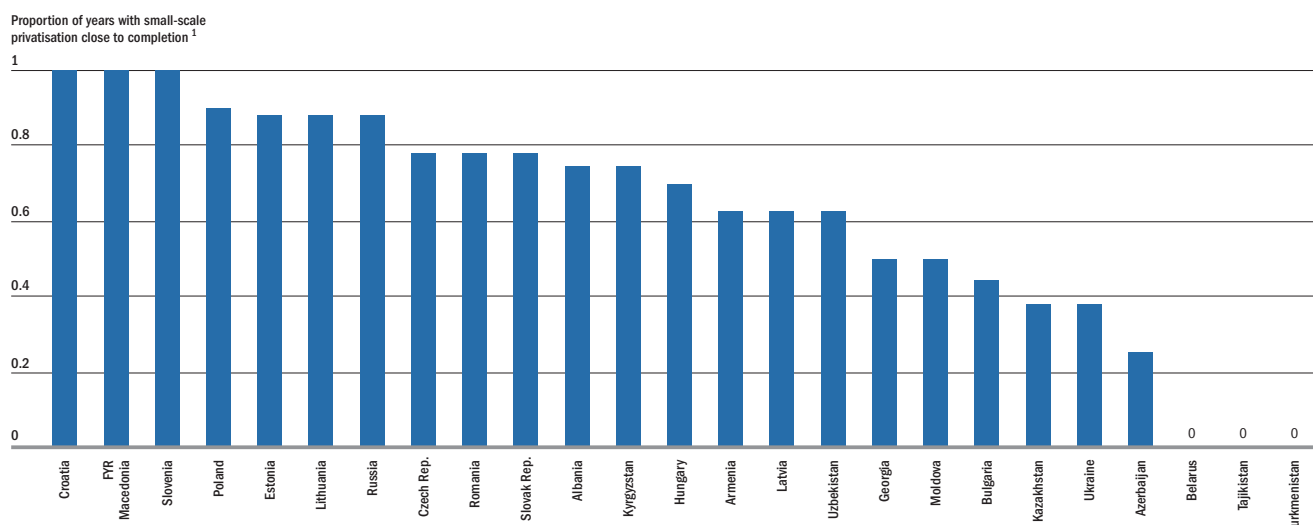
2.6 Privatisation

Privatisation in transition economies is shaped by many objectives and constraints. The main objective was to remove the state from ownership of, and decision-making within, enterprises. The speed of this disengagement was sometimes important for political considerations and for building a critical mass of support for reforms. Privatisation was therefore regarded by many as an important complement to liberalisation and stabilisation, if reforms were to be politically sustained. Moreover, privatisation also aimed to improve the post-privatisation performance of enterprises and therefore contribute to the expected economy-wide gains from the transition. In principle, this improvement would arise from the commercial focus instilled by private owners and from effective post-privatisation corporate governance.

⁴ Mark Schaffer and Gerald Turley of Heriot-Watt University prepared the tax effectiveness measures as part of an EBRD Policy Studies project.

Chart 2.9

Cumulative progress in small-scale privatisation



Source: EBRD.

¹ The proportion of years with small-scale privatisation close to completion is defined as the number of years in which the country rating on small-scale privatisation reached at least 3-, divided by the total number of years since transition began. The ratings for former Yugoslavia are 1 as small-scale enterprises were already private before the transition.

Additional objectives for privatisation sometimes included the generation of receipts for the government, the promotion of competition and the fair distribution of national wealth. The political feasibility of privatisation in transition, however, was as important in determining the extent and form of privatisation as were the multiple objectives. The balance of power among the state, enterprise managers and their employees as well as the government's administrative capacity and electoral politics placed significant constraints on the extent and form of privatisation in many countries.

Table 2.2 shows the methods of privatisation of medium-sized and large enterprises and progress in privatisation. It shows that countries seeking rapid state removal from economic activity but facing the constraints of *de facto* or *de jure* control of enterprises by managers and employees had little choice in privatisation method. For many CIS countries and countries of former Yugoslavia, privatisation has significantly benefited insiders either through voucher privatisations with significant concessions to insiders or through MEBOs. In contrast, a number of countries in central Europe and the Baltic region benefited from more favourable initial conditions and were not restricted to insider privatisation by the power of incumbent managers or employees. Estonia and Hungary sold shares to strategic investors as their primary method while the Czech Republic and Lithuania used equal access vouchers. Under this method, vouchers are allocated to most citizens without providing special ownership privileges to enterprise insiders.

To the extent that privatisation methods varied within countries, the choice of method for a particular enterprise often reflected its potential viability under market conditions. The best enterprises or parts of enterprises have frequently been singled out for sale to strategic investors. This pattern is true for countries that have pursued very different primary approaches to privatisation,

including the Czech Republic, Hungary and Poland. Moreover, there has been an increasing tendency over the past decade for large-scale privatisation to take the form of cash sales to strategic investors, as shown by the transition assessments at the back of this Report. This development reflects in part the greater weight being placed on the generation of revenue and on improvements in post-privatisation performance. The constraints on privatisation have also changed as new private sector companies have created attractive employment opportunities outside the state sector, easing some of the constraints on privatisation.

Available evidence on the effectiveness of privatisation in achieving its key objectives of removing the state from enterprise ownership and improving performance suggests mixed results. Chapter 6 of this Report argues that government interference in privatised enterprises in many transition economies remains extensive, although the nature of that interference differs significantly between privatised and state-owned firms. Moreover, the channels of influence also run from enterprises to the state. For instance in Russia, where the government sought to bolster a pro-reform coalition by giving away valuable state assets to industrial and financial centres of power (oligarchs), this new business elite has sought to influence the state and has acted to block further reforms that would erode their economic privileges. Rather than creating broad-based support for market reforms, some forms of privatisation have created entrenched vested interests that present a stumbling block for further progress.

The evidence on the impact of privatisation on enterprise performance is also mixed. Chapter 7 considers a range of evidence, which reveals some positive impact on performance. Unambiguously positive results have been found only for those enterprises privatised to strategic foreign investors or to other types of concentrated outside owners. Enterprise performance is

not necessarily better in companies with insider ownership than it is in state-owned enterprises. Overall, the lack of a strong effect from privatisation may reflect the mixture of economic and political objectives that the privatisation programmes sought to meet. In particular, where the distribution of state assets was used to mobilise support for reforms rather than to strengthen enterprise performance, the potentially positive impact of privatisation on performance has not materialised.

In contrast to the difficulties in privatising medium-sized and large enterprises, privatisation of small firms has been much easier. Most small firms were in the trade and services sectors and the power of their managers and employees was not significant. Moreover, the administration of small-scale privatisation, either in the form of competitive auctions or concessions to insiders, was often devolved to local governments, making rapid implementation possible. Most countries advanced rapidly with small-scale privatisation. Chart 2.9 shows the proportion of years since the start of transition that small-scale privatisation has been completed. This ranges from one in the countries of former Yugoslavia, where small-scale privatisation was initiated before the start of transition, to zero in Belarus and Turkmenistan, where the commitment to market reforms has been hesitant, as well as in Tajikistan, where civil war delayed reforms until recently.

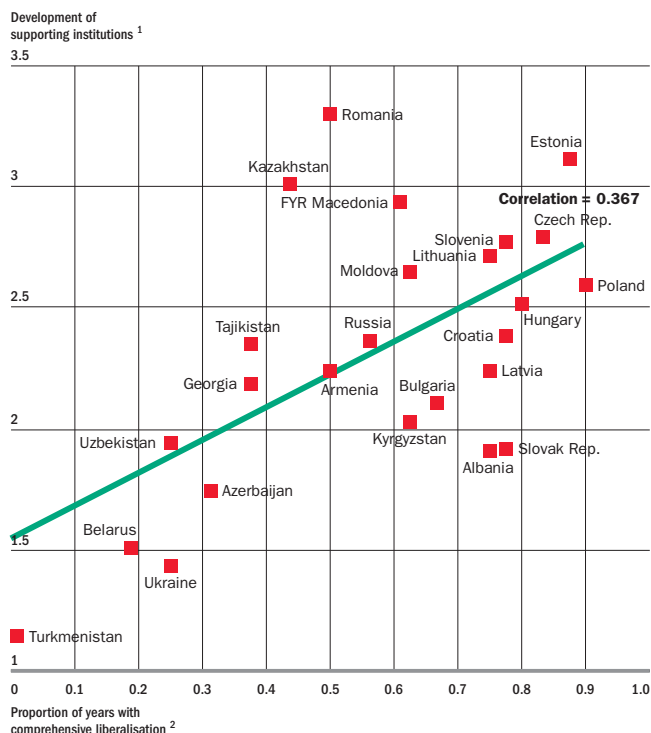
2.7 Institutions in transition: market demands and the state

While progress in liberalisation, stabilisation and privatisation has been the hallmark of the first decade of transition, the supporting administrative, legal and financial institutions have also undergone major change over this period. In many ways, the development of institutions that support markets and private enterprise is at the heart of the transition. However, the types of institutions that matter differ during the various stages of the process. The initial stages of transition are characterised by a high degree of macroeconomic instability. There are also increased transaction costs with the abolition of central planning and the need for enterprises to seek new customers and suppliers.⁵ Under these circumstances, the extent to which the state is able to secure the public finances, to protect property and contract rights and to enforce certain basic rules of market behaviour is central to the success of initial reforms. Once the basic reforms of liberalisation and privatisation have been implemented and the state has consolidated its new role, the focus of institutional reforms shifts towards the strengthening of the supporting institutions, such as competition policy, bankruptcy, corporate governance, and regulation of infrastructure and finance.

Both the EBRD transition indicators and the investment climate assessments in Annex 2.1 reveal striking differences in the quality of the business environments that have emerged across the region. It is important to recognise that the capacity of the state to provide good economic governance has differed widely across the region. Some governments inherited relatively well-established national bureaucracies, consolidated nation states and a population eager to rejoin the market economies of western Europe and with some

Chart 2.10

Institutional reforms and length of liberalisation



Source: Table 2.1.

¹ Supporting institutions are defined as the average of the transition indicators for the following categories in 1999: competition policy; enterprise reform and corporate governance; banking sector reform; securities markets; overall legal extensiveness and effectiveness; infrastructure (average of telecommunications, railways and electric power).

² The proportion of years with comprehensive liberalisation is defined as the average of the number of years in which a country achieved a score of at least 3- on price liberalisation and 4- on foreign trade and exchange liberalisation divided by the length of transition in each country.

prior exposure to market reforms. Others, particularly among the states in the CIS periphery and in south-eastern Europe, had to grapple with the challenges of nation-building and independence at the very time that they had to achieve a major transformation of the state's role in the economy.

Notwithstanding the constraint that the capacity of the state has imposed on the development of supporting institutions in the transition, most governments have implemented significant measures since the start of transition. Increasingly, new laws and regulations and their enforcement have shaped economic activity in transition economies, influencing in turn subsequent institutional changes. This section examines the factors that explain both the extent and the direction of these institutional changes, taking into account variations in the capacity of the state to enforce the new rules.

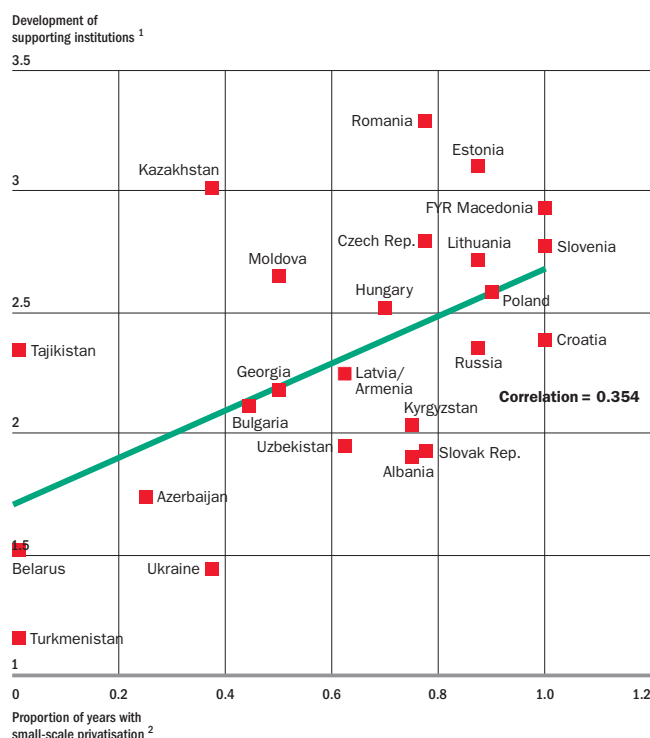
Demand for supporting institutions – liberalisation, privatisation and openness

In a market economy, the need for rules is partly determined by whether they serve the collective interest of market participants.

⁵ Blanchard and Kremer (1997) and Roland and Verdier (1999) present models of how liberalisation can initially cause transaction costs to increase during the transition. In both analyses, the combination of freedom of choice for customers, producers and suppliers with imperfect information on the quality of goods causes "disorganisation" – a breakdown of economic relationships and a drop in production.

Chart 2.11

Institutional reforms and small-scale privatisation



Source: EBRD.

¹ Supporting institutions are defined as the average of the transition indicators for the following categories in 1999: competition policy; enterprise reform and corporate governance; banking sector reform; securities markets; overall legal extensiveness and effectiveness; infrastructure (average of telecommunications, railways and electric power).

² The proportion of years with small-scale privatisation is defined as the number of years in which a country achieved a score of at least 3 on small-scale privatisation, implying almost complete privatisation, divided by the length of transition in each country.

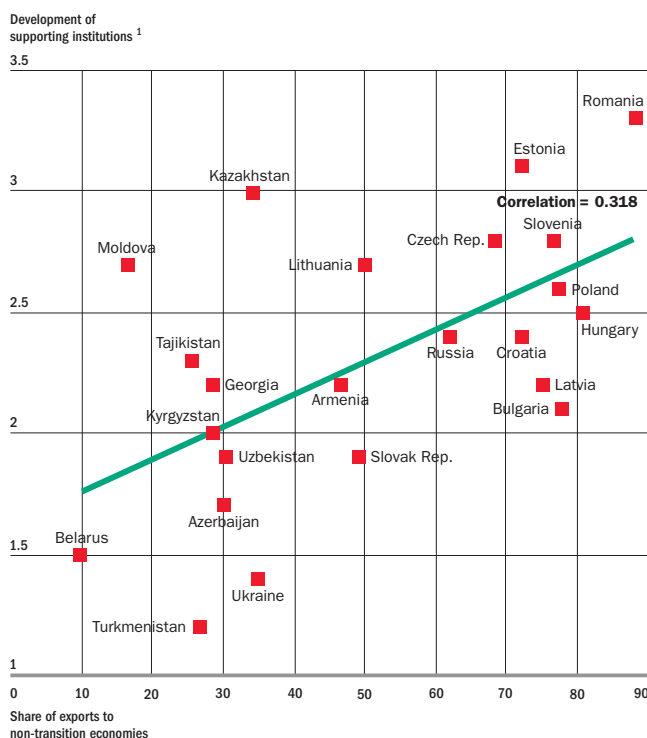
For example, accounting standards are burdensome for businesses, but these costs are vastly outweighed by the benefits of having access to reliable information about business partners and potential investment opportunities. However, collective benefit is not the only reason for demanding certain rules. Market participants may also demand regulatory favours and protection from competitors. It is the state's role to reject such demands and introduce a set of fair and transparent rules.

While established market economies differ greatly in the design of rules and regulations, the problems they try to address are fairly uniform. Among the more important market-based institutions are corporate law, including provisions for the protection of creditor and shareholder rights, bankruptcy, regulation of infrastructure and finance, and competition policy. These areas are reflected in the EBRD's transition indicators presented in Table 2.1 and in the separate ratings for corporate law and infrastructure (see Annexes 2.2 and 2.3).

In transition economies, institutions were initially not particularly well-developed in any of these areas. Institutional change was therefore likely to be relatively uniform in terms of filling these basic gaps. Indeed, key steps have been taken in almost every country

Chart 2.12

Institutional reforms and exports to the West



Sources: EBRD and IMF Direction of Trade Statistics.

¹ Supporting institutions are defined as the average of the transition indicators for the following categories in 1999: competition policy; enterprise reform and corporate governance; banking sector reform; securities markets; overall legal extensiveness and effectiveness; infrastructure (average of telecommunications, railways and electric power).

across the region. These include the formation of a two-tier banking system and the adoption of a basic framework for corporate law, including insolvency procedures, pledge law, and the rights of creditors and shareholders. Yet, beyond these basic steps, the variation is considerable, both in the extent and quality of legal provisions.

One possible explanation for this variation is the amount of time that has elapsed since markets and private enterprises started to operate effectively in transition economies. The proportion of years since the start of transition that markets have been free to operate is one measure of the strength of the demand for market-based institutions. Chart 2.10 confirms that there is a strong link across the transition economies between the proportion of years in which liberal markets have been in operation and the level of development of supporting institutions achieved by 1999. Progress in institutional development is measured as the simple average of the EBRD's transition indicators for enterprises, competition policy, the financial sector, legal reforms and infrastructure. A similar, albeit less strong, relationship exists between the number of years with macroeconomic stabilisation and progress in institutional reform.

Markets alone are not sufficient to generate the demand for supporting institutions. For example, only private owners will see the benefit of a legal system protecting their property rights. Managers of state enterprises may prefer rules that leave room for

Box 2.2

Shareholder and creditor rights in transition economies

Legal reform is a key component of institutional change in the transition. Company law constrains the practices of managers and defines the mechanisms and rules by which shareholders can exercise control. It is therefore a key complement to privatisation in creating incentives for the restructuring of companies. Similarly, the rights of creditors during bankruptcy and as holders of collateral influence the willingness of banks to lend and their ability to intervene in the restructuring decisions of companies. In the absence of an appropriate legal framework, the door is open to improper business practices, including asset-stripping, cheating of minority shareholders and fraud.

The importance of the law for economic performance has also been shown in international comparative studies (see La Porta, Lopez de Silanes, Shleifer and Vishny, 1997, and Levine, 1997). Countries offering good protection of a shareholder rights tend to have more developed capital markets and less concentrated ownership structures. Countries with better protection of creditor rights tend to have more developed banking systems, and partly as a result, tend to grow more rapidly in the long run. Such international comparisons have relied on a rating system applicable to the law in different countries.

In a pioneering study, La Porta, Lopez de Silanes, Shleifer and Vishny (1996) proposed such a rating system for the protection of shareholder and creditor rights. Their protection of shareholder rights index focuses on the rights of minority shareholders. The rating system includes the following six categories: i) one share one vote; ii) cumulative voting or other form of proportional representation on the board; iii) proxy voting by mail allowed; iv) no need to deposit shares before a shareholders' meeting; v) ability of shareholders with less than 10 per cent of shares to call an extraordinary shareholders' meeting; vi) ability of shareholders to challenge managers as well as the decisions of the shareholders' meeting in court.

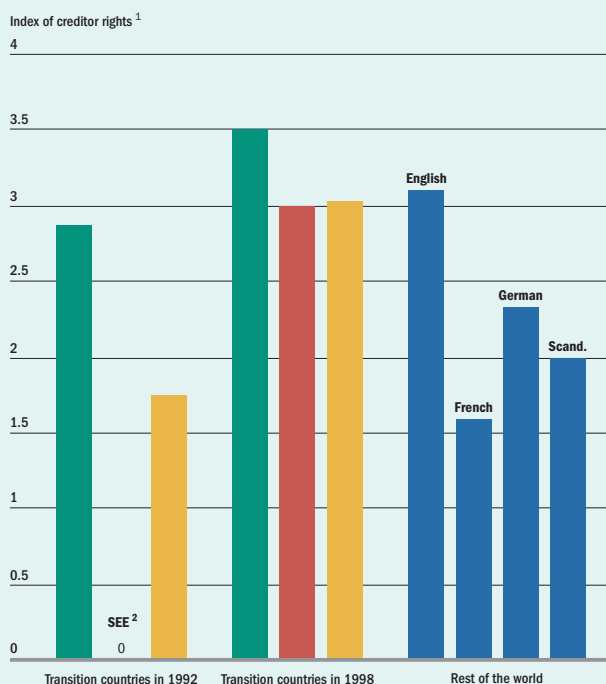
The creditor rights index includes four variables, which address the role of creditors in bankruptcy. First, restrictions such as creditor consent exist for reorganisation as opposed to liquidation. Second, secured creditors are not stayed in bankruptcy (meaning their assets are not frozen). Third, secured assets are satisfied first when assets are distributed and fourth, management is replaced with a court- or creditor-appointed manager/receiver during bankruptcy.

The same authors also showed that systematic differences exist in the legislation of countries with various legal traditions. Common law countries in the Anglo-Saxon tradition tend to have the best protection of shareholder and creditor rights and the most developed capital markets. Civil law countries in the German tradition have weaker shareholder rights protection but relatively strong creditor rights, while civil law countries in the French tradition trail the other two groups on both counts. Scandinavian countries lie somewhere in between.

In an effort to compare the transition economies with these legal families and to assess the protection that their legal framework provides to shareholders and creditors, the EBRD commissioned a legal study repeating the rating exercise of La Porta et al. for every year since the start of transition.¹ The charts in this box show the average legal scores for the countries of CEE, south-eastern Europe and the CIS in comparison with the rest of the world. The charts show how the region compared with the main legal families in terms of protection of shareholders and creditors in 1992 and how this protection has since changed. The following observations can be made:

- In 1992 the transition economies as a whole had better developed shareholder rights than creditor rights. However, within this general ranking, there were considerable regional variations. In CEE, creditor rights were better developed than shareholder rights, whereas in SEE creditors were offered hardly any protection by the law in 1992.

Creditor rights in transition economies and the rest of the world



Sources: Pistor (1999) for transition countries; La Porta, Lopez de Silanes, Shleifer and Vishny (1997) for rest of the world.

¹ The index of creditor rights has four components: i) no automatic stay on assets, ii) secured creditors first, iii) restrictions on reorganisation, iv) management changes during reorganisation. The index can reach a maximum of four points.

² South-eastern Europe.

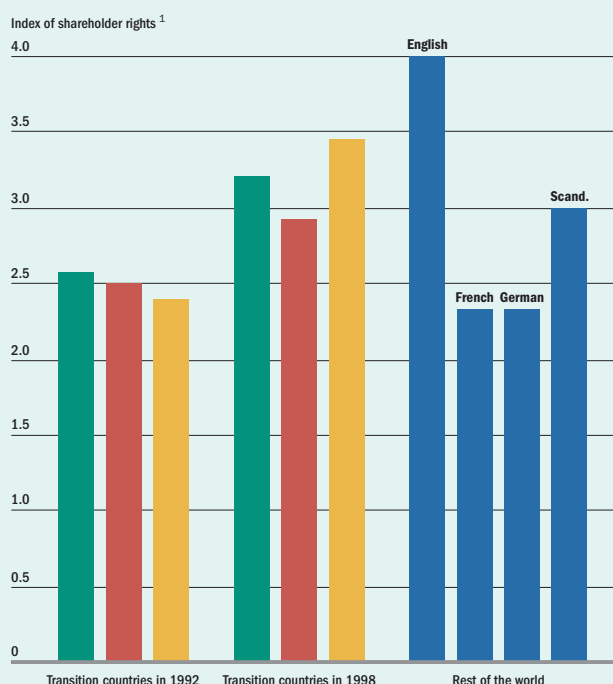
Surprisingly, despite the non-existence of stock exchanges, the CIS countries had relatively well-developed protection of shareholder rights as early as 1992.

- Creditor rights have been strengthened since 1992, particularly in SEE. In CEE the protection offered by the law now exceeds the average even in Anglo-Saxon countries. In the CIS and SEE, it exceeds the average in German law countries.
- Shareholder rights have seen dramatic improvements in the CIS, but much less so in CEE and SEE. Indeed, it seems that by 1998 the CIS countries were beginning to emulate the system of legal protection typical of common law countries, despite their civil law tradition. CEE countries remained closer to the German model, with relatively stronger emphasis on creditor rights.

These results are surprising in a number of ways. The CIS including Russia stands out for the specified protection of minority shareholders, despite widespread reports of cheating of minority shareholders and corporate governance scandals. Creditor rights are also relatively well-protected “on the books”, in contradiction with the recent experiences of creditors. This juxtaposition suggests that the law remains largely un-enforced in many CIS countries and therefore fails to constrain behaviour effectively.

The rating exercise also shows that legal reforms can advance rapidly during the transition and are not strongly constrained by legal history (Pistor, 1999). It is the tension between the written law and its application and enforcement that is at the heart of present institutional

Shareholder rights in transition economies and the rest of the world



Central Europe and Baltic states South-eastern Europe CIS
 Legal origin – English, French, German, Scandinavian

Sources: Pistor (1999) for transition countries; La Porta, Lopez de Silanes, Shleifer and Vishny (1997) for rest of the world.

¹ The index of shareholder rights is based on seven indicators: i) one share one vote, ii) proxy voting by mail, iii) shares not blocked before meeting, iv) cumulative voting, v) oppressed minority rights, vi) pre-emptive rights to new issues, vii) per cent of shares required to call extraordinary meeting. The index can reach a maximum of seven points.

bottlenecks in the transition countries. This serves to emphasise the general argument about the gradual nature of institutional change and, in particular, changes in economic behaviour. Major improvements in the state's capacity for rule enforcement will be required before the changes that have been made to the formal set of rules will affect economic outcomes.

Finally, the analysis of corporate law in transition also helps to clarify some of the factors that have driven legal change. The strong improvements in the protection of shareholder rights in several CIS countries has followed significant assistance by USAID consultants. The convergence towards Anglo-Saxon levels of shareholder protection may have resulted from this external policy advice. However, there is little evidence that legal change by design has so far followed the conscious implementation of a particular model of corporate governance. A closer look at the sub-categories of corporate law shows that legislation has often been adapted in reaction to specific problems (Pistor, 1999). Given the problems of law enforcement emphasised before, it is also far from clear what impact the patterns of legal change emerging across the region will have on the nature of corporate governance and external finance in the second phase of transition.

¹ The study was carried out by Katharina Pistor of the Max Planck Institute for Foreign and International Private Law in Hamburg as part of an EBRD Policy Studies project. In Pistor (1999) a detailed analysis of the rating system, together with some modifications to the La Porta et al. indicators, is presented.

bureaucratic discretion, over which they might hope to have some influence. Not all forms of private property generate the demand for the same type of market-based institutions, however. A system controlled by oligarchs, as in Russia, may foster a culture of corruption and regulation that stifles competition instead of rules designed to provide fair conditions for all market participants. Chart 2.11 shows a strong link between the number of years since the completion of small-scale privatisation and the demand for institutional change. Small-scale privatisation directly contributes to creating a new class of entrepreneurs, which – as revealed by Chart 2.11 – tends to promote institutional change.

The third factor that may influence the demand for institutions is the exposure of businesses to an established market environment. This is primarily achieved through openness to foreign trade and investment. Foreign trading partners are more likely to rely on formal contracts than domestic partners engaged in informal business relationships. Foreign trade may therefore help closed business networks become open and competitive.⁶ Foreign direct investment helps to introduce standards of corporate governance, which may be emulated elsewhere. Chart 2.12 shows a strong link between progress in institutional reform and trade with non-transition economies.

How can the relative contribution of each of these factors be assessed? As Section 2.4 has shown, initial conditions have a significant effect on the timing of liberalisation and the extent to which it is sustained. Does the demand for institutions, which arises from the operation of markets and private enterprise, reflect deep-seated differences between the transition economies or the level of progress in liberalisation and privatisation? Statistical analysis can help to identify the relative importance of these two factors. The results reveal that the demand for institutions arising from liberalisation and privatisation is strong even once the impact of initial conditions has been taken into account.⁷

Supply of institutions – changing laws and behaviour

The development of institutions is determined to a significant extent by the types of institutions that already exist. They include both the body of existing laws and regulations and the power of the state. Some transition economies were able to draw on relatively developed legal traditions, formed before the establishment of central planning. In these countries, mainly in CEE, initial steps in institutional reform often consisted simply of resurrecting laws that had never been repealed but had not been implemented during socialism (such as the Polish Commercial Code of 1934). The Soviet Union introduced several legal reforms during the 1980s, for instance in the area of company law, which formed the basis for subsequent legal changes.

Where legal traditions are weak, legislators face the choice of whether to develop entirely new rules to fit the specific requirements of the country or to adapt existing laws from abroad. Typically, the latter strategy has been followed by developing countries around the world and by transition economies over the past decade. Most of the transition economies have adopted legal frame-

⁶ For an elaboration of this argument, see Humphrey and Schmitz (1996).

⁷ See Fries, Raiser and Weeks (1999).

works modelled largely on the German system, a legacy that goes back to close ties between Germany, central and eastern Europe and Russia before the Second World War. In several CIS countries, however, the influence of legal consultants from the United States has sometimes led to reforms in the Anglo-Saxon tradition. External advice, particularly when combined with considerable donor funds, can be an important factor in the development of institutions.

One area that illustrates both the importance of legal traditions and the role of external advice is the development of laws on corporate governance – including the protection of shareholder and creditor rights (see Box 2.2). Tracing changes in company laws across the region over the past decade reveals interesting contrasts between CEE and the CIS. In the first group, legal traditions were relatively well-developed at the start of transition and leaned towards the German model, with good protection of creditor rights and far less developed protection of shareholder rights. By 1998, this pattern had largely persisted, even with legislative improvements in both areas. In the CIS, by contrast, there is little evidence of a strong impact of legal traditions on the pattern of legal reforms. The most significant improvement in the CIS occurred in the specification of shareholder rights, partially as a result of the significant impact of USAID consultants in drafting new company laws in several CIS countries (Armenia, Georgia, Kazakhstan, Russia and Uzbekistan).

The example of company law also suggests, however, that changes in formal rules may be largely ineffective unless matched by similar improvements in enforcement. In Russia, the adoption of an Anglo-Saxon model of company law in 1996 with wide-ranging protection for minority shareholders has not prevented large-scale asset-stripping and cheating of minority shareholders and creditors in recent corporate governance scandals. Evidence in the *Transition Report 1998* similarly suggested that it was the lack of effectiveness of banking regulations and regulatory forbearance rather than inadequate laws themselves that undermined the stability of financial systems in many transition economies.⁸ This highlights an important dilemma. When the power of the state is weak, the introduction of sophisticated new legislation may be counter-productive, at least in the short term. In view of administrative constraints, simpler rules might be more effective. Moreover, if enforcement cannot be guaranteed, the credibility of the new rules may be undermined.

The effectiveness of rule enforcement has a number of elements. First, rule enforcement institutions need to be appropriately staffed and their staff needs to be well-trained. Even gradual legal change requires judges who can interpret accurately the intentions of legislators. In periods of rapid legal transition, this is a considerable challenge, requiring additional training. Second, legislation is often of a general kind and needs to be translated into specific provisions. External legal consultants often provide advice on the drafting of framework laws, leaving the development of implementing provisions to local experts. This can sometimes introduce inconsistencies. Third, the judiciary needs to be truly

independent and must instil confidence in market participants. The best laws and lawyers are not useful if market participants do not trust the courts to uphold their rights fairly and impartially. In many transition economies, the lack of credibility of the law has led to the emergence of private enforcement mechanisms, with the arbitrariness and violence that this can entail.

2.8 Conclusions: challenges of the next decade

The analysis in this chapter has revealed large differences in patterns of reform both across countries and across the various aspects of reform. It has argued that differences in the form and extent of liberalisation and in the extent to which hard budget constraints have been imposed on enterprises are the main areas of variation in reform. These differences can be attributed in part to differing initial conditions across countries, but policy choices have also had a significant impact. Regarding the development of institutions that support markets and private enterprise, the chapter has emphasised that countries that have achieved sustained progress in liberalisation, macroeconomic stabilisation, small-scale privatisation, and openness to foreign trade and investment have also advanced steadily in the development of market institutions. However, the process of institutional change is shaped by many other factors, including the power of the state, legal traditions and foreign assistance. The differences in progress in institutional reform across the transition economies are likely to increase. This concluding section reviews the main policy challenges that emerge from the analysis in this chapter.

First, it is important to recognise that the basic reform challenges that faced the region in 1989 are still very much at the heart of the transition in many countries a decade later. Price and trade liberalisation remains incomplete in some countries, and markets are fundamentally flawed and non-competitive in a number of economies. Without the signals of free prices and the discipline of competitive markets, transition cannot succeed and economic performance will remain disappointing. Governments have found it difficult to open markets fully, primarily because of the costs that a policy of non-intervention and hard budget constraints would impose on influential groups within society. Subsidies have persisted in various guises, often in ways more detrimental to economic efficiency than direct budgetary subsidies would have been. Competitive markets and hard budget constraints are not only essential to accelerate the necessary adjustment of non-viable enterprises and support sound public finances, they also can make a strong contribution to innovation and growth of enterprises. A strong response by enterprises to reforms can in turn help to ease the very constraints that make them appear unattractive to governments (see Chapter 7).

Second, differences in the starting points for transition continue to have a lasting effect on reforms and performance, as shown in Chapters 3 and 4. The costs of introducing reforms typically increases in line with the extent of macroeconomic and structural imbalances inherited from central planning and with the distance from dynamic markets from which to learn and adapt and with

⁸ This is indeed a general pattern. Preliminary results on rating the extensiveness of competition policy as well as financial sector regulations, based on the existing laws rather than on expert opinion, show that the CIS does not lag far behind CEE in terms of the law “on the books”.

which to trade. Yet, the Baltic states and several other CIS countries have made progress despite inherited difficulties and have resisted pressures for backtracking. Policy choices will increasingly shape transition patterns in the future (see Chapter 5).

Third, sustained liberalisation, macroeconomic stabilisation and small-scale privatisation are key factors determining the demand for market-based institutions in transition economies. Institutional change is inherently slow and an imbalance has inevitably arisen between the creation of markets and the establishment of appropriate supporting institutions. However, the evidence from transition economies reveals that these institutions do develop in response to market-based demands. The policy challenge lies in shaping this demand by allowing competitive markets to operate. This requires a fair operating environment for new private sector companies and small and medium-sized enterprises (see Chapter 8) and effective strategies for the restructuring of large industrial enterprises (see Chapter 9). Where soft budget constraints are allowed to persist, new enterprises are discouraged and there is a detrimental effect on the demand for institutions and good economic governance (see Chapter 6).

Fourth, while the demand for institutions may arise from the creation of markets, the supply of institutions relies on the capacity of the state and its responsiveness to its citizens. Transforming the state requires more than its withdrawal from directing economic activity, however. It is also crucial that the state is supportive of markets and private enterprise. Providing a sound investment climate for entrepreneurship not only yields important benefits from improved economic performance, it also helps to strengthen one of the constituencies for further reforms. New private firms demand equal access to public services and they create the jobs that will help to alleviate the social costs of further structural change. The ongoing process of international integration can also help guide the development of domestic institutions. This integration takes many forms, including openness to trade and foreign direct investment and accession to the EU, and can strengthen the demands of local business for market-supporting institutions. The hope for the second decade of transition is that this voice for market-supporting institutions will become stronger.

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Annex 2.1: Business Environment and Enterprise Performance Survey

For this year's *Transition Report*, the EBRD conducted a major survey, in collaboration with the World Bank, on business environment and enterprise performance, receiving feedback from over 3,000 enterprises in 20 countries of the region. The survey asked the manager of each enterprise not only to describe the firm's basic characteristics – such as its size, the sector in which it operates, the extent of competition it faces and its ownership – but also to assess the business environment or investment climate in the country. The questions on the investment climate focused on macroeconomic conditions (inflation, exchange rate and policy stability), business regulation and taxation, the judiciary, corruption, law and order, and access to finance and infrastructure services.

In terms of size and sector, the firms in the survey are fairly representative of their domestic economies. Industrial firms and large firms (those with over 500 employees) represent only a minority of those surveyed. This means that the practices of firms in the sample will not necessarily be typical of the kind of large industrial firms that have often been the focus of privatisation and

restructuring efforts. However, the survey does provide extensive coverage of small and medium-sized enterprises, which are the backbone of most market economies.

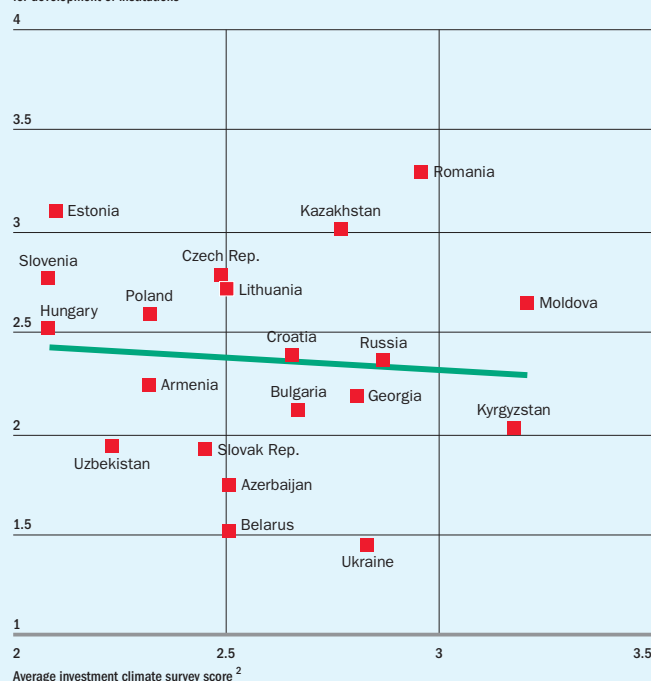
In the survey, there are representatives of three ownership categories (state-owned, privatised and new entrants) in every sector. However, state firms are strongly represented in transport, privatised firms in agriculture, and new entrants in wholesale and retail trade. It is striking that just over half of the new entrants are very small (fewer than ten employees), while over 45 per cent of state firms have more than 200 employees. The average size of firm also varies between countries, with the average number of employees particularly large in Belarus, Croatia and Ukraine and particularly small in Lithuania. These differences reflect the composition of enterprises in these countries rather than a biased sample.

Just over 7 per cent of firms in the sample have some foreign ownership stake, a proportion varying from 4 per cent of state firms to 12 per cent of privatised firms. Foreign ownership is strongly

Chart 2.1.1a

EBRD transition indicators and investment climate survey scores

Average EBRD transition indicator for development of institutions¹



Source: Business Environment and Enterprise Performance Survey.

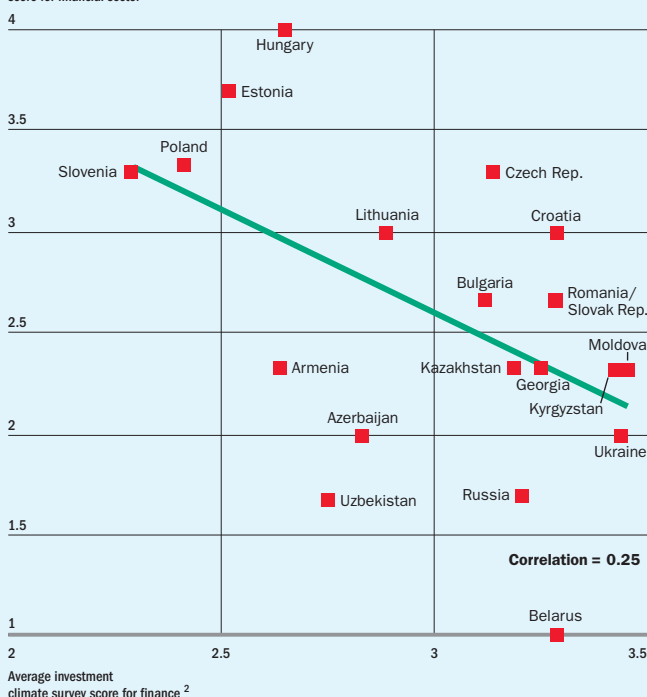
¹ EBRD transition indicators for the development of institutions comprise the scores for banking reforms, non-bank financial institutions, competition policy and enterprises. The EBRD transition indicators range from 1 (little progress) to 4 (substantial progress).

² Investment climate scores are average ratings across the dimensions of macroeconomic stability, taxation and regulation, law and order and the judiciary, as well as finance and infrastructure. Scores can reach a maximum of 4. A higher score means a less favourable investment climate.

Chart 2.1.1b

EBRD transition indicators for financial sector and investment climate survey scores for finance

EBRD transition indicator score for financial sector¹



Correlation = 0.25

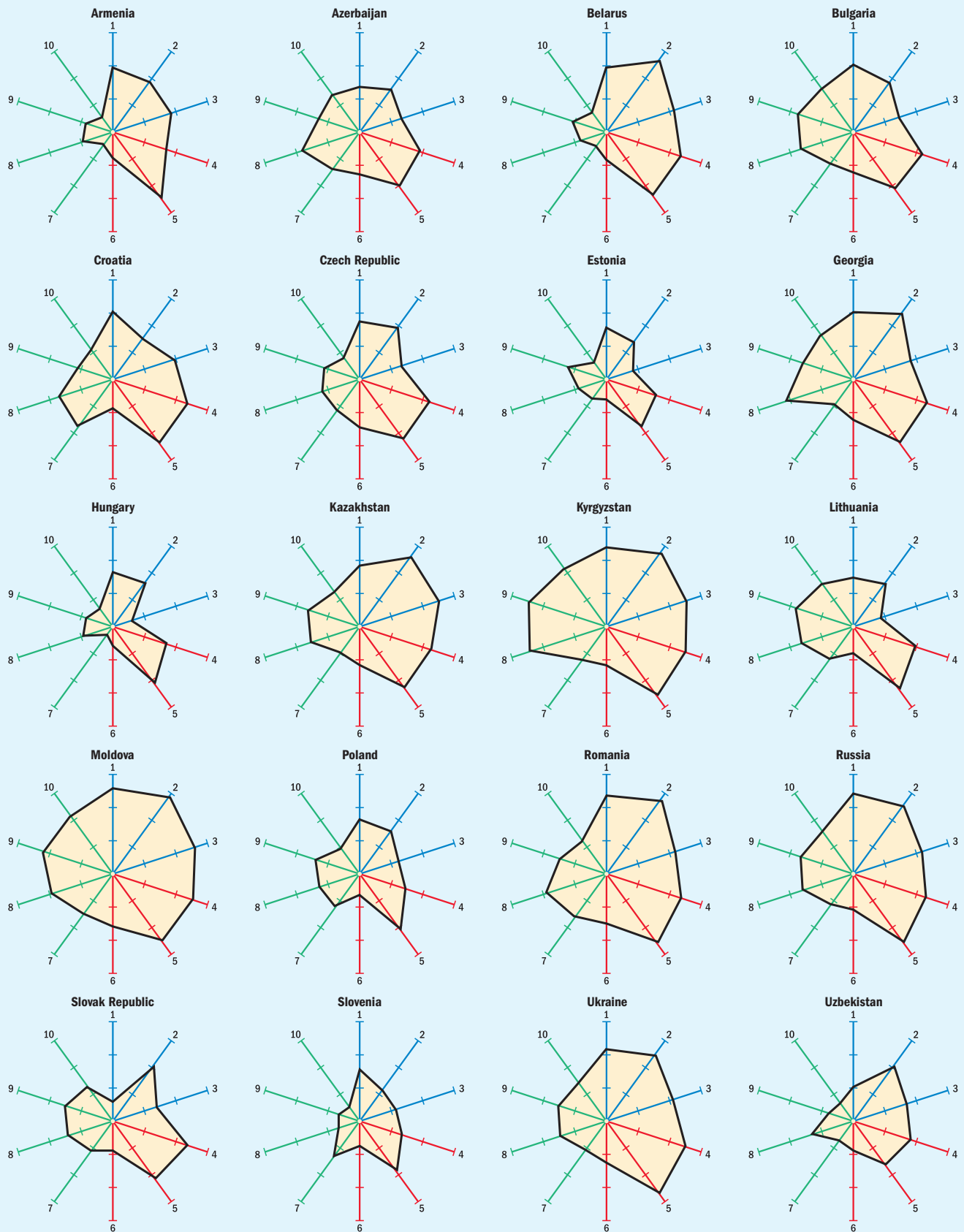
Source: Business Environment and Enterprise Performance Survey.

¹ EBRD transition indicator score is the average for banking reforms and non-bank financial institutions. The EBRD transition indicators range from 1 (little progress) to 4 (substantial progress).

² The investment climate score for finance is the single rating on the sub-category. Scores can reach a maximum of 4. A higher score means a less favourable investment climate.

Chart 2.1.2

Assessment of the investment climate by country and dimension



Macro 1 – Policy Instability
2 – Inflation
3 – Exchange rate

Micro 4 – Finance
5 – Taxes and regulations
6 – Infrastructure

Law and order 7 – Functioning of the judiciary
8 – Corruption
9 – Street crime/theft/disorder
10 – Organised crime/mafia

Note: The extremity of each axis represents a score of 4, indicating a less favourable investment climate. The fuller the circle for a country, the more challenging is its investment climate.

Source: Business Environment and Enterprise Performance Survey.

related to export orientation. On average, 28 per cent of output is exported by firms with some foreign ownership, compared with 10 per cent for the sample as a whole.

Managers were asked to assess to what extent each aspect of the investment climate was an obstacle to the operation and growth of the firm. A score of 4 indicates a major obstacle while 1 represents no obstacle. In other words, a higher score means a less favourable investment climate. A summary score for each country is calculated as the unweighted average for all firms in that country across all measured aspects of the investment climate.

Chart 2.1.1 shows the average investment climate score for each country versus the EBRD's transition indicators of institutional change, where a higher score means a more favourable investment climate. Both are measures of the development of market institutions, albeit with different emphases. The EBRD transition indicators focus on governance and restructuring of enterprises, competition policy and the financial sector, while the survey-based investment climate assessments concentrate on economic governance (macroeconomic and microeconomic), law and order and the judiciary, as well as finance and infrastructure. As expected, there is an inverse relationship between the scores. However, there is also wide variation around the trend line.

The correlation between the EBRD transition indicators and the investment climate scores in their one common area of measurement – finance – provides a consistency check. Reassuringly, there is a high correlation between the two measures for this particular aspect. This comparison suggests that the variation between two countries reflects the differing emphases of the two assessments rather than measurement error. In other words, the EBRD transition indicators and the investment climate scores from the survey provide complementary assessments of the progress in market reforms and the impact of these reforms on the functioning of markets, enterprises and financial institutions.

Chart 2.1.2 shows the variations in the investment climate between countries and across various dimensions, using a ten-dimensional simplex to depict the scores for each country. The fuller the circle for a country, the more challenging is its investment climate. The aspects of the investment climate that are systematically assessed as the most problematic are macroeconomic instability (inflation, exchange rate and policy instability), taxation and regulation, and finance. The aspects that on average do not appear to be significant business obstacles are infrastructure, the judiciary, and law and order.

There is, however, much more cross-country variation in certain aspects of the investment climate than in others. For example, not only do the areas regarding macroeconomic stability pose some of the biggest obstacles, they also have some of the highest variations in scores across countries. The countries with greater macroeconomic stability are in central Europe and the Baltic states and those with less certain policies are in south-eastern Europe and the CIS. The level and administration of taxes and the lack of access to finance are also significant business obstacles, but their severity is relatively uniform across all countries. The other aspects of the investment climate with considerable variation across countries are corruption and law and order, even though on average they do not pose the most significant business obstacles. These problems appear more significant in parts of south-eastern Europe and the CIS than elsewhere in the region.

While this annex provides a brief introduction to the investment climate as measured by the survey, Parts II and III of the Report examine the findings in more detail. Chapter 6 examines the relationship between the state and enterprises and the factors that influence the quality of governance and the investment climate. Chapter 7 assesses the impact of the investment climate and other factors on the restructuring and growth of enterprises. Chapter 8 identifies the aspects of the investment climate that impose significant obstacles to the formation and expansion of new private firms.

Annex 2.2: Legal transition indicators

Since 1995, the EBRD has conducted surveys that measure and assess the progress made to date in legal reforms in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS). Through the use of the Legal Indicator Survey, the EBRD's Office of the General Counsel (OGC) has developed measures to assess both the extensiveness and effectiveness of a number of commercial and financial laws and regulations. The surveys also provide a basis for analysing the effect of legal reform in promoting investment and growth in the region.

The survey sample covers private law firms, academics and other experts familiar with commercial laws in the transition economies. Private sector lawyers are selected on the basis of their experience in advising the EBRD on local laws. This year, through the assistance of other international financial institutions, non-governmental organisations, universities, and international accounting and consulting firms, the OGC was able to identify a greater number of potential respondents and receive a much greater number of responses than in previous years.

Since 1997, the EBRD has conducted a survey that measures the perceptions of lawyers and other experts regarding the extensiveness and effectiveness of commercial law reform. The 1997 and 1998 survey focused on the topics of pledge, bankruptcy and company law. Each of these topics corresponds to areas in which the EBRD's Legal Transition Programme is actively involved. In 1998, OGC expanded the survey to include legal reform in the financial markets area. This extension consisted of two parts: banking and financial institutions law; and the regulation of capital markets.

For 1999, the survey covered the extensiveness and effectiveness of legal reform efforts in the following areas:

- Pledge
- Bankruptcy (insolvency) law
- Company law
- Banking and financial institutions
- Capital markets
- General effectiveness of legal system and courts.

The results reflect how law reform is perceived by lawyers and other experts who are familiar with the region. These perceptions may not always correspond directly with the written legislation or regulations that exist in a given jurisdiction. Rather, they indicate how lawyers view legal transition in CEE and the CIS.¹

Legal indicator results for 1999

Table 2.2.1 provides an assessment (as of August 1999) of pledge, bankruptcy and company law on the basis of two criteria. The first assesses the extent to which commercial legal rules approach those of more developed countries regarding their impact on commercial transactions, such as secured lending, project finance, debt restructuring and the formation of joint-stock companies (referred to as extensiveness). The second assesses the extent to which such legal rules are clear and accessible and adequately implemented administratively and judicially (referred to as effectiveness). The classification system is explained below.

Table 2.2.2 provides an assessment (as of August 1999) of banking and capital markets laws on the basis of similar criteria. The first assesses the extent to which banking and capital markets legal rules approach minimum international standards, such as the Basle Committee on Banking Supervision's Core Principles or the Objectives and Principles of Securities Regulation developed by the International Organisation of Securities Commission (IOSCO) (referred to as extensiveness). The second assesses the extent to which such legal rules are clear and the frequency with which regulators take corrective action against failing banks and against enterprises or individuals that violate securities laws (referred to as effectiveness). The survey attempts therefore to measure how effectively countries in the region enforce financial laws and regulations so as to foster confidence in both banking and securities activities.

The summary measures reported in both tables reflect the subjective assessments of survey respondents as well as the views of EBRD bankers and lawyers who have experience working on commercial and financial market transactions in the field. For a few countries, the survey respondents provided significantly differing assessments. Where there were large discrepancies, recourse to the EBRD's in-house knowledge of that country's conditions was used to arbitrate among the differing views. Accordingly, while the purpose of the survey and resulting analysis is to give an impression as to how various legal practitioners perceive the extensiveness and effectiveness of laws and regulations in the region, some caution must be exercised in interpreting the results.

Trends in commercial law: from enactment to refinement and implementation

This year's survey reveals that many jurisdictions are focusing on the refinement of existing laws. Countries are now trying to fine-tune legislation and to fix problems of interpretation and ambiguity as well as to rectify implementation problems that have arisen with respect to new laws that have been enacted over the course of the past five to seven years.

¹ As in previous years, the 1999 Legal Indicator Survey tried to gauge perceptions about the effectiveness of various jurisdictions in implementing and enforcing commercial and financial laws and regulations and, more generally, in achieving a functioning and efficient legal system. In past surveys, we asked respondents to provide a simple "yes" or "no" in response to our effectiveness questions. For example, the EBRD previously asked respondents whether cases involving corrupt practices (such as bribery) are routinely prosecuted. In trying to understand more fully the perceptions of respondents, the response to our effectiveness questions was changed this year in order to provide respondents with a range of responses. Respondents were able to choose from five responses: 1 Never; 2 Rarely; 3 Sometimes (that is, about 50% of the time); 4 Frequently; 5 Almost Always. These responses did not change the scoring methodology but merely provided OGC with more information concerning how respondents perceive the effectiveness of legal rules.

Table 2.2.1

Legal transition indicators: commercial law

Country	1999			1998		
	Overall	Extensiveness	Effectiveness	Overall	Extensiveness	Effectiveness
Albania	2	2	2-	2	2	2
Armenia	3-	4-	2	3	4	3
Azerbaijan	3-	3+	2	2	3	2
Belarus	2	2	2	2	2	2
Bosnia and Herzegovina	2-	2	1	1	2	1
Bulgaria	4-	4	4-	4	4	4
Croatia	3+	4	3-	3	4	3
Czech Republic	3	3+	3-	4	4	4
Estonia	4-	3+	4-	3	3	4
FYR Macedonia	4-	4-	4-	3	3	4
Georgia	2	2	2	3	3	3
Hungary	4-	4	4-	4	4	4
Kazakhstan	3+	3+	3+	2	2+	2
Kyrgyzstan	3	3+	3	2	3	2
Latvia	3	4-	3	2+	3+	2
Lithuania	3+	4	3	3	4	3
Moldova	3+	4-	3	3	4	3
Poland	3+	4	3	4	4	4
Romania	3+	3+	4-	4	4	4
Russia	3	4-	2+	3	4-	2
Slovak Republic	3	3+	3	2	3	2
Slovenia	4	4	4	3	3	3
Tajikistan	na	na	na	2	2	3
Turkmenistan	na	na	na	na	na	na
Ukraine	2	2	2	2	2	2
Uzbekistan	3-	3-	2+	2	2+	2

Some jurisdictions have also become involved in the more lengthy and time-consuming process of implementing laws. For example, the creation of share registries is a necessary part of transparent and well-functioning capital markets and allows shareholders to quickly transfer share ownership and to ensure registration of the new owner. Establishing a depository or registry can be costly for the state. In countries such as Russia, registries are a new business for third parties, and they often suffer from a lack of experienced professionals working in this area. Implementation takes time – especially when it involves the creation of a new structure or institution and the need for trained personnel to work in the area.

Extensiveness

In general, country extensiveness scores continue to move upwards and a significant number of jurisdictions have received a 4 rating for extensiveness.

A few country scores have risen significantly, including Kazakhstan, where a new joint-stock company law and preparation for a centralised pledge registry have created positive perceptions

of commercial law reform. Similarly, Kyrgyzstan's score has improved, which may reflect the significant emphasis on corporate governance and commercial law reform provided by the Asian Development Bank. For example, companies listed on the Kyrgyzstan Stock Exchange are required to adopt a corporate charter in line with a model developed with foreign technical assistance. Kyrgyzstan has also engaged in significant pledge law reform and has been planning to create a pledge registry. The improvements in two of the three areas of Kyrgyzstani and Kazakhstani commercial law probably accounts for the increased extensiveness score.

A few countries, such as the Czech Republic and Romania, have experienced a fall in extensiveness scores. In both these countries the lower score may reflect limitations in the scope of commercial laws that have become apparent as attempts are made to apply these laws more actively.

Effectiveness

Effectiveness scores dropped slightly in 1999 for a few jurisdictions. This was notable in the Czech Republic, which may reflect

Classification system for legal transition indicators: commercial law

Extensiveness

- 1 Legal rules concerning pledge, bankruptcy and company law are very limited in scope. Laws impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation. Laws in these substantive areas often have not been amended to approximate those of more developed countries and the laws that have been amended contain ambiguities or inconsistencies.
- 2 Legal rules concerning pledge, bankruptcy and company law are limited in scope and subject to conflicting interpretations. Legislation may have been amended but new laws do not necessarily approximate to those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty with respect to the registration and enforcement of pledges. Pledge laws may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Laws may contain inconsistencies or ambiguities concerning, among other things, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.
- 3 New or amended legislation has recently been enacted in at least two of the three areas that were the focus of this survey – pledge, bankruptcy or company law – but it could still benefit from refinement and clarification. Legal rules permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still rudimentary and do not provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws may contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganisation and liquidation but may place claims of other creditors above those of secured creditors in liquidation.
- 4 Comprehensive legislation exists in at least two of the three areas of commercial law that were the focus of this survey – pledge, bankruptcy and company law. Pledge law allows parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, is not fully developed to include a centralised or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties are defined. Bankruptcy law includes detailed provisions for reorganisation and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.

- 4+ Comprehensive legislation exists in all three areas of commercial law that were the subject of this survey – pledge, bankruptcy and company law. Legal rules closely approach those of more developed countries. These legal systems have a uniform (that is, centralised registration) system for taking and enforcing a security interest in movable assets and also provide for adequate corporate governance and protect shareholders' rights. In particular, the rights of minority shareholders are protected in the event of the acquisition by third parties of less than all of the shares of a widely held company. Bankruptcy law provides in a comprehensive manner for both reorganisation and liquidation. Liquidators possess a wide variety of powers and duties to deal with the property and affairs of a bankrupt, including wide powers of investigation of pre-bankruptcy transactions carried out by the debtor. There are specialised courts that handle bankruptcy proceedings. Liquidators must possess certain minimum qualifications.

Effectiveness

- 1 Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support for the law is rudimentary. The cost of transactions, such as creating a pledge over a movable asset, is prohibitive so as to render a potentially extensive law ineffective. There are no meaningful procedures in place in order to make commercial laws fully operational and enforceable. There are significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.
- 2 Commercial legal rules are generally unclear and sometimes contradictory. Few, if any, meaningful procedures are in place to make commercial laws operational and enforceable.
- 3 While commercial legal rules are reasonably clear, administration or judicial support of the law is often inadequate or inconsistent, creating a degree of uncertainty (for example, substantial discretion in the administration of laws and few up-to-date registries for pledges).
- 4 Commercial laws are reasonably clear and administrative and judicial support of the law is reasonably adequate. Specialised courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.
- 4+ Commercial laws are clear and readily ascertainable. Commercial law is well-supported administratively and judicially, particularly regarding the efficient functioning of courts, liquidation proceedings, the registration of shares and the orderly and timely registration of security interests.

Overall

The overall score in the third column of the table is the average (rounded down) of the scores given for the two indicators. Pluses and minuses are intended to indicate countries on the borderline of two categories.

experiences of foreign investors in trying to enforce their rights as secured creditors and minority shareholders in courts.

Respondents in a majority of jurisdictions noted that court proceedings remain time-consuming and inefficient. Similarly, a great number of respondents in countries that received an effectiveness score of 3 or lower noted that regulators failed to use their enforcement powers against liquidators, directors, banks and other financial intermediaries. Failure to take prompt corrective action, coupled with time-consuming court proceedings, means

that creditors, investors and minority shareholders are often left with no real or effective legal recourse in certain jurisdictions.

Respondents also noted that the problem of insolvent financial institutions needs to be addressed through new legislation on bank insolvency but also through improved enforcement by central banks and bank regulators. Respondents felt that more banks need to be liquidated or merged and liquidation proceedings that have been commenced need to be concluded more rapidly.

Table 2.2.2

Legal transition indicators: financial regulations

Country	1999			1998		
	Overall	Extensiveness	Effectiveness	Overall	Extensiveness	Effectiveness
Albania	2+	3	2+	2-	2-	2-
Armenia	3	3	3+	2	2+	2-
Azerbaijan	2-	2	1	2-	2	1
Belarus	1+	2	1	1	2-	1
Bosnia and Herzegovina	1	1	1	1	2-	1
Bulgaria	3-	3	2+	3	4	3
Croatia	3-	3	3-	3	3	3
Czech Republic	3	3+	2+	3	3+	3-
Estonia	4-	4	3+	3	3+	3-
FYR Macedonia	2+	3	2	2	3	2
Georgia	1	1	1	1	2-	1
Hungary	4	4	4	4	4	4
Kazakhstan	3-	3	3-	2	2	2
Kyrgyzstan	2+	3-	2	2	2	2-
Latvia	3-	3	2	3	3+	2+
Lithuania	3-	3-	2	3-	3-	2
Moldova	3	4	2+	2	2+	2
Poland	4	4	4	4-	4	3
Romania	3-	3	3-	3-	3	3-
Russia	3-	3	2	3-	3-	2
Slovak Republic	3+	4	3+	3-	3	2
Slovenia	3+	3+	3+	3	3+	3-
Tajikistan	na	na	na	1	2	1
Turkmenistan	na	na	na	1	2-	1
Ukraine	2	2	2	2	2	2-
Uzbekistan	2-	2	1	2-	2	1

Pledge law

The survey examined a number of key issues relating to the ability of a party to pledge movable property as a security for credit. In particular, it asked whether countries have reformed existing civil codes and/or adopted new laws to provide for non-possessory pledges of movable property. The survey also asked whether countries have provided for cost-efficient mechanisms for the registration and enforcement of pledges in movable property.

In contrast to the 1998 survey results, there was considerable activity concerning pledge law and pledge registries in the region. Three countries adopted new pledge legislation in the middle of 1998. Azerbaijan, for example, enacted a new law on mortgages in July 1998 to supersede its 1994 law of pledge. FYR Macedonia also enacted a new law on pledge of movable property and rights in May 1998. Similarly Uzbekistan enacted a new pledge law in late May 1998. The Uzbekistan law, however, still attempts to restrict a creditor's recourse in the event of default on a debt. This may prove a disincentive for banks to provide credit to Uzbekistani

companies and therefore serve as an impediment to foreign investment activity. Countries that have adopted new laws or revised or amended their pledge laws or civil codes to include new pledge provisions include Armenia, Azerbaijan, Kazakhstan, Latvia and Ukraine.

Some countries have also begun preparations for amending their laws, which demonstrates that momentum is growing to improve the system of creating and registering pledges in movable property. Many of these jurisdictions did not permit a non-possessory pledge over movable property previously. For example, the Czech law does not permit non-possessory pledges in movables but recourse to German-style constructions (for example, fiduciary transfer of ownership by way of security)² is used to avoid this limitation. Reform in this area will complement the other reforms that have taken place in Czech commercial law. In Romania a draft law prepared with World Bank assistance has recently been adopted but its implementation is likely to be delayed due to the need to create a pledge registry.

² The fiduciary transfer simply means that the ownership is held by the lender as security for its loan, but the actual use of the asset remains with the borrower.

Classification system for legal transition indicators: financial regulations

Extensiveness

- 1 Legal rules concerning banking and securities regulation are very limited in scope. For example, capital adequacy standards and restrictions on affiliated lending in banking do not exist. There may be no functioning stock exchange in this jurisdiction, or the capital markets' legal infrastructure may be in its earliest stage of development.
- 2 Legal rules governing financial markets are somewhat limited in scope. Although regulations in banking have been amended to accord with core principles, at least one important area of regulation remains deficient – for example, capital adequacy, use of international accounting standards or use of consolidated comprehensive supervision. Oversight of securities markets is limited and regulation of securities intermediaries and investment funds, for example, are either non-existent or rudimentary.
- 3 Legislation for financial markets is reasonably comprehensive but would benefit from further refinement in some areas. Banking regulations generally conform with the Basle Committee's Core Principles, although regulations concerning bank insolvency and deposit protection may not have been adopted. Further refinement to regulation of securities intermediaries and/or investment funds and creation of shareholder depositories and registers are needed to achieve conformity with minimum international standards.
- 4 Comprehensive financial market legislation conforms generally with minimum international standards. However, refinement is still needed in at least one important area of either banking or securities regulation. For example, many jurisdictions still need to enact rules concerning money laundering or bank insolvency. Legislation concerning shareholder depositories and registries tends to be in its early stages of implementation.
- 4+ Banking and capital markets legislation and regulation are comprehensive and conform with minimum international standards.

Effectiveness

- 1 Legal rules governing financial markets are usually very unclear and often contradictory. Regulatory support of the laws is rudimentary. Supervisory mechanisms are either non-existent or poor. There are no meaningful procedures to make financial laws fully operational.
- 2 Legal rules are somewhat unclear and sometimes contradictory. Supervision of financial institutions exists only on an ad-hoc basis. There are few, if any, meaningful procedures in place to enforce the law. There may be a lack of adequately trained staff in either banking or capital markets regulatory authorities.
- 3 Although legal rules governing financial markets are reasonably clear, regulatory and supervisory support of the law may be inconsistent, creating a degree of uncertainty. Although the regulator may have engaged in corrective actions against failing banks and securities market practices, enforcement problems still exist.
- 4 Legal rules governing financial markets are readily ascertainable. Banking and securities laws are well supported administratively and judicially, particularly regarding the efficient functioning of enforcement measures against failing institutions and illegal market practices. For example, the regulator has taken corrective action to liquidate failing banks. Enforcement actions against individuals and securities intermediaries are evident, but would still benefit from more systematic and rigorous enforcement. Courts have the authority to review enforcement decisions or other corrective actions for banks and/or securities firms.
- 4+ Regulators possess comprehensive enforcement powers and exercise authority to take corrective action on a regular basis. Examination of securities intermediaries and licensing of intermediaries is frequent, as is the use of corrective action, such as prosecution for insider dealing, revocation of bank licences, and liquidation of insolvent banks.

Overall

The overall score in the third column of the table is the average (rounded down) of the scores given for the two indicators. Pluses and minuses are intended to indicate countries on the borderline of two categories.

The countries that received much lower scores for extensiveness are those experiencing continuing problems with their pledge laws or those yet to adopt such laws, including Albania, Belarus, and Bosnia and Herzegovina.

Company law

The company law segment of the survey focused on, among other things, the formation of joint-stock companies, the registration of shares and corporate governance – the duties and responsibilities of directors and the protection and rights afforded to shareholders.

In 1999 there was less movement in terms of major amendments or enactment of new legislation in company law than there was in pledge law. Kazakhstan adopted a company law in July 1998. The new law contains provisions that are similar to the Russian and Uzbekistani models and provides extensive shareholder protection, including cumulative voting for directors. However, a drawback of the Kazakhstani law is that a court may order a new share issuance upon request from the government. The government can then use the proceeds of the forced share issuance to satisfy a company's back taxes or other overdue payments to the government. This new

provision may simultaneously create a large dilution in share ownership for companies forced to create new shares.

Poland has amended its company law to conform more closely with the third EC Company Law Directive. For example, the new Polish law will define more clearly the ways in which companies can merge or "spin off". Some countries have focused on the revision of their laws, especially to improve the effectiveness of rules intended to protect minority shareholders. Russia, for example, is in the process of amending its law to provide more protection for minority shareholders. For example, under the revision, the general meeting of shareholders is required to approve charter capital increases of between 25 and 50 per cent.

In 1999, Hungary amended company legislation so that it now requires minority shareholders to seek court permission before calling a special shareholders' meeting or proposing an agenda item for the annual meeting. These new provisions seem to restrict shareholder rights. In late 1998, Lithuania relaxed its company law to permit companies to lend funds to other companies. This was previously prohibited.

Croatia is in the process of establishing a securities registry and depository. The Deputy Chairman of the Croatian Securities Commission noted in October 1998 that foreign investors had been reluctant to invest in the Croatian securities market because of the lack of a central share depository. Settlement currently takes several weeks in Croatia as opposed to the immediate transfer of payment and ownership that occurs when a centralised registry and clearing house is utilised.

Bankruptcy law

The bankruptcy and insolvency segment of the survey included questions on reorganisation proceedings (whereby creditors and a debtor may reach a settlement rather than liquidate the company), liquidation and the role of the insolvency liquidator, trustee or manager. The survey also examined the time, frequency and manner of liquidation proceedings.

Bankruptcy is the area where the least change has occurred since July 1998. This is in large part due to the fact that more than half of the countries in the region enacted new legislation between 1997 and 1998. These countries include Armenia, Azerbaijan, Croatia, the Czech Republic, Estonia, FYR Macedonia, Kazakhstan, Latvia, Lithuania, Poland and Russia. However, even with these changes respondents were universally negative about the efficiency and effectiveness of liquidation proceedings in most countries. There was a general lack of knowledge about the types of powers that a liquidator possessed and the degree to which liquidators exercised such powers. For a further discussion of the extensiveness and effectiveness of bankruptcy laws, see Annex 8.1, which discusses these issues in greater detail.

Some countries amended their legislation in 1998, including the Czech Republic and Kazakhstan. Croatia has also been considering amendments to its law that would eliminate the current statement that debtors must file for bankruptcy if they are unable to fulfil their obligations. This has been viewed as an uncertain standard for triggering proceedings. The proposed Croatian amendments would also require bankruptcy trustees to have additional qualifications. Russia has enacted special laws to prevent the liquidation of strategic companies in the defence sector.

Trends in financial law: persistent gap between extensiveness and effectiveness

In 1998 the first EBRD survey concerning legal reforms in the area of banking and financial markets revealed that while many jurisdictions had well-developed laws with respect to banking and securities, most jurisdictions faced serious problems with enforcement and implementation.³ Some of the problems identified included a lack of trained regulatory personnel, a failure to conduct adequate supervisory functions, and a failure or inability of regulators to take prompt and corrective action in the event of a financial problem or crisis. By and large, countries have made great progress in implementing international standards, especially in the banking sector, where countries have revised legislation to conform with the Core Principles developed by the Basle Committee on Banking Supervision.

The 1999 survey also showed that while the extensiveness of substantive laws in both banking and capital markets were broadly equivalent, the effectiveness of securities laws lagged behind that of banking laws. This is partly due to the more recent creation of securities commissions in many countries designed to enforce securities laws and regulations and to address shareholder protection issues. A lack of effective shareholder depositories and registration systems was another indicator that capital market enforcement was perceived as less effective than the banking sector enforcement.

Extensiveness

As in 1998, Estonia, Hungary, Poland and Slovenia received high extensiveness scores in 1999, reflecting the comprehensive legislation that exists in these jurisdictions. Countries that received a score of 4 tended to place great emphasis on compliance with international regulatory standards. For Poland and Slovenia, for example, respondents noted that meeting EU standards was an important goal.

Respondents in these countries identified the need for developing legislation covering sophisticated market mechanisms. In Poland, for example, respondents noted that there was a need for increased focus on regulation and trading in derivatives. Respondents in Hungary noted that electronic and Internet trading were areas requiring regulation.

The Slovak Republic's score increased quite significantly in 1999, reflecting a number of ongoing and planned legislative reforms. In summer 1999 the country announced plans to create a new independent regulator covering capital markets and insurance. At the same time, the Slovak Republic proposed amendments to its banking legislation that give the National Bank additional powers to decrease a bank's share capital in the event that shareholders acquire shares in violation of Slovak banking laws. The Slovak Republic also approved a new deposit protection law in June 1999. Similarly, Moldova received a high extensiveness score, probably as a result of the adoption of legislation providing for the creation of an independent securities commission.

Countries that received a 3 rating have comprehensive legislation that may conform with international standards while also being in need of refinement. In particular, these countries have often had problems with minority shareholder protection. In many instances, this has caused these jurisdictions to amend or refine existing legislation. Romania, for example, is in the process of replacing its 1994 securities legislation. The new legislation is intended to increase investor and minority shareholder protection. The Czech Republic received a slightly lower rating than its peer accession countries achieved. This may be partly due to problems that shareholders have faced when investors, acting in concert, have managed to avoid mandatory buy-out requirements.

³ See Chapter 6.2 in *Transition Report 1998*, pp. 110-14.

Bulgaria's extensiveness score has dropped since 1998, reflecting decreased investor confidence in the legal rules governing financial markets. In addition, Bulgaria has had problems with insolvent financial institutions, five of which have been in liquidation proceedings for several years. Similarly, Croatia has had five major bank insolvencies in 1999. Legislation of some countries, such as Bulgaria and Romania, may appear to conform with international standards at first sight; ambiguities brought to light through implementation of the laws, however, may have caused respondents to downgrade the legislation compared with 1998.

Surprisingly, Albania's score rose in 1999, perhaps in response to the government's attempts to revise legislation to create stronger depositor and investor protections. Albania announced in March 1999 that it would strengthen its supervision of financial institutions to prevent a recurrence of the investment frauds that occurred in 1997. The Bank of Albania plans to increase capital requirements for banks from US\$ 5 million to US\$ 7 million, and insurance companies, pension funds and investment funds would similarly be required to retain more capital.

Countries that received lower extensiveness scores appear to have relatively inactive securities markets and stock exchanges or no exchange at all. These countries also tend to have a larger number of insolvent financial institutions. Additionally, many respondents perceive that there is little commercial lending in some of these countries (for example, Azerbaijan, Bosnia and Herzegovina, and Ukraine).

Ukraine is perhaps "on the cusp" and, as such, respondents noted that the stock exchange seemed inoperative and that there was a need for a custodial depository and clearing system to spur increased trading activity. Ukraine enacted a new law on its national bank in May 1999. The Governor of the Ukrainian National Bank (UNB) will now be appointed by the parliament. The UNB will have authority to impose civil sanctions on banks for violating banking regulations or for engaging in certain risky transactions. The UNB may also dismiss management and place banks in temporary administration. Licence revocation will also be an option for insolvent banks. Ukraine also revised its banking regulations in 1999 to increase bank capitalisation and to lower the charter capital required of foreign banks to the same level as that required of Ukrainian-owned banks.

Uzbekistan also received a lower extensiveness score, with respondents noting the need for the development of the banking sector as well as the development of a secondary market for securities as major goals.

Effectiveness

Effectiveness of financial market regulation continues to lag behind extensiveness for all jurisdictions. Nonetheless, many of the countries that achieved high scores for extensiveness also received top marks for effectiveness, including Estonia, Hungary, Poland, the Slovak Republic and Slovenia.

Although Moldova received a very high score for extensiveness, its effectiveness score was much lower, reflecting a perception that while Moldovan legislation may now appear to be comprehensive, enforcement of the laws remains a problem. Respondents noted, for example, that increased regulation of capital markets would be useful, as would effective enforcement of financial markets legislation more generally.

Even for countries that received higher effectiveness scores (3 or 4), many respondents noted that enforcement problems remained. For example, respondents in Croatia noted that the Croatia Securities Commission needed to take a more active role in enforcing laws and regulations. Croatia has recently created a new central clearing agency and share depository, which should improve the functioning of its capital markets.

The Czech Securities Commission continues to face problems with implementation and enforcement of its laws and regulations. In April 1999 the Commission began to impose fines on listed companies that failed to comply with financial disclosure requirements. According to Commission data, over one-quarter of the listed companies had not complied with disclosure rules.

Several countries that received a 3 rating for effectiveness were perceived as having ineffective systems of clearing and settlement. These countries include Croatia, FYR Macedonia and Russia.

In 1998, respondents noted that in many jurisdictions the shift to international accounting standards and, in the banking sector, to consolidated supervision and financial reporting posed problems for regulators and financial institutions alike. While fewer respondents cited this problem in 1999, it was a continuing problem in the Czech Republic and Estonia.

Many respondents noted that bank liquidation was a major challenge for most jurisdictions. In response to this problem, several jurisdictions have either adopted or are considering new bank insolvency legislation. Bulgaria, for example, began drafting new insolvency legislation in 1999. Russia enacted a new law on the insolvency of credit institutions in the first half of 1999. Belarus enacted legislation on bank insolvency in July 1998, which stated that the National Bank of Belarus' Board of Directors may decide to liquidate a bank at the request of the National Bank's supervisory department.

Annex 2.3: Infrastructure transition indicators

At the start of transition, it soon became evident that the region's infrastructure networks and services, which had been designed by and for centrally planned systems, were ill-suited to the needs and standards of a market economy. Demand for water and electricity, for example, was excessive due to a structure of very low prices and cross-subsidies that barely reflected costs. Rail networks were extensive while road networks were insufficient, with a particular deficit in cross-border infrastructure, which constrained the reorientation of trade in the region. Telecommunications technology was outdated and services were vastly under-supplied. The transition economies therefore faced the considerable challenge of building new infrastructure networks and replacing old technology.

The response to this challenge has been inhibited by the severe strains on government finance and the drop in demand for many services following a contraction in output in all countries. However, financing new infrastructure networks was not the only challenge. Reforming infrastructure to promote efficient service provision and financially viable operators was also an imperative.

Other requirements included introducing increasing levels of commercialisation and competition to make services more responsive to demand, rebalancing tariffs to better reflect costs and establishing effective regulatory institutions. Ten years on, transition economies have reformed their infrastructure to a degree that differs widely across countries and sectors.

The infrastructure transition indicators presented in this annex (see Table 2.3.1), which were reported for the first time in last year's *Transition Report*, measure the extent of reform in transition economies in a selected group of infrastructure sectors. Progress is measured in three broadly defined aspects of infrastructure reform identified and discussed in the *Transition Report* 1996. These are tariff reform, commercialisation, and regulatory and institutional development. Tariff reform includes the setting of tariffs that reflect costs, elimination of cross-subsidies and improvement of collection ratios. Commercialisation includes corporatisation, the introduction of hard budget constraints and competitive pressures, including forms of private sector participation, from management service

Table 2.3 1

Infrastructure transition indicators 1999

	Telecommunications	Electric power	Railways	Roads	Water and waste water
Albania	1+	2	2	2	1+
Armenia	2+	3	2	2+	2
Azerbaijan	1+	2	2	1+	2
Belarus	2	1	1	2	1
Bosnia and Herzegovina	1+	2	2	na	1
Bulgaria	3	3	3	2+	2
Croatia	2+	2+	2+	2+	3+
Czech Republic	4	2	2+	2+	4
Estonia	4	3	4	na	4
FYR Macedonia	2	2+	2	na	1+
Georgia	2	3	3	2	na
Hungary	4	4	3+	3+	4
Kazakhstan	2+	3+	2	2	1+
Kyrgyzstan	2	2+	1+	1	1
Latvia	3	3	3+	2+	3
Lithuania	3+	2+	2+	2+	3
Moldova	2+	3	2	2	2
Poland	3+	3	3+	3+	4
Romania	3	3	4	2+	3
Russia	3	2	2+	2	2+
Slovak Republic	2+	2	2	2+	na
Slovenia	2+	2+	3+	3	4
Tajikistan	1+	1	1	na	na
Turkmenistan	1	1	1+	1	1
Ukraine	2+	2+	1+	1+	1+
Uzbekistan	2	1	2	1	1

Classification system for infrastructure transition indicators, 1999

Telecommunications

- 1 Little progress has been achieved in commercialisation and regulation. There is a minimal degree of private sector involvement. Strong political interference takes place in management decisions. There is a lack of cost-effective tariff-setting principles, with extensive cross-subsidisation. Few other institutional reforms to encourage liberalisation are envisaged, even for mobile phones and value-added services.
- 2 Modest progress has been achieved in commercialisation. Corporatisation of the dominant operator has taken place and there is some separation of operation from public sector governance, but tariffs are still politically set.
- 3 Substantial progress has been achieved in commercialisation and regulation. There is full separation of telecommunications from postal services, with a reduction in the extent of cross-subsidisation. Some liberalisation has taken place in the mobile segment and in value-added services.
- 4 Complete commercialisation (including privatisation of the dominant operator) and comprehensive regulatory and institutional reforms have been achieved. There is extensive liberalisation of entry.
- 4+ Implementation of an effective regulation (including the operation of an independent regulator) has been achieved, with a coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. There is a consumer ombudsman function.

Electric power

- 1 The power sector operates as a government department. There is political interference in running the industry, with few commercial freedoms or pressures. Average prices are below costs, with external and implicit subsidy and cross-subsidy. Very little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business.
- 2 The power company is distanced from government. For example, it operates as a joint-stock company, but there is still political interference. There has been some attempt to harden budget constraints, but management incentives for efficient performance are weak. Some degree of subsidy and cross-subsidy exists. Little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business. Minimal, if any, private sector involvement has occurred.
- 3 A law has been passed providing for full-scale restructuring of the industry, including vertical unbundling through account separation and setting-up of a regulator. Some tariff reform and improvements in revenue collection have been achieved, and there is some private sector involvement.
- 4 A law for industry restructuring has been passed and implemented, with separation of the industry into generation, transmission and distribution. A regulator has been set up. Rules for cost-reflective tariff-setting have been formulated and implemented. Arrangements for network access (negotiated access, single buyer model) have been developed. There is substantial private sector involvement in distribution and/or generation.
- 4+ Business has been separated vertically into generation, transmission and distribution. An independent regulator has been set up, with full power to set cost-reflective effective tariffs. There is large-scale private sector involvement. Institutional development has taken place, covering arrangements for network access and full competition in generation.

Railways

- 1 Monolithic organisational structures still exist. State railways are still effectively operated as government departments. Few commercial freedoms exist to determine prices or investments. There is no private sector involvement. Cross-subsidisation of passenger service obligations with freight service revenues is undertaken.
- 2 New laws distance rail operations from the state, but there are weak commercial objectives. There is no budgetary funding of public service obligations in place. Organisational structures are still overly based on geographic or functional areas. Ancillary businesses have been separated but there is little divestment. There has been minimal encouragement of private sector involvement. Initial business planning has been undertaken, but the targets are general and tentative.
- 3 New laws have been passed that restructure the railways and introduce commercial orientation. Freight and passenger services have been separated, and marketing groups have been grafted onto traditional structures. Some divestment of ancillary businesses has taken place. Some budgetary compensation is available for passenger services. Business plans have been designed with clear investment and rehabilitation targets, but funding is unsecured. There is some private sector involvement in rehabilitation and/or maintenance.
- 4 New laws have been passed to fully commercialise the railways. Separate internal profit centres have been created for passenger and freight (actual or imminent). Extensive market freedoms exist to set tariffs and investments. Medium-term business plans are under implementation. Ancillary industries have been divested. Policy has been developed to promote private rail transport operations.
- 4+ Railway law has been passed allowing for separation of infrastructure from operations, and/or freight from passenger operations, and/or private train operations. There is private sector participation in ancillary services and track maintenance. A rail regulator has been established. Access pricing has been implemented. Plans have been drawn up for a full divestment and transfer of asset ownership, including infrastructure and rolling stock.

Roads

- 1 There is a minimal degree of decentralisation, and no commercialisation has taken place. All regulatory, road management and resource allocation functions are centralised at ministerial level. New investments and road maintenance financing are dependent on central budget allocations. Road user charges are based on criteria other than relative costs imposed on the network and road use. Road construction and maintenance are undertaken by public construction units. There is no private sector participation. No public consultation or accountability take place in the preparation of road projects.
- 2 There is a moderate degree of decentralisation, and initial steps have been taken in commercialisation. A road/highways agency has been created. Initial steps have been undertaken in resource allocation and public procurement methods. Road user charges are based on vehicle and fuel taxes but are only indirectly related to road use. A road fund has been established but it is dependent on central budget allocations. Road construction and maintenance is undertaken primarily by corporatised public entities, with some private sector participation. There is minimal public consultation/participation and accountability in the preparation of road projects.
- 3 There is a fairly large degree of decentralisation and commercialisation. Regulation, resource allocation, and administrative functions have been clearly separated from maintenance and operations of the public road network. Road user charges are based on vehicle and fuel taxes and fairly directly related to road use. A law has been passed allowing for the provision and operation of public roads by private companies under negotiated commercial contracts. There is

private sector participation either in road maintenance works allocated via competitive tendering or through a concession to finance, operate and maintain at least a section of the highway network. There is limited public consultation and/or participation and accountability in the preparation of road projects.

- 4 There is a large degree of decentralisation of road administration, decision-making, resource allocation and management according to government responsibility and functional road classification. A transparent methodology is used to allocate road expenditures. A track record has been established in implementing competitive procurement rules for road design, construction, maintenance and operations. There is large-scale private sector participation in construction, operations and maintenance directly and through public-private partnership arrangements. There is substantial public consultation and/or participation and accountability in the preparation of road projects.
- 4+ A fully decentralised road administration has been established, with decision-making, resource allocation and management across road networks and different levels of government. Commercialised road maintenance operations are undertaken through open and competitive tendering by private construction companies. Legislation has been passed allowing for road user charges to fully reflect costs of road use and associated factors, such as congestion, accidents and pollution. There is widespread private sector participation in all aspects of road provision directly and through public-private partnership arrangements. Full public consultation is undertaken in the approval process for new road projects.

Water and waste water

- 1 There is a minimal degree of decentralisation, and no commercialisation has taken place. Water and waste-water services are operated as a vertically integrated natural monopoly by a government ministry through national or regional subsidiaries or by municipal departments. There is no, or little, financial autonomy and/or management capacity at municipal level. Heavily subsidised tariffs still exist, along with a high degree of cross-subsidisation. There is a low level of cash collection. Central or regional government controls tariffs and investment levels. No explicit rules exist in public documents regarding tariffs or quality of service. There is no, or insignificant, private sector participation.
- 2 There is a moderate degree of decentralisation, and initial steps have been taken in commercialisation. Water and waste-water services are provided by municipally owned companies, which

operate as joint-stock companies. There is some degree of financial autonomy at the municipal level but heavy reliance on central government for grants and income transfers. Partial cost recovery is achieved through tariffs, and initial steps have been taken to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality but these are both still under ministerial control. There is some private sector participation through service or management contracts or competition to provide ancillary services.

- 3 A fairly large degree of decentralisation and commercialisation has taken place. Water and waste-water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. A municipal finance law has been approved. Cost recovery is fully operated through tariffs and there is a minimum level of cross-subsidies. A semi-autonomous regulatory agency has been established to advise on tariffs and service quality but without the power to set either. More detailed rules have been drawn up in contract documents, specifying tariff review formulae and performance standards. There is private sector participation through the full concession of a major service in at least one city.
- 4 A large degree of decentralisation and commercialisation has taken place. Water and waste-water utilities are managerially independent, with cash flows – net of municipal budget transfers – that ensure financial viability. A municipal finance law has been implemented, providing municipalities with the opportunity to raise finance. Full cost recovery exists and there are no cross-subsidies. A semi-autonomous regulatory agency has the power to advise and enforce tariffs and service quality. There is substantial private sector participation through build-operate-transfer concessions, management contracts or asset sales to service parts of the network or entire networks. A concession of major services has taken place in a city other than the country's capital.
- 4+ Water and waste-water utilities are fully decentralised and commercialised. Large municipalities enjoy financial autonomy and demonstrate the capability to raise finance. Full cost recovery has been achieved and there are no cross-subsidies. A fully autonomous regulator exists with complete authority to review and enforce tariff levels and performance quality standards. There is widespread private sector participation via service management/lease contracts, with high-powered performance incentives and/or full concessions and/or divestiture of water and waste-water services in major urban areas.

contracts to full private asset ownership, finance and operations. Regulatory and institutional development includes the establishment and implementation of laws and regulations that protect consumers by limiting monopoly power and protect investors by ensuring entry and fair competition.

The infrastructure indicators reported here define a rating (from 1 to 4+), which is based on the overall reform progress in the three broad areas described above. The coverage of the indicators includes the three sectors covered in last year's Report (telecommunications, electricity and railways) and two new sectors: roads and water and waste water. The rating definitions reflect the different challenges faced in each sector. In telecommunications, for example, the scope for competition is very large because of a large unmet demand and the low cost of new entry in certain segments of the market, such as mobile telephony. In this sector, interconnection rules are crucial for regulating market entry.

Other sectors – for example, electric power – face more complex organisational restructuring and tariff reform needs, such as introducing competition in generation and supply to large users. Railway reform also requires substantial organisational restructuring, involving the shedding of large numbers of jobs. This sector is also subject to frequent political pressures to maintain unprofitable passenger routes. Reform of the road sector requires new sources of financing, such as a road fund, and decentralisation, such as local companies undertaking road maintenance. The decentralisation of decision-making and an adequate municipal finance law are key ingredients for the autonomy of municipalities and the effective commercialisation of municipal services, including water and waste water. All infrastructure sub-sectors, however, share the common challenge of designing and implementing effective legal and regulatory systems.

The infrastructure transition ratings show considerable variation across countries and sectors. On average, however, there is a positive relationship between these ratings and those derived from the country transition indicators presented in Table 2.1 in Chapter 2. This indicates that countries that have pursued market reforms across most areas tend also to be at the forefront of the reform of infrastructure. Given that the ratings reflect the current state of progress, they do not indicate the initial conditions at the beginning of transition or the speed of commitment to reforms shown by governments. Further analysis is required to link current progress in reform with these other factors as well as to link reform progress with market performance.

While a few countries and sectors have seen their infrastructure ratings changed, most of them retain the same ratings as in last year's *Transition Report*. All countries, for example, have the same railway ratings as last year indicating both the slow speed of change in the sector and the absence of major reform breakthroughs since last year's exercise. In the telecommunications sector, Belarus and Kazakhstan enjoy a higher score due to the award of new licences in the cellular segment of the market, allowing for increased competition. Electric power is the only sector where a significant number of countries, driven by various factors, have pushed forward reform during last year. These factors include EU accession and the need to comply with the EU Power Directive, poor financial viability due to low tariffs and/or collections, and the need to finance budget deficits through sale of profitable assets. Progress since last year's *Transition Report* has taken place in EU accession countries, such as Estonia, Bulgaria, Latvia and Romania. Power sector ratings for some less advanced countries, such as Armenia, Georgia and Moldova have also been upgraded from last year signifying that substantial reform is now under way, with the passing of a law for restructuring, the setting up of a regulator, and unbundling of generation, transmission and distribution networks.

Annex 2.4: Transition towards sustainable development

Transition aims to develop a market economy that attains both efficiency and environmental sustainability. This annex assesses the ongoing efforts in environmental policy reform in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS), and the relationship between economic changes and environmental quality. The analysis draws on studies that have examined how changes in environmental quality are linked to economic reform, environmental policy development, changes in production and consumption patterns, and the level of public involvement.

In common with the creation of markets and private enterprise, the promotion of sustainable development requires strong institutions, a good regulatory framework and the provision of adequate incentives. This annex focuses on three elements that can serve as an indicator of countries' progress in environmental reform. The first is the connection between transition and environmental performance. Using the example of energy efficiency, an assessment is made of the extent to which economic transition and environmental protection go hand-in-hand. The second element concerns the development of environmental policy and systems to monitor environmental performance, in particular the formulation and implementation of National Environmental Action Plans (NEAPs). The third focuses on the compliance of countries in the region with international environmental treaties and standards.

Improvements in environmental quality in the region so far are related more to economic changes than to environmental policies.¹ Economic reform can generate efficiency gains that reduce industrial pollution and other pressures on the environment. The analysis on energy efficiency presented in this annex, for example, shows the potential relationship between tariff levels and increased energy efficiency. It indicates that tariff reforms in advanced transition economies can have a positive influence on energy efficiency and consequently on air quality. Countries need to build on these gains by establishing an effective environmental policy, creating strong environmental institutions and putting in place a good regulatory framework.

Environmental reform at the policy and legislative level is moving forward throughout the region. Since a survey of progress in environmental policy reform was carried out for the *Transition Report* 1997, advances have been made in terms of the status of NEAPs and regarding participation in, and implementation of, environmental treaties. However, in spite of the general development of environmental policy, there is wide variation in environmental performance. Advanced transition economies have generally achieved more significant improvements in environmental quality than less advanced transition economies. As a consequence, there is a growing discrepancy in the quality of the environment between CEE and CIS countries (see Annex 2.3 of the *Transition Report* 1998).

Economic transition and environmental performance

Industrial pollution decreased throughout CEE and the CIS when output fell during the first phase of transition. With economic growth resuming, the challenge is to separate economic activity from environmental degradation, and to start addressing environmental legacies from the past. Economic transition can help to achieve these tasks. For example, the improvement or closure of old production sites is generally of benefit to the environment, as modern technology tends to be more efficient and less polluting. In addition, the introduction of competition and cost-based pricing will lead to less wasteful production processes, again to the benefit of the environment. Structural change from heavy industry towards a service-based economy is also likely to reduce adverse effects on the environment.

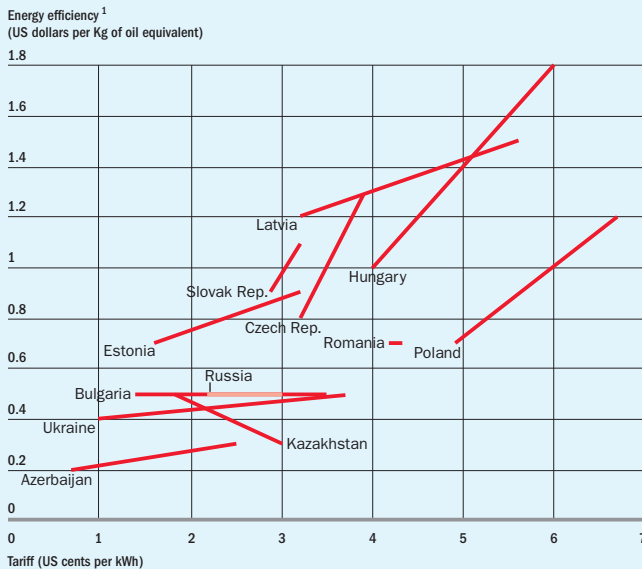
Energy production and consumption – which are closely related to environmental degradation, particularly air pollution and its associated impact on health – provide a good example of the links between economic transition and the environment. The transition economies have exceptionally low levels of recorded energy efficiency. In CEE, energy efficiency is improving, but it is still only about half of the level in western Europe (measured as GDP per unit of energy use). In CIS countries, energy efficiency has remained approximately constant since 1992 and is over four times lower than in western Europe, although it must be recognised that estimates of the unofficial economy and unrecorded output are larger for the CIS than for CEE. However, even at the levels of energy efficiency in CEE, there are significant opportunities to make improvements and, by implication, to reduce pollution in the energy sector.

To what extent has economic transition, in particular the ongoing efforts to reform the energy sector and to introduce cost-based tariffs, brought about improvements in energy efficiency? Chart 2.4.1 shows changes in energy efficiency and tariffs from 1994 to 1996. A sharp contrast is shown between countries in CEE, such as Hungary and Poland, which recorded increases in both energy tariffs and efficiency, and countries in the CIS, such as Russia and Ukraine, where increases in tariffs led to only a negligible increase in energy efficiency. This suggests that investments in energy efficiency take place some time after an increase in tariffs. However, it also suggests that other reforms are of relevance – in particular, the existence of institutions that can enforce (cash) payment. Low collection rates, as experienced in Russia and Ukraine, clearly diminish the effects of higher tariffs.

Where there have been energy efficiency improvements, as in the advanced transition countries, the benefit to the environment is significant and can be observed, for example, in a reduction in air emissions per unit of output. A World Bank analysis in advanced transition countries for 1989-95 found a sustained reduction in emissions per unit of output for all important air pollutants – particulate matter, SO₂, NO_x and volatile organic compounds.

¹ See European Environment Agency (1998), *Europe's Environment: The Second Assessment*.

Chart 2.4.1

Tariffs and energy efficiency 1994-96

Sources: EBRD; International Energy Agency; and World Development Indicators.

¹ Energy efficiency is defined as the ratio of GDP produced over Kg of oil-equivalent primary energy used. Energy consumption comprises electric power, fossil fuel and fuel wood.

Moreover, the analysis indicates that the improvements in CEE countries are greater than would be accounted for by the decline in production and consumption.² No such changes are observed in the slower reforming countries. This finding indicates that economic transition and reform can indeed lead to environmental improvements.

Environmental policy-making

A starting point for environmental policy reform is often a NEAP. The main objectives of a NEAP are to assess the state of the environment, to identify problem areas, to set priorities and to formulate an action plan for better environmental management. The status of NEAPs gives an indication, therefore, of the extent to which governments are embracing environmental reform. A survey of progress in environmental policy reform, carried out for the *Transition Report 1997*, included the status of NEAPs as one of its indicators. At that time, NEAPs had been prepared in 16 countries in CEE and the CIS. In the EBRD's remaining ten countries of operations, a NEAP was either planned or under preparation.

Since 1997, progress has been made in terms of the status of NEAPs. As of August 1999, all but six countries in the region had started to implement NEAPs. Azerbaijan, FYR Macedonia, Kazakhstan and Slovenia had started implementation since the last survey in 1997, while Armenia, Bosnia and Herzegovina, Croatia, Georgia, Tajikistan and Turkmenistan are still in the process of preparing a NEAP (see Table 2.4.1).

A key element of sound environmental management, recognised in most NEAPs, is performance monitoring, which in turn requires good and consistent environmental data. Most EU accession countries now have an extensive amount of verifiable environmental data. Their efforts to compile and analyse data, as well as the EU's

own monitoring of the accession process, have greatly improved the quality of environmental data. However, there is a critical lack of comparable information for CIS countries. Environmental data is often lacking or unreliable – for example, on access to safe drinking water in rural areas, water quality and use, air quality in cities, industrial pollution, and municipal and hazardous waste generation and management. Their absence impedes the monitoring of environmental quality changes over the transition period.

The publication of environmental data allows non-governmental organisations (NGOs) and the public to monitor performance and to take part in environmental decision-making. In many transition economies, NGOs and local groups are now involved in environment-related activities in a way that was not possible under the previous regime. In some EU accession countries, private industries and industrial associations are playing an increasingly important role in environmental policy discussions and in improving environmental management. However, the still weak nature of public consultations in some parts of the region does not always encourage an open discussion of environmental issues.

Compliance with international treaties

Regional and global environmental problems are now often regulated through international treaties. Such treaties do not replace the need for domestic legislation and environmental regulation, which are required to enforce and monitor compliance. The degree of commitment to international environmental treaties gives some indication of the extent to which governments are prepared to subscribe to international environmental initiatives.

The survey of environmental policy reform undertaken for the *Transition Report 1997* examined the participation of transition economies in six environmental treaties. These treaties covered both nature conservation issues (wetlands, biodiversity and trade in endangered species) and the protection of the global and regional environment (ozone layer depletion, climate change and transboundary environmental impact).

The signing and ratification of a treaty does not, of course, guarantee that governments will comply with treaty obligations. Consequently, assessments have also been made of countries' compliance with treaty obligations based on information collected through the secretariats for the six treaties.

Significant progress has been made in terms of ratification of treaties since 1997 (see Table 2.4.1 and Box 2.3 of the *Transition Report 1997*). Azerbaijan has ratified the Endangered Species and Transboundary Impacts Conventions; FYR Macedonia has ratified the Framework Convention on Climate Change and the Convention on Biodiversity; Latvia has ratified the Transboundary Impacts Convention; Tajikistan has ratified the Montreal Protocol, the Climate Change, and the Biodiversity Conventions; and Uzbekistan has ratified the Endangered Species Convention. All countries in the region, except Bosnia and Herzegovina and Kyrgyzstan, have ratified at least three of the treaties, although the Central Asian countries have been relatively slow in making commitments to international conventions.

² See Hughes, Gordon and Magda Lovei (1999), "Economic reform and environmental performance in transition economies", World Bank Technical Paper, No. 446, Washington DC.

Table 2.4.1

International environment treaties and stage of implementation

Issue	Environmental policy	Ramsar Convention		CITES		Montreal Protocol		UNFCCC		Convention on Biological Diversity		Trans-boundary EIA
Action	NEAP	Status	Country reports, rating	Status	Compliance category (June 99)	Status	ODS phasing out, year of completion	Status	National comm.	Status	Country report	Status
Albania	✓	R	2					R		R		R
Armenia	UP	R	3					R	✓	R	✓	R
Azerbaijan	✓(1998)			R (1998)		R	2001	R		S		R (1999)
Belarus	✓			R	2	R	2000	S		R	✓	S
Bosnia and Herzegovina	UP					R	Article 5					
Bulgaria	✓	R	2	R	2	R	✓	R	✓	R	✓	R
Croatia	UP	R	3			R	Article 5	R		R		R
Czech Republic	✓	R	3	R	2	R	✓	R	✓	R		S
Estonia	✓	R	1	R	2	R	2002	R	✓	R	✓	
FYR Macedonia	✓(1997)	R	3			R	Article 5	R (1999)		R (1997)		
Georgia	UP	R	3	R	3	R	Article 5	R		R		
Hungary	✓	R	2	R	2	R	✓	R	✓	R	✓	R
Kazakhstan	✓(1999)					R (1998)	na	R	✓	R		
Kyrgyzstan	✓									R		
Latvia	✓	R	1	R	3	R	2000	R	✓	R	✓	R (1998)
Lithuania	✓	R	1			R	2001	R	✓	R		R
Moldova	✓					R	Article 5	R		R		R
Poland	✓	R	2/3	R	3	R	✓	R	✓	R	✓	R
Romania	✓	R	2/3	R	3	R	Article 5	R	✓	R	✓	S
Russia	✓	R	2	R	2	R	2001	R	✓	R	✓	S
Slovak Republic	✓	R	2/3	R	3	R	✓	R	✓	R	✓	S
Slovenia	✓(1998)	R	1			R	✓	R		R	✓	S
Tajikistan	UP	*				R (1998)	na	R (1998)		R (1997)		
Turkmenistan	UP					R	2003	R		R		
Ukraine	✓(1998)	R	2			R	2002	R		R	✓	R (1999)
Uzbekistan	✓(1998)	*		R (1997)	3	R	2002	R		R	✓	

Key

✓ Completed

UP Under preparation

R Ratified

S Signed

The year is marked if countries have signed/ratified treaties since 1997 (the EBRD's first Indicators exercise).

* Tajikistan and Uzbekistan have deposited with UNESCO a Declaration of Succession to the former USSR but have not yet designated any Ramsar sites.

Wetlands (Ramsar) Convention

The Convention on Wetlands of International Importance, adopted in Ramsar (Iran) in 1971, is the first modern intergovernmental treaty on conservation and the sustainable use of natural resources. The countries' commitments were assessed for this annex on a scale of 1 (fully implemented) to 3 (start of implementation), based on the following parameters: preparation of a national strategy; legislation requiring environmental impact assessments (EIAs) for projects in wetlands; existence of education and public awareness programmes; existence of plans and monitoring schemes for Ramsar sites; and preparation of wetland inventories.

Trade in Endangered Species Convention

The 1973 Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES) aims to protect wildlife against over-exploitation and to prevent international trade in products from species threatened with extinction. Participating countries are required to take the necessary measures at the national level. Compliance is assessed and categorised by the Convention Secretariat, depending on whether their legislation meets most (1 rating), some (2 rating) or very few (3 rating) of the requirements for the implementation of CITES.

Montreal Protocol on Ozone-depleting Substances

The Montreal Protocol on Substances that Deplete the Ozone Layer originally came into force in 1989, but was subsequently strengthened in a series of amendments. Its objective is the phasing out of ozone-depleting substances (ODS), such as chlorofluorocarbons and related substances. The Protocol and its amendments contain explicit commitments and timetables for the phasing out of ODS. Most transition economies are classified as developed countries for the purposes of the Protocol, and as such were expected to phase out ODS by 1996 (2010 for developing countries, which have different commitments in Article 5 of the Protocol).

Climate Change Convention

The United Nations Framework Convention on Climate Change (UNFCCC), signed in 1992, has as its goal the stabilisation of greenhouse gas concentrations in the atmosphere at a level that prevents dangerous human interference with the climate system. Initial emission reduction commitments to achieve this goal were agreed in the 1997 Kyoto Protocol to the Convention. Under the Protocol, which has yet to come into force, most CEE countries, Russia and Ukraine have agreed to binding emission reduction targets. Parties to the Convention are required to periodically submit reports ("national communications") in which they document their emissions and climate change policies.

Biodiversity Convention

The Convention on Biological Diversity, adopted in 1992, enjoins countries to halt and reverse the loss of biological and genetic resources. The Convention has three overall themes: conservation, sustainable use, and the equitable sharing of the benefits of biodiversity. Parties are committed to submit periodic reports on measures taken to implement the Convention.

Transboundary Environmental Impacts Convention

The Convention on Environmental Impact Assessment (EIA) in a Transboundary Context was adopted in Espoo, Finland, in 1991, and came into force in 1995. The Convention specifies the procedural rights and duties of parties with regard to the transboundary environmental impacts of certain activities, including notification of affected countries and their potential involvement in the EIA and the public consultation process.

Macroeconomic performance and prospects

The past ten years have been a turbulent period for the countries of central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS). The scale and speed of economic change in some countries have been breathtaking at times. In other countries, changes have occurred more gradually. Growth rates have been impressive in recent years in several cases, but disappointing in others. In some countries growth has been sustained for over half of the decade, some have experienced setbacks after several years of growth, while others have yet to see the first year of economic recovery.

Many important lessons from the first ten years of transition emerge from a close examination of the significant differences in macroeconomic performance between countries. The starting points for each country differed widely across the region. The transition economies inherited different degrees of structural as well as macroeconomic distortions, were integrated to varying extents into the world market, and covered a wide spectrum of income levels and living conditions. Some countries had introduced limited market reforms a long time before the general collapse of communism at the end of the 1980s, whereas others had adhered rigidly to central planning for as long as possible. There has been large variation across the region in the commitment of governments to stabilisation programmes and structural reforms. Partly as a result of these differences, countries have differed enormously in macroeconomic outcomes.

This chapter provides an overview of macroeconomic developments during the transition and examines the principal reasons for the wide disparity in performance across the region. The chapter begins by summarising the main facts over the last ten years with regard to output, employment and productivity, inflation, fiscal and external imbalances, and capital inflows (see Section 3.1). It then proceeds to analyse the first half of the 1990s, the so-called “transition recession” period when all economies in the region suffered significant declines in output and rising inflation. Different explanations have been offered as to why some countries recorded smaller initial output declines and recovered more quickly than others: some explanations stress the differences in starting points, others emphasise the importance of credible stabilisation policies, while a third set of reasons points to the role of structural reforms.

Section 3.2 assesses the validity of each explanation. It concludes that initial conditions have a lasting effect on performance, both directly through the impact on the cost of restructuring and indirectly by delaying progress on structural reform. Stabilisation is necessary but not sufficient for sustained growth. If structural

reforms are not carried out, stabilisation may not be sustainable and any recovery will be short-lived.

Section 3.3 focuses on the recent macroeconomic reversals that have occurred in a number of countries. Reversals in output and inflation have occurred both because of internal, country-specific factors and because of external pressures, such as the crisis in East Asia, the oil price declines and the effects of the crisis in Russia. Although the circumstances underlying each reversal differ from one country to the next, a common theme of all reversals is the link between structural reforms and macroeconomic performance, including vulnerability to external pressures.

Lastly, Section 3.4 reviews briefly recent macroeconomic developments across the region, and concludes by assessing prospects for economies in the region in both the short and medium term and some of the main challenges that remain to be addressed. These include EU accession-related challenges for most of central Europe and the Baltic states, post-war Balkan reconstruction for some of the less advanced countries of south-eastern Europe, and building the foundations for sustainable growth for Russia and other CIS countries. The chapter contains two annexes. Annex 3.1 provides a comprehensive set of tables on the macroeconomic performance of transition economies over the past ten years.¹ Annex 3.2 considers in some detail the implications of the Kosovo crisis for macroeconomic performance in the Balkan region as well as recent proposals for its reconstruction.

3.1 Ten years of transition: the “facts”

In the early years of transition, all countries faced rapid inflation and falling output due to a combination of factors: the monetary overhang from central planning, the erosion of the old (notional) tax base, difficulties in asserting monetary and fiscal control in new economic circumstances, and disorganisation arising from the collapse of a rigid system. However, some countries gained monetary and fiscal control more quickly and effectively than others and these differences are reflected in the disparity in their macroeconomic performance. The macroeconomic facts of the first decade of transition centre on the initial “transition recession”, the timing and strength of recovery, and the incidence of reversals. These overall trends are reflected in output, employment, inflation, and fiscal and external developments.

Output

The severity of the initial recession came as a surprise to most analysts of the region.² Many had underestimated the impact of the breakdown of a cumbersome and highly integrated economic system. In most transition countries, payments for goods and

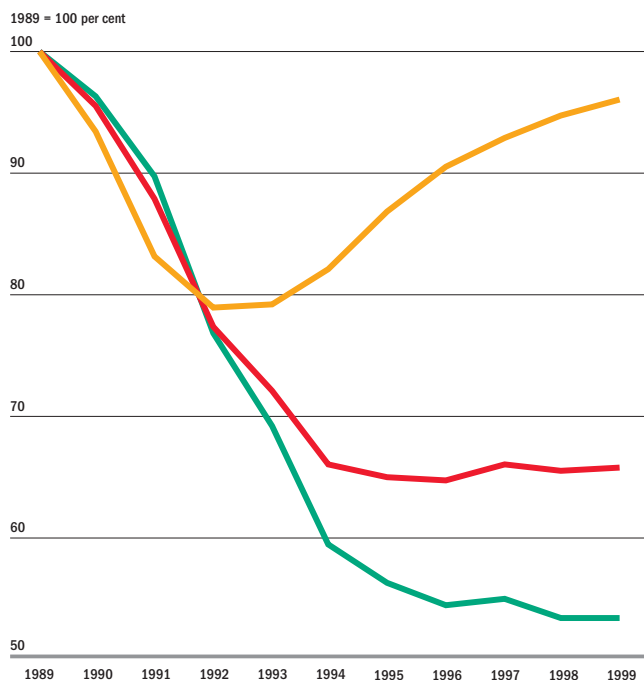
¹ As in previous *Transition Reports*, summary tables and charts exclude Bosnia and Herzegovina. Data for this country are provided in the selected economic indicators at the end of the Report.

² Portes (1994), for example, noted that the transformation to a market economy “has proved much more costly than we expected five years ago”.

Chart 3.1

Index of real GDP

(Weighted averages for selected country groups)



— Central and eastern Europe and Baltic states — CIS — Total

Source: Table 3.1.1.

Note:

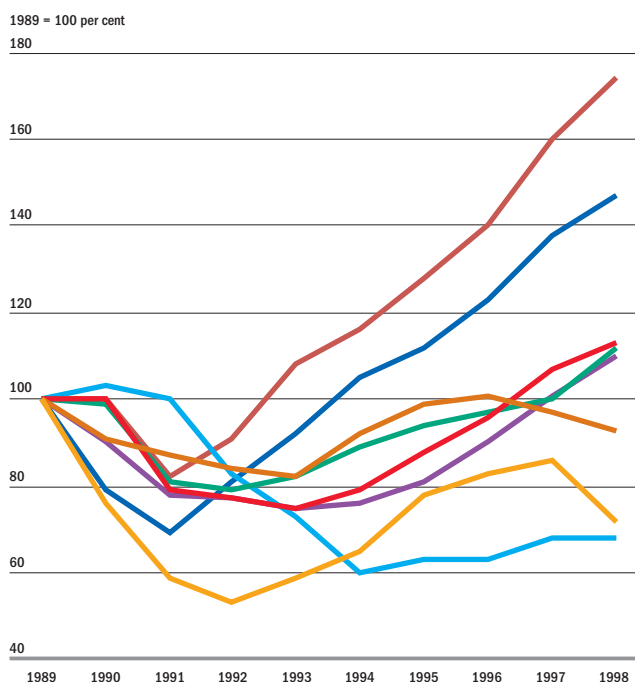
The weighted average is calculated using GDP in US dollars at PPP exchange rates in 1989.

services switched suddenly to hard currency, with prices moving towards world levels. Crucial inputs became unavailable or unaffordable. At the same time, competition from imports increased, with many enterprises being ill-equipped to compete in unfamiliar circumstances.³ In the early years of transition, every country had at least two years of consecutive decline in output and only in Slovenia was the growth rate above -10 per cent in the worst year.

Although output fell everywhere across the region, there is a notable difference between CEE and the CIS, as highlighted in Chart 3.1 (and Table 3.1.1). In the former, output since 1989 has followed a U-shaped pattern, with the minimum point being reached around 1992-93. In contrast, the pattern in the CIS has been one of continuous decline, with a slight upturn only in 1997. Since 1994, the pace of decline has fallen, leading some to describe this path as L-shaped, but this is probably a better characterisation of the whole region (CEE and CIS combined), as Chart 3.1 illustrates. It is important to note that this aggregate regional picture hides significant differences, and recent years have seen both rapid growth in some CIS countries (Caucasus and Kyrgyzstan) and severe setbacks in parts of CEE (Bulgaria and Romania).

To what extent do these statistics reflect reality? It has often been pointed out (see previous *Transition Reports*) that official output figures are usually an underestimate of the true level. There are many reasons for this, including the incentive for firms to under-report outputs and revenues for tax reasons or to operate in the

Chart 3.2

Labour productivity growth in manufacturing, selected countries

— Bulgaria — Croatia — Czech Republic — Hungary — Poland — Romania — Slovak Republic — Russia

Source: Table 3.1.2.

underground economy, the failure to take account of new products and quality, and the weak statistical coverage of new enterprises. Yet, the general impression of a deep depression and decline in living standards is not misleading. As discussed in Chapter 1, various social indicators confirm the difficult situation that has faced most people across the region during the decade.

Employment, productivity and wages

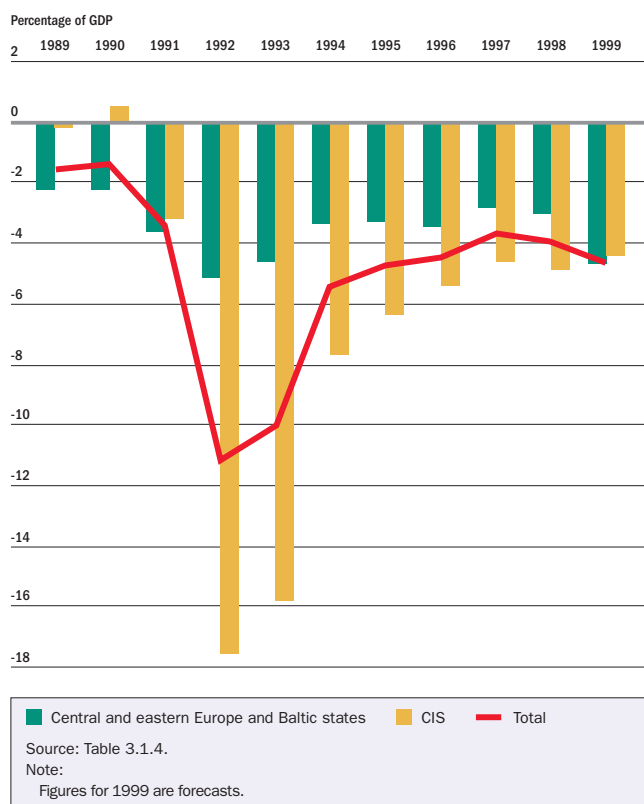
The decline in output in the early years was accompanied by falls in employment and labour force participation, sharp increases in unemployment, and declining productivity and investment. Trends in manufacturing productivity are shown in Chart 3.2 (and Table 3.1.2) for selected countries in CEE and for Russia. In the early stages of transition, developments in productivity throughout the region were dominated by the decline in output, as many firms initially avoided large-scale layoffs even though demand for their products had collapsed. This decline in measured productivity began to be reversed in most countries after two or three years, primarily as a result of labour shedding. More recently, some of the advanced countries have entered a phase of rapid productivity growth, driven by product innovation, fresh capital investment, improved technologies and modern management methods (that is, by deep restructuring). Most central European countries thus exhibit a J-curve pattern for labour productivity, with especially rapid increases in Hungary and Poland. In contrast, manufacturing productivity in Russia fell by 40 per cent between 1990 and 1994 and has since then remained flat.

³ See Blanchard and Kremer (1997) and Roland and Verdier (1999).

Chart 3.3

Government balances

(Unweighted averages for selected country groups)



Corresponding to the decline in productivity, real wages fell sharply in the early years of transition. Since then, however, diverging trends in wages and productivity can be observed across the region. In CEE, real wages have been increasing with the recovery of output since 1993, sometimes at rates considerably above productivity growth. Measured in terms of producer prices, real wage growth has far exceeded productivity growth in Croatia and in the three Baltic states. Real wage increases have been more modest further east, such as in Bulgaria, Romania, Russia and Ukraine. But when combined with substantial real exchange rate increases, foreign currency unit labour costs have often shot up considerably over the second half of the decade, and competitiveness has deteriorated in these countries. In Russia and Ukraine, enterprises have often responded by not paying wages.

Despite the difficulty of comparing unemployment statistics across the region, the steep decline in employment in virtually all countries indicates that unemployment is pervasive in transition economies.⁴ Moreover, in those countries with reliable statistics, unemployment was growing several years after the decline in output had bottomed out and it remains stubbornly high. While an initial expectation was that higher unemployment would result from the shift in labour from the state to the private sector, the evidence for central European countries is that most state-to-private sector flows take place without any intervening spell of

unemployment. A large percentage of those leaving unemployment drop out of the labour force rather than shift to the private sector.⁵ This pattern implies that many people who have become unemployed have little prospect of ever re-entering employment.

Inflation and monetary control

Although it is well known that inflationary pressures were repressed under the old regimes (witness the shortages and queues that were pervasive across the region), the size of the subsequent price rises – above 1,000 per cent per annum in all CIS countries (see Table 3.1.3) – was surprising to many. In most countries the initial jump in inflation came from a combination of price liberalisation on the one hand, and large fiscal and quasi-fiscal deficits on the other, largely due to the collapse of the tax base. The absence of other sources of finance led to the monetary financing of budget deficits, and hence rapid inflation. By 1995, however, inflation had come down significantly across the region, to single-digit levels by the end of the year in six CEE countries. In 1995 there were also significant improvements in the CIS, and double-digit inflation became the norm the following year.

While the initial disinflation was a remarkable achievement, the foundations for sustained macroeconomic stability were weak in many countries. In a number of countries, high rates of inflation were reduced through heavy reliance on official and market-based financing of large fiscal deficits. In other countries, relatively high inflation persisted because of recourse to directed bank lending and accumulation of quasi-fiscal deficits in the banking sector. These weak foundations, combined with strong external pressures from the crises in East Asia and in Russia, have contributed to recent reversals in several CIS countries, where inflation has more than doubled in the last year (see Section 3.4).

Fiscal imbalances

One source of inflationary pressure in the transition has been the emergence of significant fiscal imbalances. Chart 3.3 shows clearly the U-shaped path of general government deficits and the fact that these deficits have been much greater in the CIS than in CEE. This pattern is closely related both to the output collapse across the region and to the process of structural reform in the public sector. On the revenue side, the major challenge has been to create a new tax system that balances the decline in profit and turnover taxes from the contracting state sector with increased revenues from other sources, such as VAT and personal income taxes. This task is far from complete in many economies, especially in the CIS, where tax revenues have been limited by poor administration, erosion of the tax base, development of barter and tax evasion. Governments in many CIS countries and to a lesser extent in the slow-reforming countries of CEE have also allowed large tax arrears to become accumulated as a form of implicit subsidisation of inefficient enterprises. The persistence of soft budget constraints is therefore partly responsible for the poor fiscal performance of these countries over the past decade (see Chapter 2).

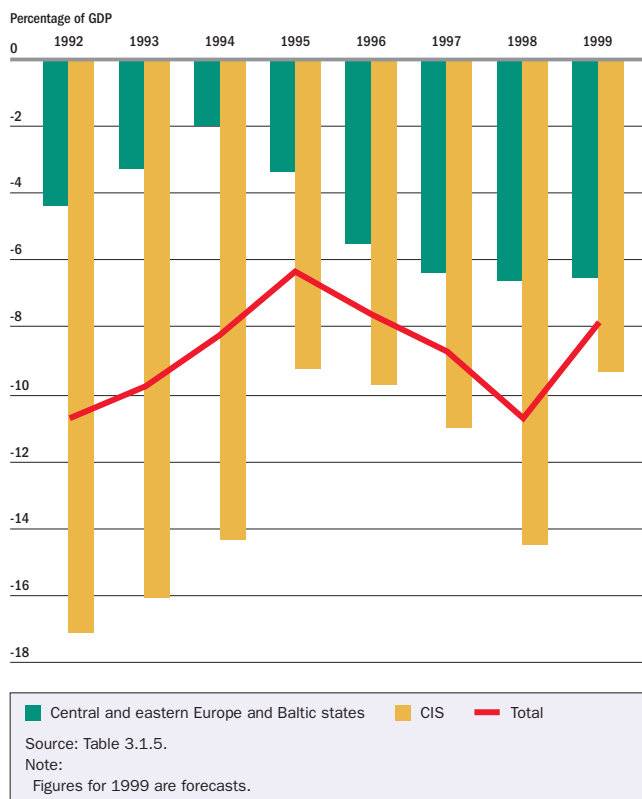
⁴ Lower official unemployment figures in the CIS are largely a reflection of unattractive benefit packages, depressing the number of registered job seekers.

⁵ See Boeri (1999).

Chart 3.4

Current account balances

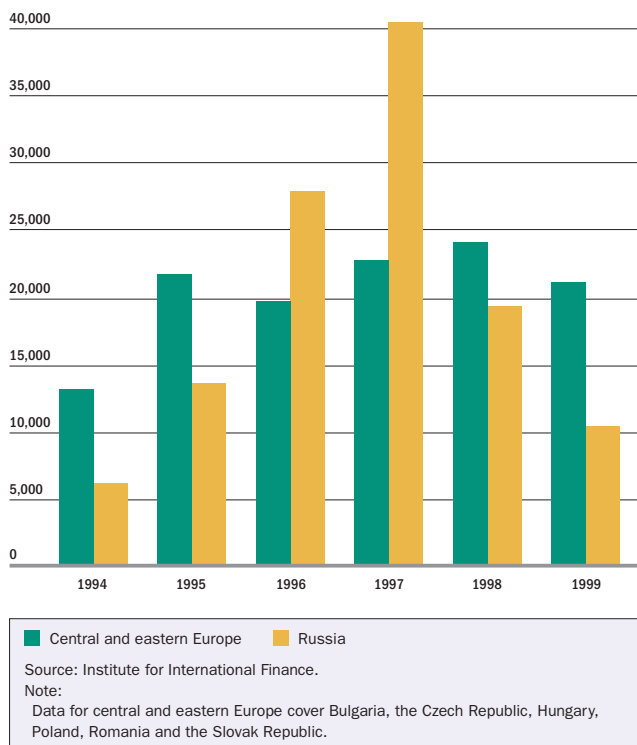
(Unweighted averages for selected country groups)



On the expenditure side, the advanced countries of CEE and the less advanced transition economies have faced very different challenges. In the former, generous social safety nets were introduced at the start of reforms. In particular, the pension system was widely used as a way of cushioning the social impact of large-scale redundancies. As a result, the social security systems have recorded increasing deficits, which have been a burden to the fiscal position. Expenditures in CEE have remained above the level in typical middle-income countries, with associated high tax burdens and disincentives for private investment. Pension reform is high on the agenda, due to the accumulation of large contingent liabilities in this area. In the CIS, social safety nets were largely non-existent. Here the management of expenditure has been complicated by a large number of extrabudgetary funds only weakly controlled by the central government. Although direct subsidies decreased dramatically during the early transition years, they have remained relatively high in a number of CIS countries (including Russia), demonstrating the difficulty that these countries are having in moving from support for enterprises to support for households.

It is noteworthy that forecasts for 1999 indicate that the CIS may for the first time since 1991 record a better fiscal position on average than CEE. Large fiscal adjustments in Russia and a number of other countries in the wake of limited access to market financing lie behind this reversal in ranking, as well as looser fiscal policies in parts of the Balkans following Kosovo-related pressure.

Chart 3.5

Total capital flows, selected countriesMillions of US dollars
45,000**External imbalances**

Current account deficits have been pervasive throughout the decade, as Chart 3.4 (and Table 3.1.5) shows. An examination of the unweighted average for each region reveals three distinct phases. There was first an initial sharp increase in deficits, as exports to the former trading partners of the Council for Mutual Economic Assistance (CMEA) slumped and imports became more widely available. Subsequently, current account deficits decreased in 1993-94, as stabilisation took hold, output started to recover and exports began to be reoriented towards Western markets. Third, deficits increased again during 1995-98, reflecting the surge in imports and increased capital flows into the region. The same shape is observed in the CIS, although the size of the deficits is always bigger than in CEE.

In principle, current account deficits would be expected to arise in a country in transition where growth has resumed, both from reduced savings rates, due to improved consumer confidence, and from rising demand for investment to replace existing, mostly obsolete equipment. However, although moderate current account deficits are in principle “desirable”, high current account deficits raise doubts about the ability of a country to pay off long-term liabilities in the future. A deficit greater than 7 per cent of GDP is sometimes used as a rule-of-thumb warning sign; 15 of the EBRD’s 26 countries of operations exceeded this measure in 1998. In several cases in CEE (Hungary in 1995, the Czech Republic in 1997, Croatia and the Slovak Republic in 1999) high current

account deficits were at the origin of subsequent exchange rate devaluations and macroeconomic austerity programmes.

Capital flows

Transition economies gained significant access to capital markets only after macroeconomic stabilisation had begun to take hold. Prior to 1994, significant capital flows occurred in only a few CEE countries, notably Hungary and the Czech Republic. However, after some initial hesitancy, capital flows have increased sharply over the past few years. Chart 3.5 presents figures for the six largest CEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic) and Russia, and shows that total capital flows to the region increased from nearly US\$ 20 billion in 1994 to more than US\$ 60 billion in 1997, but fell to around US\$ 43 billion in 1998. In 1997, about two-thirds of this was to Russia, inflating an unsustainable asset “bubble”. Capital flows to Russia collapsed by more than half in 1998, along with the domestic financial system, with a further decline forecast in 1999. However, they have remained relatively stable in CEE.

Foreign direct investment (FDI) can be a crucial catalyst in the transition, but is more likely to be directed to countries with a strong reform commitment. In CEE, there was an approximate fourfold increase between 1993 and 1998, from US\$ 4 billion to US\$ 16 billion (see Table 3.1.6). Compared with many other emerging markets, this region has been relatively successful in attracting FDI. In the CIS, FDI peaked in 1997, fuelled by equity investments in Russia. With the crisis in Russia in 1998, total FDI across the CIS fell by one-third, to just over US\$ 5 billion, as strategic investors differentiated sharply between countries that provide genuine long-term investment opportunities and those where the investment climate is still volatile and unpredictable.

Since the end of 1997, it has been more difficult for emerging market borrowers to raise funds in international financial markets. The impact of the emerging markets crisis on other types of capital flows has been more pronounced than on FDI. In 1998 total syndicated lending was less than half the level recorded in 1997. The impact of the Russian crisis on international bond issues from the region was immediate and stark. There were no international bond issues at all in the two months following the crisis. Initially, the conflict in Kosovo further disrupted debt issuance by some transition economies, but conditions eased quickly for those countries with better ratings. It is also noteworthy that, with the exception of a US\$ 750 million Eurobond issue by Hungary, in the first half of 1999 all sovereign bond issues in the region were in euros.

3.2 Understanding the transition recession

Why was the recession so severe across the region? Why did output fall much further in some countries than in others? Why did growth resume relatively quickly in some countries, while remaining zero or negative in others throughout the 1990s? As the transition approaches the end of the decade, many analysts of the region have attempted to provide answers to these questions. This section assesses different explanations and evidence.

Four broad sets of explanations can help to explain different performances across countries. First, countries differed widely in their initial conditions. The extent of structural and macroeconomic distortions at the start of transition, the distance to important markets in western Europe (and East Asia), the level of development as well as the extent of national consolidation may all have affected economic performance during the initial transition phase.

Second, countries differ in the timing and scale of the introduction of comprehensive stabilisation policies. The previous section noted the wide disparity in inflation performance, especially between CEE and the CIS. However, the introduction of a credible stabilisation programme usually involves tough choices in terms of reduced fiscal spending as well as adjustments to real wages and real exchange rates that may lead in the short term to a contraction of aggregate demand and falling output. It was therefore unclear initially whether tight fiscal and monetary policies in the early stages of transition would alleviate or exacerbate the recession.

Third, recession and recovery are likely to be affected by the extent of structural reform. Liberalisation and the opening of a country to foreign competition in particular could provoke temporary declines in aggregate output if activities that have become unviable under world market prices contract at a more rapid rate than new activities expand. Indeed, the level of these temporary adjustment costs might increase in line with the extent of the initial distortions and the speed and extensiveness of the liberalisation effort.⁶ In common with stabilisation, although the long-term benefits of deep structural reforms are widely acknowledged, the short-term consequences may be unpleasant.

Fourth, the sheer scale and scope of institutional change during the transition may also have caused initial friction and adjustment costs that could have led to output losses. As central planning was abolished, transactions shifted from the fulfilment of mandatory delivery targets to market-based contracting. However, the legal basis for contract enforcement was weak and reliance on informal contract enforcement mechanisms, such as the loss of reputation, was fraught with uncertainty and risks in view of the scale of economic change. The resulting “disorganisation” may have contributed to the initial output decline.⁷

Initial conditions

Countries across the region started the transition with very different initial conditions. While all centrally planned economies were heavily distorted, these distortions were nonetheless more accentuated in some countries than in others. Trade among the countries of the former Soviet Union was largely geared towards an extreme pattern of regional specialisation and almost complete isolation from the forces of the global market place. By contrast, some of the central European countries had achieved competitiveness in Western markets for at least a few selected goods. The dissolution of the CMEA therefore affected countries with varying impact. Geographical location is also likely to have had a major influence on subsequent growth, because of factors such as transport costs and market access and, in much of CEE, the stability

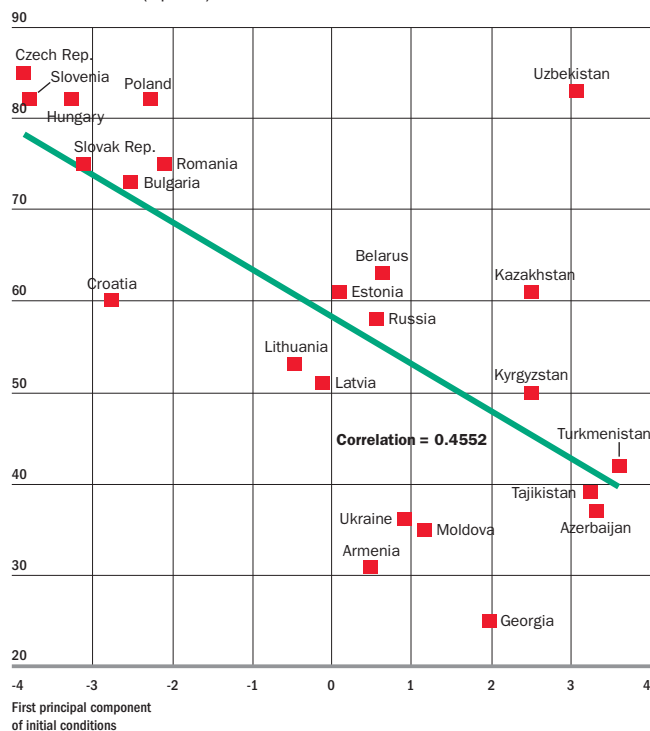
⁶ For a review and discussion of the debate about the relative merits of shock therapy versus gradualism, see Dewatripont and Roland (1992).

⁷ See Blanchard and Kremer (1997).

Chart 3.6

Explaining recession: initial conditions and real GDP growth

Cumulative decline in real GDP during the transition recession (in per cent)



Source: EBRD staff calculations.

Note:

The transition recession is defined as the period in which annual growth was negative. The cumulative decline in GDP is thus measured over all years since 1989 (=100 per cent) until the first year of positive growth. Albania and FYR Macedonia are excluded because of missing values on initial conditions. Initial conditions are represented by the first principal component of a factor analysis (see Chapter 2 for details).

provided by the prospect of EU accession. Macroeconomic conditions differed widely, with significant monetary “overhang” in the former Soviet Union and south-eastern Europe contrasting with little repressed inflation in the Czech Republic and Hungary. The need for a substantial tightening of domestic demand was therefore less in the latter two countries. Some countries entered the transition in the midst of war and national disintegration, while others (mainly in central Europe) essentially reverted to the position of a relatively developed and well-integrated nation state.

Chart 3.6 presents the correlation between the cumulative decline in GDP during the transition recession and a summary measure of initial conditions (based on factor analysis) that captures, *inter alia*, dependence on CMEA trade, the level of development, macroeconomic distortions and geographical distance from western Europe. The transition recession for each country is defined as the period from 1989 until the first year of positive

growth. The chart shows a clear correlation between favourable initial conditions and relatively small cumulative declines in output.⁸ This evidence, combined with the fact that the decline in the CIS was more severe and prolonged than in CEE, suggests that differences in initial conditions play a major role in explaining why some countries fared so much worse than others in the first phase. Both economic distortions and the capacity to adapt rapidly to a changing economic environment have played a role. CEE had an advantage in both of these areas, with less macroeconomic and structural distortions to begin with and a higher capacity for change due to more consolidated nation states and the benefits of proximity to the EU.

Stabilisation

The upsurge in inflation early in the transition was followed by the adoption of stabilisation programmes across the region. Table 3.1 shows the dates of the adoption of a comprehensive stabilisation programme, along with information on the timing of inflation peaks and output troughs and the type of exchange rate regime adopted. This table reveals significant differences in the timing of stabilisations, allowing a distinction to be drawn between “early” and “late” stabilisers. The former are those countries that adopted a stabilisation programme by the end of 1993. These include most CEE countries, and Kyrgyzstan and Moldova in the CIS. Chart 3.7 shows that there is a clear link between early stabilisation and early recovery. After 1994, unweighted average growth is consistently positive, whereas it remains negative in the late stabilisers until 1997. From this evidence, there is no indication that rapid disinflation itself contributed to the significant output declines.⁹

Stabilisation is clearly a necessary condition for the recovery of output, but is not by itself sufficient.¹⁰ When annual inflation reaches a level above 100 per cent, there can be little doubt that it depresses growth and lowers efficiency.¹¹ However, at lower rates of inflation, there is less evidence of a clear link between inflation and growth. Inflation is associated with weaker growth only above a certain threshold rate. While the precise location of this threshold is difficult to determine, and most likely varies across countries, an examination of growth and inflation in transition economies shows that sustained growth is usually associated with inflation below 30 per cent.¹² Exceptions to this rule are Romania in 1994-96 and Belarus in 1997-98, but Romania’s growth ended with a very hard landing in 1997. Growth in Belarus has been fuelled by inflationary financing and substantial directed credits and subsidies that will be difficult to sustain.

Liberalisation and institutional reform

There is ample evidence now that economic reforms in transition economies pay off. Countries with the highest EBRD transition indicators, such as Poland and Hungary, are also among the best

⁸ A notable outlier is Uzbekistan, where access to domestic energy sources has allowed industry to maintain relatively high levels of production and where cotton and mineral exports have provided the necessary foreign exchange revenues to support a policy of protecting the economy from foreign competition.

⁹ This view is supported by evidence in Cottarelli and Doyle (1999).

¹⁰ See Havrylyshyn and Botouscharov (1995) and Fischer et al. (1997).

¹¹ Lougani and Sheets (1997) suggest that a country with 500% inflation in one year loses about two percentage points of GDP the following year and four percentage points of GDP in the longer term.

¹² Some recent studies suggest that the threshold is even lower. For instance, Ghosh (1997) identifies a 10% threshold for inflation, above which growth is unlikely to occur, while Christofferson and Doyle (1998) find a threshold of about 13%.

Table 3.1

Inflation and output performance in transition economies

	Year(s) in which inflation peaked	Maximum end-year inflation rates ¹	Year in which inflation fell below 40%	Stabilisation programme date	Exchange regime adopted at the date of stabilisation	Year in which output was lowest	Ratio of lowest registered GDP to 1989 (in per cent)	Cumulative output growth between lowest level year 1998 (in per cent)
Central and eastern Europe and the Baltic states								
Albania	1992/1997	236.6/42.1	1993/1998	Aug 92	Flexible	1992	60.4	43.1
Bulgaria	1991/1997	338.9/578.6	1995/1998	Feb 91	Flexible	1997	63.2	3.5
Croatia	1993	1,149.0	1994	Oct 93	Fixed	1993	59.5	20.6
Czech Republic	1991	52.0	1992	Jan 91	Fixed	1992	84.6	12.7
Estonia	1992	953.5	1993/1995	Jun 92	Fixed	1994	60.8	25.7
FYR Macedonia	1992	1,935.0	1995	Jan 94	Fixed	1995	55.1	5.3
Hungary	1990	33.4	Always	Mar 90	Fixed	1993	81.9	16.2
Latvia	1992	959.0	1993	Jun 92	Flexible/Fixed ²	1995	51.0	14.0
Lithuania	1992	1,161.1	1995	Jun 92	Flexible/Fixed ²	1994	53.3	19.8
Poland	1990	249.0	1993	Jan 90	Fixed	1991	82.2	42.5
Romania	1993/1997	295.5/151.4	1995/1999	Oct 93	Flexible	1992	75.0	1.8
Slovak Republic	1991	58.3	1992	Jan 91	Fixed	1993	75.0	32.9
Slovenia	1991	247.1	1993	Feb 92	Flexible	1992	82.0	25.7
Commonwealth of Independent States								
Armenia	1993	10,896.0	1995	Dec 94	Flexible/Fixed ³	1993	31.0	31.8
Azerbaijan	1994	1,788.0	1996	Jan 95	Flexible/Fixed ³	1995	37.0	17.9
Belarus	1993/1998	1,996/181.7	1996/Not yet	Nov 94	Flexible/Fixed ³	1995	62.7	22.6
Georgia	1993	7,487.9	1996	Sep 94	Flexible/Fixed ³	1994	25.4	29.2
Kazakhstan	1992	2,984.1	1996	Jan 94	Flexible/Fixed ³	1998	61.2	0.0
Kyrgyzstan	1993	1,363.0	1995	May 93	Flexible/Fixed ³	1995	50.4	20.4
Moldova	1992	2,198.0	1995	Sep 93	Flexible	1998	32.1	0.0
Russia	1992/1998	2,506.1/84.5	1996/Not yet	Apr 95	Flexible/Fixed ²	1998	55.3	0.0
Tajikistan	1993	7,343.7	1994/1998	Feb 95	Flexible	1996	39.2	5.8
Turkmenistan	1993	9,750.0	1997	Jan 97	Flexible	1997	42.0	4.2
Ukraine	1993	10,155.0	1996	Nov 94	Flexible	1998	36.6	0.0
Uzbekistan	1994	1,281.0	1998	Nov 94	Flexible	1995	83.4	6.1

Sources: Fischer et al. (1996), EBRD and national authorities.

1. For countries with inflation reversals (an increase in inflation from below 30% to above 30%) both the initial peak inflation and the subsequent peak during the reversal is shown.

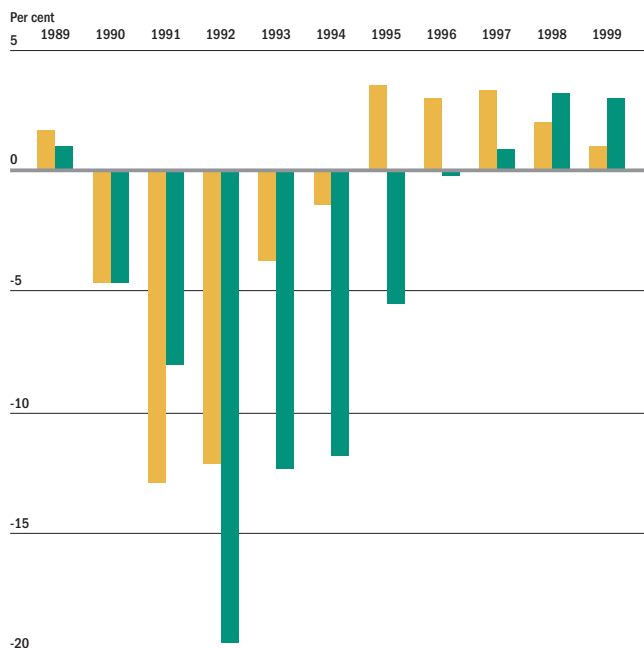
2. The Latvian currency was pegged to the SDR in February 1994. Lithuania adopted a currency board in April 1994. Russia announced an exchange rate corridor in July 1995. All three countries had flexible exchange rate regimes prior to these dates.

3. As of 1995, these countries adopted a de facto peg to the US dollar.

Chart 3.7

Stabilisation and real GDP growth

(Unweighted averages for selected country groups)



Early stabilisers Late stabilisers

Sources: Table 3.2 and EBRD staff calculations.

Note:

Early stabilisers are countries that introduced a stabilisation plan by the end of 1993. The group so defined includes: Albania, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania, the Slovak Republic and Slovenia. Late stabilisers are all other countries. Figures for 1999 are forecasts.

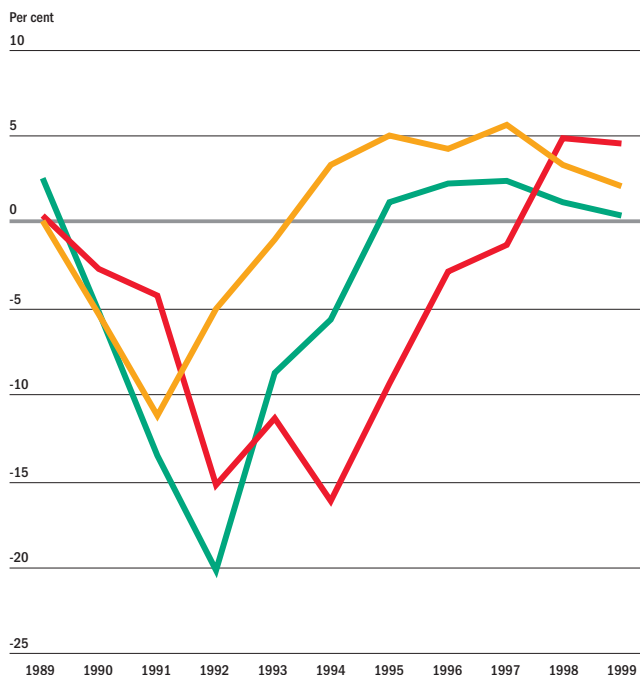
performers in terms of output growth.¹³ Within regional groupings, too, it seems that countries that have reformed more rapidly and comprehensively have largely done better than those that have lagged behind. For example, Hungary has fared better than the Czech Republic in recent years, due to the advances made in corporate restructuring following policies to attract strategic investors. Similarly, following the Armenia-Azerbaijan war from 1988 to 1994, recovery was recorded at a far earlier stage in the former than in the latter.

Chart 3.8 confirms the strong association between early liberalisation and growth. The rationale for focusing on liberalisation and privatisation follows the evidence in Chapter 2 that a large proportion of the variation in reform outcomes during the first decade can be attributed to cross-country differences in the extensiveness of these “first phase” reforms. The chart classifies countries into early reformers, late reformers and non-reformers. The first group comprises those countries that achieved price liberalisation, foreign trade and exchange liberalisation and small-scale privatisation by the end of 1993, whereby the respective reform thresholds correspond to complete price liberalisation except for utilities, full current account convertibility, and almost complete small-scale privatisation (see Chapter 2). These countries have on average enjoyed positive growth rates since 1993. Those countries

Chart 3.8

Liberalisation and real GDP growth

(Unweighted averages for selected country groups)



Early liberalisation Late liberalisation No liberalisation

Source: EBRD staff calculations.

Note:

Early liberalisers are countries that had achieved complete price liberalisation, full current account convertibility and almost complete small-scale privatisation by 1993. The group includes the Czech Republic, Estonia, Hungary, Poland, the Slovak Republic and Slovenia. Late liberalisers achieved these thresholds after 1993, and include Albania, Armenia, Bulgaria, Croatia, FYR Macedonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Romania and Russia. Countries that have not yet reached these thresholds are Azerbaijan, Belarus, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Figures for 1999 are forecasts.

that achieved the same threshold later than 1993 had to wait until 1995 for positive average growth, while countries that have failed to reach this point have seen positive growth only since last year. It is noteworthy that the non-reformers were able to contain the transition recession up to 1993, but thereafter have trailed in growth performance behind both the first and second group with the exception of 1998.

Output growth during the first decade: a comparison of explanations

While the evidence on each of the factors examined above seems relatively strong, their analysis in isolation from each other is fraught with methodological problems. For instance, the extensiveness of reforms is likely to be partially determined by other factors, such as initial conditions and the timing of stabilisation. It is therefore not clear whether the positive impact of reforms on performance identified in Chart 3.8 simply reflects an underlying relationship between initial conditions and growth. In addition, macroeconomic performance is likely to feed back into reforms, making it difficult to disentangle the contribution of different factors.¹⁴ Rapid growth and rising living standards make it easier

¹³ An early contribution establishing this simple correlation was the *World Development Report* (1996).

¹⁴ This point is emphasised by Heybey and Murrell (1998).

for governments to push ahead with radical measures that would otherwise cause considerable pain for the population in general. Any statement about the effectiveness of reforms needs to address these relationships.

A growing number of recent studies have examined the determinants of economic growth during the first decade of transition. Several have employed regression analysis in order to test statistically the importance of the various factors. An early study, which focused on the link between initial conditions and economic reforms, found that the latter were more important than the former in explaining annual GDP growth over the first four years of transition.¹⁵ Moreover, while reforms led to a small decline in output in the year after they were introduced, this was followed by a strongly positive impact in subsequent years. The study also established, however, a strong link between initial conditions and reform, without addressing it methodologically.

Subsequent studies have largely supported and refined this basic result.¹⁶ In particular, it was shown that initial conditions tend to become less important for economic growth over time, while the impact of liberalisation tended to be higher in countries that also made greater progress with privatisation. These later studies also included measures of stabilisation efforts into the analysis and confirmed the strong beneficial impact of stabilisation on growth.

Two questions that have received less attention so far in the literature are the following. First, what is the relative importance for growth of liberalisation and privatisation on the one hand, and institutional reform on the other? Second, do structural reforms (both liberalisation/privatisation and institutional reforms) and stabilisation policies significantly influence growth once the relationship between these policies and initial conditions is taken into account?

These questions have been addressed using the macroeconomic data presented in this chapter, the structural reform measures and the measure of initial conditions presented in Chapter 2.¹⁷ The results confirm the importance of liberalisation, privatisation and stabilisation during the first decade of transition, even once the close relationship with initial conditions is taken into account. Institutional reforms are shown to matter less during this period. This should not be taken to mean that institutional reforms are unimportant for growth in the long term. On the contrary, international experience emphasises the importance of an adequate institutional infrastructure for economic growth and prosperity. One recent study for transition economies, moreover, found that broader measures of the institutional environment including the quality of governance do seem to have a significant, albeit not very large, effect on growth in the transition economies.¹⁸

Broad conclusions about the causes of the depth and severity of the transition recession must be drawn tentatively, as actual outcomes often reflect country-specific factors. Nevertheless, the evidence reviewed in this section is consistent with the following observations: favourable initial conditions have helped to mitigate the negative effects of early transition; rapid stabilisation brings long-term benefits with little short-term costs relative to a more gradual approach; liberalisation and small-scale privatisation contribute strongly to growth.

3.3 Sustaining the recovery

By the end of 1995, most of the countries in CEE had weathered the worst of the transition recession. Average weighted growth in 1995 was 5.5 per cent, and only FYR Macedonia had failed to record at least one year of positive growth. In addition, year-end inflation had been brought below 40 per cent in all countries. In contrast, stabilisation and growth had not yet taken root in many countries of the CIS, but most economies in this region were starting to grow by the end of 1996. Inflation too was largely under control. Some economists predicted that the countries of the CIS would follow a similar path to many of the CEE countries, but with a two- or three-year lag, taking into account the later start for the transition process in the CIS (end of 1991 as opposed to the end of 1989).¹⁹ This assessment was made at a time when it looked as though growth in Russia, marginally positive in 1997, would become established. Many forecasters and other analysts of the region believed that growth was here to stay.²⁰

Two years later, the picture looks far more uncertain. It is instructive, for example, to look at Chapter 9 of the *Transition Report* 1996, which discusses medium-term forecasts (to the year 2000) for selected countries from three institutions.²¹ Forecasts for Hungary, Poland and (to a lesser extent) the Slovak Republic for 1998-99 were broadly in line with actual outcomes so far and current projections for 1999. Those for the Czech Republic, Romania, Russia and Ukraine, however, have proved to be too optimistic.

The last two years have seen macroeconomic reversals in a number of countries, with significant output falls in countries that had started to grow again and a return to high inflation in two CIS countries – Belarus and Russia. This section will attempt to explain why reversals have taken place. The main conclusion is that, while external pressures have played a role, the roots usually lie in the failure to implement sound macroeconomic policies and necessary structural reforms. The section will also discuss how to anticipate future reversals.

¹⁵ See De Melo et al. (1997). This study also includes China and Vietnam in its analysis.

¹⁶ See Havrylyshyn et al. (1998); Berg et al. (1999).

¹⁷ Technically, the analysis employs a two-stage regression procedure, which takes as measures of reforms and stabilisation the residuals of a regression of these variables against initial conditions, and uses these in a cross-sectional regression against average growth during 1989-98. This allows the analysis to uncover the impact of reforms and stabilisation on growth over and above the impact that would have been expected, given the variation in starting points. See Falcetti et al. (1999).

¹⁸ See Havrylyshyn and van Rooden (1999). The long-term importance of institutions for economic growth is stressed in the *Transition Report* 1997, Chapter 6.

¹⁹ For example, see Fischer et al. (1997).

²⁰ However, the *Transition Report* 1997 concluded with an analysis of banking crises and deficiencies in structural reforms and argued that "the transition process remains fraught with uncertainty and systemic risks".

²¹ The three institutions are PlanEcon, Project Link and the Economist Intelligence Unit.

Box 3.1

Reversals: examples of home-grown factors**Albania: Pyramid schemes rather than banks**

The severe recession in Albania in 1997 arose not from macroeconomic imbalances but rather from the absence of essential market institutions, in particular a well-functioning banking sector. Prior to the crisis, confidence in the (mostly) state-owned banking sector was very low and private savings, mainly from emigrant remittances, were increasingly channelled into fraudulent “pyramid” schemes. Their inevitable collapse in early 1997 led to widespread anarchy and a temporary breakdown of social order. Although Albania’s experience was unique in many respects, it emphasised how the failure to implement key reforms in the financial sector can have major adverse consequences in the real sectors of the economy.

Bulgaria: Soft budget constraints for enterprises and bad loans for banks

Two factors contributed to the Bulgarian economic crisis in 1996-97. First, the banking system financed the losses of the essentially unreformed state enterprise sector for several years, leading to large and hidden losses in the banking sector (quasi-fiscal deficits). In effect, the government used the banking system to maintain soft budget constraints on the enterprise sector. When liquidity was tightened in 1995 to counter the acceleration in inflation, confidence in the banking sector eroded quickly. Second, excessive creation of money resulted in a loss of international reserves. The continued absence of enterprise restructuring and mounting losses in the state-owned banking sector precipitated a wave of banking failures and a collapse of confidence, with the real economy contracting sharply during 1996-97.

Czech Republic: Weak supply response to reforms fails to match recovery in demand

By the middle of the decade, the Czech Republic appeared to be one of the successes among the transition countries, with positive growth in 1993, rapid growth by 1995 and, uniquely, very low unemployment. However, the trend of growing fiscal and current account imbalances started in 1995, as the supply-side of the economy failed to respond to the upsurge in demand. Weaknesses in corporate governance structures at the enterprise level, that slowed down restructuring and innovation while failing to check rapid real wage increases, were largely to blame for the growing lack of competitiveness. Against this background, the

central bank’s exchange rate policy increasingly lacked credibility, necessitating a change in the exchange rate regime in spring 1997. Since then, bank regulation has been toughened by the central bank, which in turn led to hard budget constraints being imposed on enterprises. This has led to bankruptcies, output decline as a result of tight liquidity and – a decade after other CEE countries – rising unemployment.

Romania: Budgetary subsidies, budget deficits and bad loans lead to macroeconomic austerity

In common with Bulgaria, Romania maintained soft budget constraints on enterprises for a long period in the transition, in the form of both budgetary subsidies and bad loans in the banking system. These policies also boosted domestic demand during 1994-96, but this expansion was accompanied by swelling imports, weak exports and rising inflation. As external financing conditions tightened in 1997 with mounting political instability, the government was compelled to implement a comprehensive stabilisation package. These stabilisation efforts have reduced inflation, but have not yet reversed the decline in output.

Russia: Political instability, blocked tax reforms and weak banks undermine macroeconomic stability and investor confidence

The origins of the collapse of Russia’s financial markets in August 1998 were in the country’s flawed fiscal position, which was in turn undermined by weak enterprises and banks. Although the government’s stabilisation programme in 1995-96 managed to bring down inflation, the reform programme failed to address the underlying structural causes of the macroeconomic imbalances, including chronic structural weaknesses in the tax system and toleration of arrears. The government replaced monetary financing of the deficit with borrowing both on a newly created Treasury bill market and on international capital markets. However, it failed to support this borrowing with the necessary fiscal strengthening, as vested interests blocked meaningful tax reform. Channels of soft financing to enterprises with a large subsidy element also remained significant, keeping non-viable firms alive. At the same time, low world prices for oil and other commodities weakened tax revenues, and investor sentiment shifted away from emerging markets following the crisis in East Asia. The Russian crisis was triggered in August 1998 when the government abandoned attempts to peg the rouble and defaulted on domestic debt obligations.

Examples of reversals and common factors

For the purposes of this section, a reversal is defined as a year of negative real GDP growth after at least one year of positive growth. According to this definition, Bulgaria was the first case among CEE countries in 1996, followed by Albania and Romania in 1997, and the Czech Republic in 1998.²² In the CIS, reversals took place in 1998 in Kazakhstan, Moldova and Russia. An alternative way of defining a reversal is to identify countries that have had significant increases in inflation after stabilisation, where significant is defined as more than 20 percentage points (or exceeding the 30 per cent per annum threshold for moderate inflation). In CEE, Albania, Bulgaria and Romania stand out, with inflation in the latter two rising from moderate to triple-digit levels. In the CIS, Belarus and Russia had significant increases in 1998 (the increasing trend started earlier in Belarus).²³ Output and inflation reversals therefore typically go hand-in-hand.

“Home-grown” factors

A number of countries in the region have suffered reversals largely because of “home-grown” problems, usually a combination of

growing macroeconomic imbalances and lack of structural reform. Box 3.1 presents several summary cases: Albania, Bulgaria, the Czech Republic, Romania and Russia. The detailed circumstances underlying each reversal are very different. However, a common theme can be identified. In all cases, key structures of the economies were not reformed in the early years of transition, in particular enterprises and banks, which were allowed to continue operating under soft budget constraints. This lack of reform at the level of individual enterprises and banks reflects the influence both of initial conditions (see Chapter 2) and of political factors, including vested interests against reform (see Chapter 5). As a result, these economies were unable to bring about a sustained recovery from the transition recession.

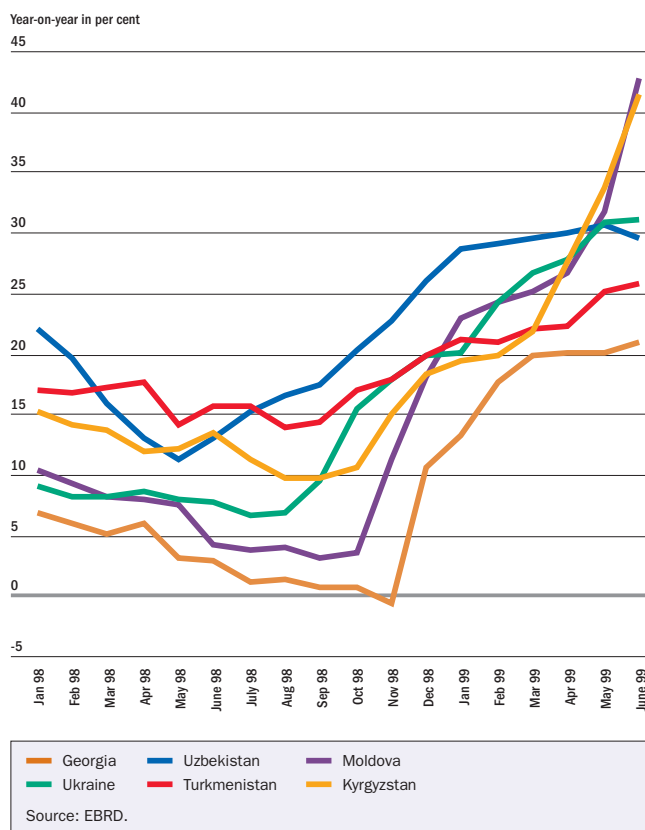
The effect of a crisis on the subsequent path of reform would seem to be diverse. One consequence can be that the crisis acts as a “wake-up” call, leading to the adoption of tough policies that had previously been avoided. An alternative reaction is to blame the crisis on previously implemented reforms and backtrack on these. A middle way is to do neither and revert to a strategy of “muddling

²² Latvia had a slight decrease in output in 1995 after a modest increase the previous year, but is not included among the reversals.

²³ Inflation in Tajikistan has fluctuated wildly, from more than 7,000% in 1993 to 1.1% in 1994 and back to 4-digit levels in 1995, reflecting civil war-related disruption to the economy.

Chart 3.9

Consumer price inflation, selected countries



through". This diversity has been demonstrated by the reaction to home-grown crises. Bulgaria and, to a lesser extent, Albania have adopted the first path, pushing ahead with a number of key reforms in privatisation, enterprise restructuring and in the banking sector. Russia, however, responded to the August 1998 crisis by temporarily re-introducing price and exchange controls. Both the Czech Republic and Romania have taken decisive policy action only after a long period of muddling through.

External shocks

While domestic factors alone can set a crisis in motion, they can also interact with external pressures. For example, the crisis in Russia certainly had a strong set of contributing domestic factors, but the timing of the crisis was strongly influenced by the shift in investments away from emerging markets following the crisis in East Asia in the second half of 1997 and by the collapse in world oil prices in 1998. Similarly, this setback in Russia has had a major effect on other economies in the region and has contributed to output reversals in 1998 in Kazakhstan and Moldova. With some exceptions, evidence of the crisis leading to higher inflation is limited so far, but the deterioration of the macroeconomic environment has put renewed pressure on the stabilisation programmes of a number of countries. Chart 3.9 illustrates this point for six CIS countries (Georgia, Kyrgyzstan, Moldova, Turkmenistan, Ukraine and Uzbekistan), where inflation has risen substantially (more than doubled in some cases) since the collapse

of the Russian rouble in August 1998. In four of the six cases, these increases in inflation coincide with a projected decline in growth rate in 1999.

The fall of the rouble has led to substantial effective real exchange rate appreciation in those countries that conduct a large proportion of their trade with Russia. As shown by Table 3.2, the value of intra-CIS trade decreased by more than 20 per cent in 1998, and by 36 per cent in the first quarter of 1999. With the exception of Tajikistan and Turkmenistan, exports and imports decreased in all countries. This dramatic decline in the mutual trade of the CIS appears to be largely due to the Russian financial crisis. In the first quarter of 1999 Russia's imports from CIS countries were down by 50 per cent. Chart 3.10 emphasises the strong negative correlation between output growth in 1998 and trade exposure to Russia pre-crisis.

CEE countries have been affected much less by developments in Russia during 1998, primarily because many have reoriented their trade flows to the EU. Nevertheless, the Baltic states, Bulgaria and Poland suffered considerably from the collapse of the Russian market, and in the first quarter of 1999 exports to Russia and the CIS from these countries plunged by 50-70 per cent. In addition, the decline in EU growth rates has had a major impact on some CEE countries. Overall, exports from CEE to the developed world continued to grow in the first quarter of 1999, but the rise of some 7 per cent was less than half the rate in 1998.

Declining world commodity prices have also adversely affected many countries, especially in the CIS, where most economies are highly dependent on commodity exports. The prices of crude oil, gold and other metals, and cotton are therefore a major factor in trade performance. In the first quarter of 1999 prices of crude oil, petrol and heating oil were 17-23 per cent lower than in the same period of 1998, although most commodity prices began to recover significantly in the second quarter of the year. In addition to weak global demand, ferrous metal shipments from across the region face anti-dumping activities around the world (for instance, anti-dumping measures against Kazakhstani, Russian and Ukrainian steel producers).

Reversals and vulnerability

To what extent are countries in the region likely to face future crises and reversals? Many studies have been published on which macroeconomic variables are good "predictors" of future crises.²⁴ One conclusion is that countries vulnerable to crises tend to show several warning signs simultaneously.

Table 3.3 shows a number of signs of vulnerability, including the size of the current account and fiscal deficits, and the ratio of external debt to exports. It also displays groupings around net external debt-to-GDP ratios, the ratio of liquid domestic assets (broad money plus outstanding Treasury bills and other money market instruments) to international reserves, and the ratio of short-term foreign debt to foreign reserves. The latter are indicators of vulnerability to shifts in portfolio preferences. The table

²⁴ See, for example, Kaminski, Lizondo and Reinhardt (1997); Berg et al. (1999); and Fries, Raiser and Stern (1999) for an application to transition economies.

Table 3.2

CIS countries' trade with CIS and non-CIS countries, 1998-99

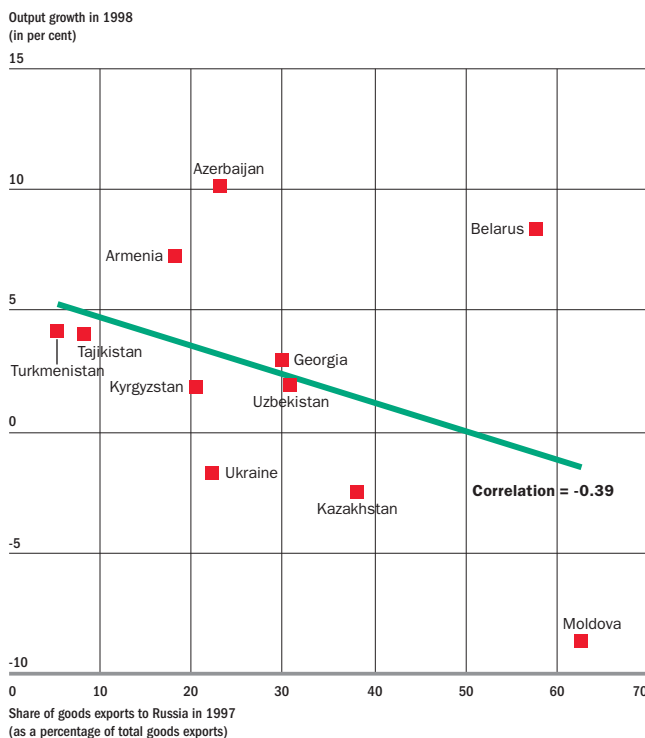
(In millions of dollars, growth rates in per cent)

	Export growth (per cent)		Import growth (per cent)		Trade balances (in millions of dollars)		
	1998	1999 Q1	1998	1999 Q1	1998	1998 Q1	1999 Q1
Armenia							
Non-CIS	3.3	31.2	13.7	-7.2	-532.0	-115	-96
CIS	-14.4	-49.5	-26.0	-17.4	-140.0	-30	-34
Azerbaijan							
Non-CIS	-7.2	82.4	51.7	28.8	-299.0	-59	-50
CIS	-38.6	-52.2	15.3	-7.0	-173.0	-10	-40
Belarus							
Non-CIS	-0.7	34.0	4.6	-29.3	-1,094.0	-359	-4
CIS	-5.1	-40.1	-5.3	-41.7	-399.0	-142	-62
Georgia							
Non-CIS	-17.4	23.9	12.7	-53.4	-592.0	-146	-56
CIS	-23.5	-28.6	11.3	-25.4	-274.0	-62	-47
Kazakhstan							
Non-CIS	-7.9	-15.1	13.8	-3.4	999.0	324	222
CIS	-29.6	-45.3	-14.2	-11.5	99.0	194	-54
Kyrgyzstan							
Non-CIS	-0.5	-10.8	46.5	-3.2	-118.0	2	-4
CIS	-27.8	-8.1	1.1	-37.7	-210.0	-54	-19
Moldova							
Non-CIS	-23.6	5.1	2.9	-61.3	-381.0	-114	-13
CIS	-29.5	-61.9	-27.2	-46.6	-11.0	-4	-22
Tajikistan							
Non-CIS	-16.7	-2.8	-1.3	16.7	129.0	38	26
CIS	-23.8	7.0	5.0	-20.4	-299.0	-98	-64
Turkmenistan							
Non-CIS	47.2	43.3	-9.5	35.4	-39.0	-23	-25
CIS	-66.3	446.2	-28.2	-21.3	-348.0	-108	127
Ukraine							
Non-CIS	-2.4	-11.4	-6.5	-38.1	1,657.0	501	853
CIS	-24.8	-41.0	-20.1	-20.1	-3,695.0	-1,319	-1,279
Uzbekistan							
Non-CIS	-9.3	-6.4	-27.1	-19.5	237.0	29	98
CIS	-39.2	-19.0	-27.8	-8.5	3.0	17	-9
Total above							
Non-CIS	-4.3	-4.1	-2.5	-25.6	-33.0	77	952
CIS	-22.3	-34.0	-14.6	-25.8	-5,446.0	-1,615	-1,502
Russia							
Non-CIS	-15.8	-8.7	-16.7	-47.4	26,146.0	3,339	7,158
CIS	-18.4	-37.9	-20.5	-50.5	2,314.0	747	892
Commonwealth of Independent States							
Non-CIS	-13.3	-7.7	-12.2	-41.3	26,113.0	3,416	8,110
CIS	-20.4	-36.0	-16.9	-35.4	-3,133.0	-868	-610

Source: UN/ECE secretariat (1999), Uzbekistan Economic Trends.

Chart 3.10

Change in output versus trade exposure to Russia



Source: EBRD staff calculations.

classifies countries according to whether they are slightly, moderately or highly vulnerable in each of these categories, with the cut-off points for each category shown in each case. Countries showing high vulnerability on several counts are likely to be in need of relatively urgent policy correction, if future strains are to be avoided.²⁵

Table 3.3 shows the association of high current account deficits with significant budgetary imbalances in several countries, including Armenia, Kyrgyzstan, Lithuania, Moldova and the Slovak Republic. In all of these countries, except Lithuania, vulnerability is also high on at least one other count. Another country showing vulnerability in a number of areas is Russia, despite last year's traumatic macroeconomic adjustment and recent signs of a modest recovery. Macroeconomic policy continues to face serious challenges in the region's largest economy, with significant uncertainty as a result for its neighbours in the CIS.

With very few exceptions, the international debt burden is not high by international standards. However, it has been growing very rapidly over the past few years, especially in some of the smaller CIS countries. The large number of countries with significant current account deficits provides some indication of this. Armenia and Kyrgyzstan show particularly high figures for gross external debt to export revenues, although it should be noted that this measure does

not distinguish between debt on commercial terms (to which these countries have little access) and low-interest loans, mainly from bilateral sources and international organisations.

Although conditions in emerging markets have become more settled in 1999 than in the two preceding years, it is nonetheless instructive to examine data on liquid domestic liabilities to international reserves as well as short-term debt as key indicators of vulnerability to shifts in portfolio preferences. Romania, Russia, Ukraine and several central European countries show vulnerability in this area. In Hungary and the Czech Republic, short-term debt is relatively high, although a sudden cut-off from international lending to refinance these obligations remains unlikely. The Slovak Republic is in the midst of a serious macroeconomic austerity programme, partially in response to the concerns of foreign lenders, on whom it had increasingly relied to finance large external imbalances under the Meciar Government.

3.4 Recent developments and prospects for the next decade

As the end of the decade approaches, and after ten years of upheaval and turbulence, it is natural to ask whether the next ten years are likely to show a noticeable improvement across the region in macroeconomic performance. Most observers agree that there is at least the potential for relatively fast growth, even though historically episodes of rapid economic growth (sustained annual rates of growth in GDP per capita above 3 per cent for two to three decades) have been quite rare. In general, these episodes are associated with growth phases in which relatively underdeveloped countries have caught up with the more advanced economies, including recovery from major upheaval and in particular from the destruction of war.

In transition economies, the positive relationship outlined above between market-oriented reforms and short-term growth suggests further potential for growth through the more efficient use of existing resources, and through restructuring, investment in plant and equipment, and the introduction of new technologies. Nevertheless, the previous section has demonstrated that much of the region is far from stable and that, in many countries, the foundations for sustained growth are not yet in place.

Recent developments

Developments in much of the region in 1999 continue to be heavily influenced by the crisis in Russia. In the first half of the year, growth rates have slowed considerably in countries with strong trade and other links with Russia, including all three Baltic states and Azerbaijan. Other countries are finding that their recoveries are being delayed. Kazakhstan, Moldova and Ukraine – the three economies in the CIS (in addition to Russia) where output fell last year – all remain mired in recession.

However, developments in Russia are pointing towards recovery, although its sustainability remains in question in the absence of

²⁵ It should be noted that the cut-off points for "low", "medium" and "high" are necessarily somewhat arbitrary. Also, the fiscal deficit criteria should ideally be expanded to cover "quasi-fiscal" deficits resulting from the state's influence over the activity of banks and enterprises. The accounts for Belarus and Turkmenistan, for instance, would then look far worse.

Table 3.3

Indicators of macroeconomic vulnerability, end-1998

	Current account balance (in per cent of GDP)	Fiscal balance ¹ (in per cent of GDP)	Gross external debt/ exports (in per cent)	Net external debt/GDP ² (in per cent)	Short-term foreign debt/ foreign reserves ³ (in per cent)	Liquid domestic liabilities/ foreign reserves ⁴
Low	CA deficit < - 2%	Fiscal deficit < - 2%	Ratio < 100 %	Ratio < 30 %	Ratio < 25 %	Ratio < 2
	Russia Slovenia Uzbekistan Czech Republic	Bulgaria Croatia Estonia Belarus Latvia Slovenia FYR Macedonia	Belarus Slovenia Ukraine Czech Republic Lithuania	Azerbaijan Slovenia Belarus Poland Albania Turkmenistan Czech Republic Romania Lithuania Uzbekistan Croatia Ukraine Armenia Kazakhstan	Azerbaijan Albania Bulgaria Armenia Slovenia Moldova Kyrgyzstan Poland Latvia	Armenia Hungary Kyrgyzstan Azerbaijan Kazakhstan Bulgaria Moldova Lithuania FYR Macedonia Estonia
	0.9 0.0 -1.7 -1.9	1.0 0.6 -0.3 -0.3 -0.8 -1.4 -1.7	31.8 54.5 83.9 89.5 94.0	5.7 7.1 10.9 11.7 16.5 18.1 19.5 21.6 21.7 22.5 24.6 24.8 25.4 26.5	2 11 15 16 16 17 19 22 24	0.6 0.8 1.0 1.0 1.3 1.3 1.5 1.5 1.8 1.9
Medium	- 2% < CA deficit < - 7%	- 2% < Fiscal deficit < - 5%	100% < Ratio < 200%	30% < Ratio < 50%	25% < Ratio < 50%	2 < Ratio < 4
	Bulgaria Ukraine Poland Hungary Kazakhstan Albania Belarus	Czech Republic Ukraine Turkmenistan Bosnia and Herzegovina Poland Romania Tajikistan Uzbekistan Azerbaijan Georgia Hungary	Azerbaijan FYR Macedonia Estonia Slovak Republic Uzbekistan Romania Hungary Kazakhstan Poland Latvia Croatia	FYR Macedonia Latvia Hungary Estonia Slovak Republic Georgia	Lithuania Kazakhstan Estonia Belarus Croatia FYR Macedonia	Latvia Poland Slovenia Belarus Romania Croatia Czech Republic
	-2.3 -2.8 -4.5 -4.8 -5.6 -6.3 -6.6	-2.6 -2.7 -2.7 -2.9 -3.0 -3.3 -3.8 -3.8 -4.2 -4.4 -4.8	100.9 105.9 107.8 111.6 111.6 115.8 129.0 136.1 148.5 151.3 178.0	30.1 36.2 36.4 40.2 44.1 47.0	25 34 40 42 45 46	2.3 2.4 2.6 2.9 2.9 3.2 3.2
High	CA deficit > - 7%	Fiscal deficit > - 5%	Ratio > 200 %	Ratio > 50 %	Ratio > 50 %	Ratio > 4
	Croatia Georgia Romania FYR Macedonia Estonia Slovak Republic Tajikistan Latvia Lithuania Kyrgyzstan Moldova Armenia Azerbaijan Turkmenistan	Armenia Russia Lithuania Slovak Republic Kazakhstan Moldova Kyrgyzstan Albania	Russia Kyrgyzstan Tajikistan Moldova Bulgaria Turkmenistan Bosnia and Herzegovina Georgia Armenia Albania	Russia Kyrgyzstan Moldova Bulgaria Tajikistan	Romania Czech Republic Hungary Ukraine Slovak Republic Russia	Russia Slovak Republic Albania Ukraine
	-7.1 -7.5 -7.9 -9.0 -9.2 -10.1 -10.8 -11.1 -12.1 -16.7 -17.6 -26.7 -33.1 -45.8	-5.2 -5.4 -5.8 -5.8 -8.0 -8.1 -9.9 -10.4	201.9 202.7 207.1 207.2 235.3 284.9 352.4 352.7 363.3 424.3	50.6 54.6 64.4 68.0 96.4	52 57 60 71 86 221	4.2 4.3 4.9 5.9

Sources:

EBRD selected macroeconomic indicators, except short-term foreign debt which is reported in the *BIS Quarterly Review*.¹ Data refer to the general government.² Net external debt equals gross external debt net of gross reserves of the monetary authorities.³ Short-term foreign debt is defined as the sum of consolidated cross-border claims in all currencies and local claims in non-local currencies with maturity up to and including one year.⁴ Liquid domestic liabilities include M2 (M1 and quasi-money), T-bills and money market instruments.

renewed commitment to reform. Figures released for the first half of 1999 suggest that GDP declined by only 1 per cent year-on-year, and that industrial output has picked up considerably following the real depreciation of the rouble in August 1998. The exchange rate has returned to relative stability and inflation is coming down rapidly – end-year inflation in 1999 is likely to be around half the 1998 level. Similar trends are beginning to emerge in other CIS countries, and positive growth may be achieved for a majority of countries during the second half of 1999.

Within CEE, the overall picture is one of continued resilience, but with considerable variation between countries. Recent figures for the Czech Republic and Romania suggest that the recession may finally be coming to an end in the former, while the decline in output in the latter was less than expected. As discussed below, countries in south-eastern Europe have suffered to different degrees as a result of the Kosovo crisis, while Hungary and Poland have both slowed down as a result of business cycle effects. Inflation across CEE has halted its decline, partly as a result of the increasing prices of energy imports, and partly as a result of expansionary monetary policies, particularly in the Czech Republic and Poland.

Short-term prospects

As in previous *Transition Reports*, the EBRD invited 11 institutions to provide short-term forecasts of growth for both the current and following year. The results for 1999 and 2000 respectively are presented in Tables 3.1.7 and 3.1.8. Previous experience suggests that short-term forecasts should be treated with considerable caution.²⁶

Turning to the growth projections for 1999 first, the picture that emerges from CEE is one of increasing divergence this year between relatively well-off and poorer countries. Most forecasters predict sustained growth in Hungary, Poland and Slovenia, but opinion varies more widely concerning growth prospects in the Baltic states and in the Slovak Republic. The negative impact of the Kosovo crisis is reflected in modest or negative growth forecasts for much of south-eastern Europe, with the exception of Albania, which appears to have emerged relatively unscathed despite having hosted the largest number of refugees during the war. The rapid rates of growth forecast for Albania and Bosnia and Herzegovina, however, must be considered in the context of the very low starting bases and the economic and political crises of recent years in both countries. Forecasts across the CEE region for 2000 present a similar picture to 1999, although an important difference is that all countries are expected on average to have positive rates of growth.

In the CIS, there is considerable disagreement about growth prospects in Belarus, Russia and Turkmenistan. For Belarus, all observers predict a reduction from previous high growth rates, but the EBRD remains more optimistic than other institutions, predicting marginally positive growth in 1999. Forecasts for Russia made earlier in the year predicted another large fall,

whereas more recent forecasts, including the EBRD's, foresee zero or positive growth. JP Morgan in particular is quite bullish about prospects for the country, predicting positive growth of more than 2 per cent. The resumption of gas exports from Turkmenistan is responsible for the high growth forecast by the EBRD and a number of other institutions this year. Looking ahead to 2000, prospects for most CIS countries are generally quite favourable. The present recession should be overcome in Kazakhstan and Moldova, the Caucasus countries are likely to grow moderately over the next two years, and most forecasters expect the decline in output in Ukraine to stop finally in 2000.

Prospects for the medium term

Over the medium term, transition economies should be well-placed for rapid growth because of their high level of acquired skills and the introduction of new technology. These factors point to long-term average annual growth rates in the range of 4 to 7 per cent for most countries. To realise this potential, all the elements of a sound investment climate – peace, order, stability and a market-oriented government – will be prerequisites. It will also be necessary to establish institutions that will create incentives for high investment and rapid productivity growth. If further improvement in institutions does not materialise, long-term growth prospects will look much less favourable.²⁷

The macroeconomic challenges facing countries in transition differ from one country to the next. Nevertheless, certain broad themes can be identified that pertain to specific regions. The following are likely to be among the most important in the next ten years.

EU accession

Most countries in CEE are gearing up for EU accession, a process that involves considerable costs and obligations prior to membership. Five transition countries – the Czech Republic, Estonia, Hungary, Poland and Slovenia – have already entered formal negotiations for membership. Membership for this group may come as early as 2003, but is more likely to take place towards the middle of the decade. Five others (Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic) have yet to embark on membership negotiations.

Balkans reconstruction

For some of the countries in south-eastern Europe, EU membership is a distant prospect, but opportunities are arising in the context of post-conflict reconstruction and stability pacts. Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia are still feeling the aftershocks of the conflicts over the break-up of Yugoslavia and/or the conflict in Kosovo in 1999. Now that hostilities have ceased, these countries have a chance to build closer ties with the West and to take advantage of the variety of programmes and initiatives that are planned or already in place. Annex 3.2 summarises the economic effects of the Kosovo conflict and the implications for the development of the Balkan region.

²⁶ Forecasters were also asked for inflation projections, but these are not presented here. Most expect that inflation will be under control throughout the region by 2000.

²⁷ These themes were explored in Chapter 6 of the *Transition Report* 1997.

Sustainable growth for the CIS?

For the CIS countries, the main challenge is to break out of the cycle of political instability and poor governance that has delayed the recovery until now. This Report has shown that the CIS countries have faced high hurdles in the transition so far. Their poor starting position in terms of the extent of structural distortions and the capacity of the state continues to present a heavy legacy. Expectations should therefore be moderate. Yet, structural reforms have been introduced successfully in a number of CIS countries and some have by now experienced several years of growth. The challenge will be to sustain these advances in the face of considerable uncertainty emanating not least from the region's biggest economy, Russia. As reforms become consolidated and translated into improved performance, they are likely to gain increasing support from the population. For most countries in the CIS, positive growth throughout the next decade should be feasible.

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Annex 3.1: Macroeconomic performance tables

Table 3.1.1

Growth in real GDP in central and eastern Europe, the Baltic states and the CIS

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Estimated level of real GDP in 1998 (1989=100)
Albania	9.8	-10.0	-27.7	-7.2	9.6	9.4	8.9	9.1	-7.0	8.0	8.0	86
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.1	-7.0	3.5	0.0	66
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.3	-0.5	78
Czech Republic	1.4	-1.2	-11.5	-3.3	0.6	3.2	6.4	3.8	0.3	-2.3	0.0	95
Estonia	-1.1	-8.1	-13.6	-14.2	-9.0	-2.0	4.3	3.9	10.6	4.0	0.0	76
FYR Macedonia	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	0.8	1.5	2.9	0.0	72
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	5.1	3.0	95
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.6	1.5	59
Lithuania	1.5	-5.0	-6.2	-21.3	-16.0	-9.5	3.5	4.9	7.4	5.2	0.0	65
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	3.5	117
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.1	-6.9	-7.3	-4.0	76
Slovak Republic	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.8	100
Slovenia	-1.8	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.9	3.5	104
<i>Central and eastern Europe and the Baltic states¹</i>	-0.2	-6.6	-10.7	-3.6	0.4	3.9	5.5	4.0	3.6	2.4	1.6	95
Armenia	14.2	-7.4	-17.1	-52.6	-14.8	5.4	6.9	5.8	3.1	7.2	4.0	41
Azerbaijan	-4.4	-11.7	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.1	3.7	44
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	10.4	8.3	1.5	78
Georgia	-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	11.0	2.9	3.0	33
Kazakhstan	-0.4	-0.4	-13.0	-2.9	-9.2	-12.6	-8.2	0.5	2.0	-2.5	-1.7	61
Kyrgyzstan	4.0	3.0	-5.0	-19.0	-16.0	-20.0	-5.4	7.1	9.9	1.8	0.0	60
Moldova	8.5	-2.4	-17.5	-29.1	-1.2	-31.2	-3.0	-8.0	1.3	-8.6	-5.0	32
Russia	na	-4.0	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	0.0	55
Tajikistan	-2.9	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	5.0	42
Turkmenistan	-6.9	2.0	-4.7	-5.3	-10.0	-18.8	-8.2	-8.0	-26.1	4.2	17.0	44
Ukraine	4.0	-3.4	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	-1.7	-2.5	37
Uzbekistan	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.4	3.3	3.0	90
<i>Commonwealth of Independent States²</i>	0.6	-3.7	-6.0	-14.2	-9.3	-13.8	-5.2	-3.5	0.9	-3.5	0.0	53
Central and eastern Europe, the Baltic states and the CIS	0.3	-5.0	-8.1	-9.5	-5.0	-6.0	-0.5	-0.2	2.0	-1.2	0.8	65

Notes:

Data for 1989-97 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1998 are preliminary actuals, mostly official government estimates. Data for 1999 represent EBRD projections. Estimates for Bosnia and Herzegovina are only available since 1995 and therefore are not included in this summary table. Data for Bosnia and Herzegovina are provided in the selected economic indicators at the back of this Report.

¹ Estimates for real GDP represent weighted averages for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The weights used for the growth rates were EBRD estimates of nominal dollar-GDP lagged by one year; those used for the index in the last column were EBRD estimates of GDP converted at PPP US\$ exchange rates in 1989.

² Here taken to include all countries of the former Soviet Union, except Estonia, Latvia and Lithuania. Estimates of real GDP represent weighted averages. The weights used for the growth rates were EBRD estimates of nominal dollar-GDP lagged by one year; those used for the index in the last column were EBRD estimates of GDP converted at PPP US\$ exchange rates in 1989.

Table 3.1.2

Indicators of competitiveness (change, in per cent)

	1994	1995	1996	1997	1998	1993-98		1994	1995	1996	1997	1998	1993-98
Bulgaria¹							Estonia⁴						
Industrial gross output	8.5	4.9	0.2	-7.0	-9.4	-3.9	Manufacturing gross output	-3.2	2.9	2.2	18.5	2.9	24.1
Productivity in industry	12.6	7.3	2.1	-3.4	-4.4	13.9	Productivity in manufacturing	6.7	0.4	3.7	26.1	-8.1	28.7
Real wage in industry (PPI-based)	-12.1	3.3	-15.0	15.6	11.6	-0.5	Real wage in manufacturing (PPI-based)	26.9	14.1	7.7	11.4	10.7	92.4
Real D-Mark exchange rate (CPI-based)	-5.2	14.3	-12.2	40.8	17.7	57.7	Real D-Mark exchange rate (CPI-based)	44.0	26.7	21.5	9.1	9.5	164.9
D-Mark unit labour costs	-32.1	5.4	-21.0	44.1	36.6	11.3	D-Mark unit labour costs	61.7	35.2	19.2	-5.1	24.0	206.6
Croatia²							Hungary⁵						
Industrial gross output	-2.7	0.3	3.1	3.9	3.2	7.9	Manufacturing gross output	9.3	5.0	3.4	14.8	16.2	58.4
Productivity in industry	1.6	5.8	11.4	12.0	9.2	46.5	Productivity in manufacturing	7.3	10.9	9.0	14.3	8.6	61.1
Real wage in industry (PPI-based)	29.8	30.8	11.0	8.2	11.4	127.0	Real wage in manufacturing (PPI-based)	7.7	-3.8	-0.6	3.6	7.4	14.7
Real D-Mark exchange rate (CPI-based)	13.3	1.5	3.1	3.4	3.3	26.6	Real D-Mark exchange rate (CPI-based)	-1.6	-6.8	5.6	9.4	0.3	6.4
D-Mark unit labour costs	33.6	25.9	2.0	0.4	-1.2	70.2	D-Mark unit labour costs	-3.6	-19.1	-3.4	0.6	-4.7	-27.8
Czech Republic³							Latvia⁶						
Manufacturing gross output	0.1	8.2	5.5	6.4	2.5	24.6	Manufacturing gross output	-12.0	-5.0	7.0	17.0	0.0	4.7
Productivity in manufacturing	4.9	11.1	9.6	11.1	5.6	49.7	Productivity in manufacturing	2.0	13.6	15.3	12.6	2.5	54.3
Real wage in manufacturing (PPI-based)	11.1	8.7	11.9	8.4	5.6	54.8	Real wage in manufacturing (PPI-based)	33.0	9.3	0.5	17.5	4.4	79.1
Real D-Mark exchange rate (CPI-based)	6.7	2.8	10.2	5.1	9.3	38.7	Real D-Mark exchange rate (CPI-based)	57.3	15.0	16.4	16.3	3.6	153.8
D-Mark unit labour costs	11.3	1.5	10.0	0.9	4.3	30.8	D-Mark unit labour costs	85.7	2.8	-0.9	18.4	2.6	129.8

Sources:

- Industrial production, employment and wages are taken from annual and monthly publications of the Bulgarian Statistical Office for figures up to 1996, and from monthly publications of the National Bank, the Institute for Market Economics and the Vienna Institute for International Economic Studies for later figures. Real wages are calculated as average gross monthly wages in industry, deflated by the PPI in industry.
- Production, employment and wages are taken from the 1997 *Statistical Yearbook* and various issues of the *Monthly Statistical Report*, published by the Central Bureau of Statistics. Figures from 1994-96 refer to industry and thereafter to manufacturing. Real wages are calculated as average monthly wages, deflated by the PPI. PPI refers to industry between 1994-97 and to manufacturing in 1998. The 1994 growth rate refers to net wages; subsequent growth rates refer to gross wages.
- Production, employment and wages are taken from annual and monthly publications of the Czech Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing, deflated by the PPI in manufacturing.

- Production and wages are taken from annual and monthly reports by the Estonian Statistical Office. Employment figures come from the Estonian Statistical Office. Real wages are calculated as average gross monthly wages in manufacturing, deflated by the PPI in manufacturing.
- Production, employment and wages are taken from the *Monthly Bulletin of Statistics* of the Hungarian Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing, deflated by the PPI in manufacturing.
- Production, employment and wages are taken from the 1998 *Statistical Yearbook*, various issues of *Monthly Bulletin of Latvian Statistics* and direct information from the Statistical Bureau of Latvia. Real wages are calculated as average monthly gross wages in industry, deflated by the PPI in industry.

Table 3.1.2

Indicators of competitiveness (change, in per cent)

	1994	1995	1996	1997	1998	1993-98		1994	1995	1996	1997	1998	1993-98
Lithuania⁷							Russia¹⁰						
Manufacturing gross output	-29.7	0.9	3.5	8.0	7.0	-15.2	Manufacturing gross output	-24.0	-3.9	-6.8	2.0	-5.2	-34.2
Productivity in manufacturing	-12.2	12.0	8.5	7.6	7.9	24.0	Productivity in manufacturing	-17.7	4.8	0.2	7.9	na	na
Real wage in manufacturing (PPI-based)	13.6	14.0	14.9	19.1	27.5	126.2	Real wage in manufacturing (PPI-based)	-17.5	-31.3	9.6	7.6	6.4	-28.9
Real D-Mark exchange rate (CPI-based)	65.7	29.6	29.2	23.1	5.6	260.6	Real D-Mark exchange rate (CPI-based)	75.4	18.4	36.6	14.8	5.7	243.9
D-Mark unit labour costs	85.2	23.3	30.4	32.8	11.9	342.3	D-Mark unit labour costs	79.8	-4.9	54.6	16.9	na	na
Poland⁸							Slovak Republic¹¹						
Manufacturing gross output	13.7	11.6	9.8	12.8	6.7	67.8	Manufacturing gross output	4.5	10.2	2.4	1.6	6.5	27.6
Productivity in manufacturing	14.0	7.0	10.0	12.1	6.3	60.0	Productivity in manufacturing	9.3	5.3	2.5	4.1	11.5	36.7
Real wage in manufacturing (PPI-based)	10.1	5.4	14.5	12.1	8.4	61.4	Real wage in manufacturing (PPI-based)	6.3	6.0	9.8	7.5	6.1	41.1
Real D-Mark exchange rate (CPI-based)	1.4	4.5	11.7	7.0	5.4	33.5	Real D-Mark exchange rate (CPI-based)	2.7	3.6	6.3	9.4	2.3	26.5
D-Mark unit labour costs	-6.2	2.9	9.0	3.0	3.2	11.9	D-Mark unit labour costs	0.7	5.5	14.0	12.9	-5.0	30.0
Romania⁹							Slovenia¹²						
Manufacturing gross output	3.8	12.1	7.9	-6.8	-18.1	-4.2	Manufacturing gross output	6.7	2.9	0.8	0.2	3.9	15.2
Productivity in manufacturing	10.1	20.0	7.5	3.24	-15.9	23.3	Productivity in manufacturing	11.8	8.4	6.7	4.5	5.4	42.4
Real wage in manufacturing (PPI-based)	-3.7	13.6	2.7	-16.4	6.4	-0.1	Real wage in manufacturing (PPI-based)	9.8	4.7	7.3	6.2	5.0	37.6
Real D-Mark exchange rate (CPI-based)	43.9	-5.1	-5.0	23.1	29.7	107.0	Real D-Mark exchange rate (CPI-based)	1.5	7.1	-0.5	3.9	4.2	17.2
D-Mark unit labour costs	-1.4	-4.2	0.4	-7.3	40.2	23.3	D-Mark unit labour costs	-2.1	3.7	-1.6	4.8	2.8	7.6

Sources:

⁷ Production, employment and wages are taken from the 1998 *Statistical Yearbook* and various issues of *Economic and Social Development in Lithuania* published by the Lithuanian Department of Statistics. Output refers to mining, quarrying and manufacturing. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in mining, quarrying and manufacturing.

⁸ Production, employment and wages are taken from monthly and quarterly reports of the Polish Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing, deflated by the PPI in manufacturing.

⁹ Production, employment and wages are taken from the 1998 *Statistical Yearbook* and various issues of the *Monthly and Quarterly Statistical Bulletin*, published by the National Commission for Statistics. Data on wages until 1996 are taken from *OECD Short-term Economic Indicators*, various issues. Real wages are calculated as average net wages in manufacturing deflated by the PPI in manufacturing.

¹⁰ Production, employment and wages are taken from *OECD Short-term Economic Indicators*, various issues, until 1997. Figures for 1997 and 1998 refer to industry rather than manufacturing and are taken from *Russian Economic Trends*. Real wages are calculated as average gross monthly wages in manufacturing deflated by the PPI in industry.

¹¹ Production, employment and wages are taken from various issues of annual and monthly publications by the Slovak Statistical Office. Real wages are calculated as average gross monthly wages in manufacturing deflated by the PPI in manufacturing.

¹² Production, employment and wages are taken from the *Statistical Yearbooks* of the Statistical Office of the Slovenian Republic, and from the monthly *Slovenian Economic Mirror* published by the Slovenian Institute for Macroeconomic Analysis and Development. Real wages are calculated as average gross monthly wages in industry deflated by the PPI in manufacturing.

Note:

Data for 1994-97 represent the percentage change of annual averages based on actual data. Figures for 1998 represent preliminary official estimates. Productivity is calculated as the ratio of manufacturing/industry production over manufacturing/industry employment. The real D-Mark exchange rate is calculated as the domestic CPI divided by the product of the German CPI and the exchange rate. A positive sign represents a real appreciation. D-Mark unit labour costs are calculated as wages in D-Mark divided by productivity. Data on the exchange rate to the D-Mark, on CPI and PPI are based on national authorities, the IMF and EBRD estimates.

Table 3.1.3

Inflation in central and eastern Europe, the Baltic states and the CIS

(Change in year-end retail/consumer price level, in per cent)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998 (estimate)	1999 (projection)
Albania	0.0	0.0	104.1	236.6	30.9	15.8	6.0	17.4	42.1	8.7	2.0
Bulgaria	10.0	72.5	338.9	79.4	63.8	121.9	32.9	310.8	578.6	1.0	2.0
Croatia	na	136.0	249.8	938.2	1,149.0	-3.0	3.8	3.4	3.8	5.4	4.0
Czech Republic	1.5	18.4	52.0	12.7	18.2	9.7	7.9	8.6	10.0	6.8	3.5
Estonia	na	na	303.8	953.5	35.6	42.0	29.0	15.0	12.5	4.4	3.1
FYR Macedonia	na	na	229.7	1,935.0	241.8	55.0	9.0	-0.6	2.6	-3.1	2.0
Hungary	18.1	33.4	32.2	21.6	21.1	21.2	28.3	19.8	18.4	10.3	8.0
Latvia	na	na	262.4	959.0	35.0	26.0	23.1	13.1	7.0	2.8	2.1
Lithuania	na	na	345.0	1,161.1	188.8	45.0	35.5	13.1	8.5	2.4	2.5
Poland	639.5	249.0	60.4	44.3	37.6	29.4	21.6	18.5	13.2	8.6	6.5
Romania	0.6	37.7	222.8	199.2	295.5	61.7	27.8	56.9	151.4	40.6	40.0
Slovak Republic	1.5	18.4	58.3	9.1	25.1	11.7	7.2	5.4	6.4	5.6	14.5
Slovenia	2,772.0	104.6	247.1	92.9	22.8	19.5	9.0	9.0	8.8	6.5	6.5
<i>Central and eastern Europe and the Baltic states</i>											
Median ¹	5.8	37.7	229.7	199.2	35.6	26.0	21.6	13.1	10.0	5.6	3.5
Mean ¹	430.4	74.4	192.8	511.0	166.6	35.1	18.5	37.7	66.4	7.7	7.4
Armenia	na	na	25.0	1,341.0	10,896.0	1,885.0	31.9	5.8	21.8	-1.3	8.0
Azerbaijan	na	na	126.0	1,395.0	1,294.0	1,788.0	84.5	6.5	0.3	-7.6	2.0
Belarus	na	na	93.0	1,559.0	1,996.0	1,960.0	244.0	39.3	63.4	181.7	155.0
Georgia	0.9	4.8	131.0	1,176.9	7,487.9	6,474.4	57.4	14.3	7.2	10.7	9.5
Kazakhstan	na	104.6	136.8	2,984.1	2,169.0	1,160.0	60.4	28.6	11.3	1.9	19.6
Kyrgyzstan	na	na	170.0	1,259.0	1,363.0	95.7	31.9	35.0	14.7	18.3	40.0
Moldova	na	na	151.0	2,198.0	837.0	116.0	23.8	15.1	11.2	18.2	30.0
Russia	na	na	161.0	2,506.1	840.0	204.4	128.6	21.8	10.9	84.5	45.0
Tajikistan	na	na	204.0	1,364.0	7,343.7	1.1	2,133.3	40.5	163.6	2.7	55.0
Turkmenistan	na	na	155.0	644.0	9,750.0	1,328.0	1,262.0	446.0	21.5	19.8	40.0
Ukraine	na	na	161.0	2,730.0	10,155.0	401.0	181.0	39.7	10.1	20.0	17.0
Uzbekistan	na	na	169.0	910.0	885.0	1,281.0	117.0	64.0	50.0	26.0	42.0
<i>Commonwealth of Independent States</i>											
Median ¹	na	na	153.0	1,379.5	2,082.5	1,220.5	100.8	31.8	13.0	18.3	35.0
Mean ¹	na	na	140.2	1,672.3	4,584.7	1,391.2	363.0	63.0	32.2	31.2	38.6

Notes:

Data for 1989-97 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1998 are preliminary actuals, mostly official government estimates. Data for 1999 represent EBRD projections. Estimates of inflation for Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

¹ The median is the middle value after all inflation rates have been arranged in order of size. The mean (unweighted average) tends to exceed the median, due to outliers caused by very high inflation rates in certain countries.

Table 3.1.4

General government balances in central and eastern Europe, the Baltic states and the CIS

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998 (estimate)	1999 (projection)	Change 1996-97	Change 1997-98	Change 1998-99
	(in per cent of GDP)											(in percentage points)		
Albania	-9.0	-15.0	-31.0	-20.3	-14.4	-12.4	-10.3	-12.1	-12.6	-10.4	-13.8	-0.5	2.2	-3.4
Bulgaria	na	na	na	-5.2	-10.9	-5.8	-6.4	-10.4	-3.0	1.0	-2.8	7.4	4.0	-3.8
Croatia	na	na	na	-3.9	-0.8	1.6	-0.9	-0.4	-1.3	0.6	-3.6	-0.8	1.9	-4.2
Czech Republic	-2.8	-0.2	-1.9	-3.1	0.5	-1.1	-1.8	-1.1	-2.1	-2.6	-5.0	-0.9	-0.6	-2.4
Estonia	na	na	5.2	-0.3	-0.7	1.3	-1.3	-1.9	2.2	-0.3	-3.0	4.1	-2.5	-2.7
FYR Macedonia	na	na	na	-9.6	-13.8	-2.9	-1.2	-0.5	-0.4	-1.7	-7.8	0.1	-1.3	-6.1
Hungary	-1.4	1.0	-3.0	-7.2	-6.6	-8.4	-6.4	-3.0	-4.8	-4.8	-4.5	-1.8	0.0	0.3
Latvia	na	na	na	-0.8	0.6	-4.0	-3.9	-1.7	0.1	-0.8	-3.8	1.8	-0.9	-3.0
Lithuania	-3.6	-5.4	2.7	0.5	-3.3	-5.5	-4.5	-4.5	-1.8	-5.8	-7.0	2.7	-4.0	-1.2
Poland	-7.4	3.1	-6.7	-6.7	-3.1	-3.1	-2.8	-3.3	-3.1	-3.0	-3.0	0.2	0.1	0.0
Romania	8.4	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-4.0	-3.6	-3.3	-2.7	0.4	0.3	0.6
Slovak Republic	na	na	na	na	-7.0	-1.3	0.2	-1.9	-4.4	-5.8	-3.2	-2.4	-1.5	2.6
Slovenia	0.3	-0.3	2.6	0.2	0.1	-0.3	-0.5	-0.2	-1.7	-1.4	-1.0	-1.5	0.3	0.4
<i>Central and eastern Europe and the Baltic states¹</i>	-2.2	-2.2	-3.6	-5.1	-4.6	-3.4	-3.3	-3.5	-2.8	-3.0	-4.7	0.7	-0.1	-1.8
Armenia	na	na	-1.9	-13.9	-54.7	-10.5	-11.0	-9.3	-5.9	-5.2	-5.5	3.4	0.7	-0.3
Azerbaijan	na	na	na	na	-15.3	-12.1	-4.9	-2.8	-1.7	-4.2	-4.0	1.1	-2.5	0.2
Belarus	na	na	na	0.0	-1.9	-2.5	-1.9	-1.6	-0.7	-0.3	-3.0	-0.9	0.4	-2.7
Georgia	na	na	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	-3.8	-4.4	-3.7	0.6	-0.6	0.7
Kazakhstan	0.0	1.4	-7.9	-7.3	-4.1	-7.5	-2.7	-4.7	-6.8	-8.0	-7.0	-2.1	-1.2	1.0
Kyrgyzstan	2.1	0.3	4.6	-17.4	-13.5	-11.6	-17.3	-9.5	-9.0	-9.9	-7.0	0.5	-0.9	2.9
Moldova	na	na	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	-7.5	-8.1	-4.5	-0.8	-0.6	3.6
Russia	na	na	na	-42.6	-15.9	-9.7	-5.9	-9.1	-8.1	-5.4	-6.0	1.0	2.6	-0.6
Tajikistan	na	na	-16.4	-30.5	-23.4	-5.4	-11.9	-5.8	-3.3	-3.8	-3.0	2.5	-0.5	0.8
Turkmenistan	-1.9	1.2	2.5	13.2	-0.5	-1.4	-1.6	-0.2	0.0	-2.7	-4.0	0.2	-2.7	-1.3
Ukraine	na	na	na	-25.4	-16.2	-9.1	-4.9	-3.2	-5.6	-2.7	-1.5	-2.4	2.9	1.2
Uzbekistan	-0.9	-1.1	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	-2.3	-3.8	-3.8	5.0	-1.5	0.0
<i>Commonwealth of Independent States¹</i>	-0.2	0.5	-3.2	-17.6	-15.8	-7.7	-6.4	-5.4	-4.6	-4.9	-4.4	0.8	-0.3	0.5

Notes:

Data for 1989-97 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1998 are preliminary actuals, mostly official government estimates. Data for 1999 represent EBRD projections. Estimates of government balances for Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

¹ Unweighted average for the region.

Table 3.1.5

Current account balance in central and eastern Europe, the Baltic states and the CIS

(as a percentage of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Change 1997-98	Change 1998-99
Albania	-5.8	-22.1	-66.3	-30.8	-14.2	-7.3	-9.1	-12.2	-6.3	-12.8	5.9	-6.6
Bulgaria	-10.1	-5.4	-9.3	-12.8	-2.1	-0.5	1.2	4.3	-2.3	-5.7	-6.6	-3.4
Croatia	4.2	-3.2	8.0	5.5	5.4	-6.8	-4.4	-12.0	-7.1	-6.8	4.9	0.3
Czech Republic	-2.8	1.2	-1.0	0.3	-0.1	-2.6	-7.4	-6.1	-1.9	-1.1	4.2	0.7
Estonia	na	na	3.3	1.3	-7.3	-4.4	-9.1	-12.1	-9.2	-6.3	2.9	2.9
FYR Macedonia	na	-5.6	-0.8	0.6	-5.7	-5.2	-6.5	-7.4	-9.0	-8.8	-1.6	0.1
Hungary	0.4	0.8	0.9	-9.0	-9.4	-5.6	-3.7	-2.1	-4.8	-5.4	-2.7	-0.6
Latvia	na	na	1.7	14.4	-0.2	-3.6	-4.2	-6.1	-11.1	-8.0	-5.0	3.2
Lithuania	na	na	10.6	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.3	-1.9	2.7
Poland	1.0	-2.6	1.1	-0.7	2.5	4.6	-1.0	-3.1	-4.5	-5.5	-1.4	-1.0
Romania	-4.7	-4.5	-7.8	-4.7	-1.7	-4.9	-7.3	-6.2	-7.9	-7.0	-1.7	0.9
Slovak Republic	na	na	na	-5.0	4.8	2.3	-11.2	-10.0	-10.1	-5.2	-0.1	5.0
Slovenia	3.0	1.0	7.4	1.5	4.2	-0.1	0.2	0.2	0.0	-0.7	-0.2	-0.7
<i>Central and eastern Europe and the Baltic states¹</i>	<i>-1.9</i>	<i>-4.5</i>	<i>-4.4</i>	<i>-3.3</i>	<i>-2.0</i>	<i>-3.4</i>	<i>-5.5</i>	<i>-6.4</i>	<i>-6.6</i>	<i>-6.5</i>	<i>-0.2</i>	<i>0.1</i>
Armenia	na	na	-70.4	-68.1	-35.7	-37.5	-26.8	-28.0	-26.7	-25.8	1.4	0.9
Azerbaijan	na	19.1	na	0.2	-9.2	-13.1	-25.5	-23.7	-33.1	-27.2	-9.4	6.0
Belarus	na	na	na	-30.4	-13.2	-2.4	-3.6	-5.9	-6.6	-4.8	-0.8	1.8
Georgia	na	na	-33.5	-40.2	-22.3	-7.6	-6.1	-7.2	-7.5	-5.9	-0.3	1.6
Kazakhstan	na	na	-31.5	-2.6	-7.7	-3.1	-3.6	-4.0	-5.6	-4.7	-1.5	0.9
Kyrgyzstan	na	na	-1.8	-18.5	-11.3	-16.2	-23.4	-7.9	-16.7	-10.8	-8.9	6.0
Moldova	na	na	-3.0	-11.9	-5.8	-9.0	-13.4	-13.5	-19.7	-20.3	-4.1	-0.6
Russia	na	na	na	na	3.4	2.3	2.8	0.7	0.9	5.5	0.2	4.6
Tajikistan	na	na	18.4	-29.9	-21	-18.7	-7.3	-5.0	-10.8	-4.2	-5.8	6.5
Turkmenistan	na	na	na	14.1	3.8	0.9	2.2	-28.2	-45.8	-9.3	-17.6	36.5
Ukraine	na	na	-2.9	-2.4	-3.7	-3.2	-2.5	-3.0	-2.8	-1.3	0.2	1.5
Uzbekistan	na	na	-11.9	-8.4	2.1	-0.2	-8.6	-6.0	-1.7	-3.4	4.3	-1.7
<i>Commonwealth of Independent States¹</i>	<i>na</i>	<i>na</i>	<i>-17.1</i>	<i>-16.1</i>	<i>-14.3</i>	<i>-9.2</i>	<i>-9.7</i>	<i>-11.0</i>	<i>-14.5</i>	<i>-9.3</i>	<i>-3.5</i>	<i>5.2</i>
Central and eastern Europe, the Baltic states and the CIS¹	na	na	-10.7	-9.7	-8.2	-6.3	-7.6	-8.7	-10.7	-7.8	-1.8	2.5

Notes:

Data for 1990-97 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1998 are preliminary actuals, mostly official government estimates. Data for 1999 represent EBRD projections.

¹ Unweighted average for the region.

Table 3.1.6

Foreign direct investment

(Net inflows recorded in the balance of payments)

	1989	1990	1991	1992	1993	1994	1995	1996	1997 (revised)	1998 (estimate)	1999 (projection)	Cumulative FDI-inflows 1989-98 per capita	FDI-inflows per capita 1997	FDI-inflows per capita 1998	FDI-inflows 1997	FDI-inflows 1998
						(in US\$ millions)						(in US\$ millions)			(in US\$)	
Albania	-	-	8	32	45	65	89	97	42	45	43	423	13	14	1.9	1.5
Bulgaria	-	-	56	42	40	105	82	100	497	401	700	1,323	60	48	4.8	3.1
Croatia	-	-	-	13	77	95	83	529	346	854	750	1,997	72	190	1.8	4.2
Czech Republic	-	-	-	983	552	749	2,526	1,388	1,275	2,485	3,500	9,957	124	241	2.5	4.5
Estonia	-	-	-	-	156	212	199	111	130	575	350	1,382	89	396	2.8	10.6
FYR Macedonia	-	-	-	-	-	24	13	12	18	175	30	242	9	88	0.5	5.7
Hungary	187	311	1,459	1,471	2,339	1,146	4,453	1,987	1,653	1,453	1,550	16,459	163	144	3.7	3.1
Latvia	-	-	-	43	51	155	244	376	515	220	150	1,604	206	88	9.3	3.5
Lithuania	-	-	-	-	30	31	72	152	328	921	400	1,534	89	249	3.4	8.9
Poland	-	-	117	284	580	542	1,134	2,768	3,041	6,600	6,500	15,066	79	171	2.2	4.5
Romania	-	18	37	73	97	341	417	263	1,224	2,040	1,345	4,510	54	90	3.5	4.7
Slovak Republic	-	24	82	100	168	250	202	251	177	508	500	1,762	33	94	0.9	2.5
Slovenia	-	-2	41	113	111	131	170	178	295	154	210	1,192	148	77	1.6	0.8
<i>Central and eastern Europe and the Baltic states</i>	187	351	1,800	3,154	4,246	3,847	9,683	8,212	9,541	16,431	16,028	57,451	30	53	1.1	2.1
Armenia	-	-	-	-	-	3	19	22	52	232	150	328	14	63	3.2	12.6
Azerbaijan	-	-	-	-	20	22	282	661	1,093	1,024	780	3,102	144	135	28.4	24.9
Belarus	-	-	-	-	18	11	15	73	198	141	188	456	19	14	1.5	1.0
Georgia	-	-	-	-	-	8	6	54	236	221	96	526	44	41	4.5	4.3
Kazakhstan	-	-	-	-	473	635	964	1,137	1,320	1,132	800	5,661	84	74	5.9	5.1
Kyrgyzstan	-	-	-	-	10	45	96	46	83	52	64	332	18	11	4.7	3.1
Moldova	-	-	-	17	14	18	73	56	64	88	170	330	15	20	2.9	5.1
Russia	-	-	-	-	-	539	1,710	1,700	3,752	1,200	3,500	8,901	25	8	0.8	0.4
Tajikistan	-	-	-	-	9	12	20	25	30	34	29	130	5	6	2.7	2.8
Turkmenistan	-	-	-	-	79	103	233	129	108	110	100	762	23	23	5.9	5.2
Ukraine	-	-	-	200	200	100	300	526	600	700	600	2,626	12	14	1.2	1.7
Uzbekistan	-	-	-	9	48	73	-24	90	167	170	226	533	7	7	1.2	1.2
<i>Commonwealth of Independent States</i>	-	-	-	226	871	1,568	3,684	4,520	7,703	5,104	6,703	23,687	11	7	0.4	0.3
Total	187	351	1,800	3,380	5,117	5,415	13,377	12,732	17,244	21,535	22,731	81,138	17	17	0.7	0.7

Sources: IMF, central banks and EBRD estimates.

Notes:

For most countries, figures only cover investment in equity capital and in some cases contributions in kind. For those countries (e.g. Estonia, Slovak Republic)

where net investment into equity capital was not easily available, more recent data include reinvested earnings as well as inter-company debt transactions.

The increasing outward FDI flows of transition economies are driving a wedge between net and gross FDI inflows. In 1998, for example, gross inflows

exceeded net inflows by 15% in Croatia, 30% in the Slovak Republic, 7% in Slovenia, and 36% in Russia.

Table 3.1.7

GDP growth forecasts for 1999

(in per cent)

	Average ¹	Range ²	EBRD (Aug 99)	European Union (March 99)	OECD (June 99)	IMF (Sept 99)	United Nations DESA ⁴ (July 99)	Economist Intelligence Unit (July 99)	PlantEcon (June 99)	IWH ⁵ (July 99)	Kopint-Datorg ⁶ (Sept 99)	Vienna Institute (June 99)	CSFB ⁷ (Sept 99)	JP Morgan (Sept 99)	Dun & Bradstreet (July 99)
Central and eastern Europe and the Baltic states															
Albania	5.5	5.0	8.0	—	—	8.0	3.0	6.0	5.4	—	—	—	—	—	5.5
Bulgaria	0.4	5.5	0.0	3.5	—	1.5	0.0	-1.0	2.1	0.0	-1.0	-2.0	-0.5	—	2.0
Croatia	-1.0	3.4	-0.5	—	—	-2.0	-2.0	-2.0	1.4	—	-1.5	-1.5	-0.5	—	-0.8
Czech Republic	-0.6	2.3	0.0	0.3	-0.5	0.0	-1.0	-1.8	-0.4	-1.0	-0.7	-1.5	-1.0	0.5	-0.7
Estonia	1.9	4.9	0.0	3.6	—	0.5	1.0	0.5	4.9	4.0	0.8	—	—	—	2.2
FYR Macedonia	-5.6	15.0	0.0	—	—	-4.0	-10.0	-15.0	-2.4	—	—	0.0	—	—	-6.0
Hungary	3.7	1.5	3.0	4.0	4.1	3.7	3.5	3.0	3.8	4.0	3.7	3.7	3.5	4.0	4.5
Latvia	2.0	3.9	1.5	3.8	—	2.0	1.0	0.0	3.9	3.5	0.7	—	—	—	1.6
Lithuania	2.1	3.6	0.0	3.6	—	0.5	1.5	0.5	4.1	3.0	1.3	—	—	—	3.0
Poland	3.3	2.0	3.5	3.7	3.5	3.7	3.5	2.9	3.8	3.5	3.3	3.5	2.0	2.0	4.0
Romania	-4.3	3.9	-4.0	-4.1	—	-3.5	-4.0	-5.0	-2.1	-5.0	-6.0	-5.0	-4.0	—	-5.0
Slovak Republic	0.8	4.2	1.8	2.1	2.0	0.7	-2.0	-2.0	1.6	2.0	0.5	0.0	0.0	—	2.2
Slovenia	2.9	1.4	3.5	3.5	—	3.0	3.0	2.8	3.0	3.0	3.0	2.5	2.6	—	2.1
Average	0.8	3.3	1.3	2.4	2.3	1.1	-0.2	-0.9	2.2	1.7	0.4	0.0	0.3	2.2	1.1
Weighted average ³	1.4	—	1.6	—	—	1.7	1.2	0.6	2.3	—	—	—	—	—	1.8
Commonwealth of Independent States															
Armenia	4.2	2.5	4.0	—	—	3.5	4.0	6.0	3.6	—	—	—	—	—	—
Azerbaijan	5.4	3.1	3.7	—	—	3.8	6.0	6.0	6.8	—	—	—	—	—	6.0
Belarus	-1.3	10.3	1.5	—	—	-2.0	-1.0	0.0	-7.3	-2.0	—	—	—	—	3.0
Georgia	2.4	1.0	3.0	—	—	2.0	2.0	3.0	3.0	—	—	—	—	—	2.5
Kazakhstan	-3.1	5.5	-1.7	—	—	-1.5	-3.0	-2.5	-2.3	—	—	—	—	—	-7.0
Kyrgyzstan	1.3	4.0	0.0	—	—	2.7	3.0	-1.0	2.2	—	—	—	—	—	1.0
Moldova	-5.2	4.0	-5.0	—	—	-5.0	-3.0	-7.0	-6.0	—	—	—	—	—	—
Russia	-1.5	6.2	0.0	—	-1.0	0.0	-4.0	-3.0	-1.5	-4.0	-0.5	-2.0	0.0	2.2	-4.0
Tajikistan	4.1	3.6	5.0	—	—	5.5	3.0	2.0	5.6	—	—	—	—	—	3.0
Turkmenistan	10.9	13.5	17.0	—	—	18.5	5.0	9.0	9.0	—	—	—	—	—	7.0
Ukraine	-2.4	2.0	-2.5	—	—	-2.5	-3.0	-3.2	-1.2	-2.0	-2.5	-2.0	-2.5	—	-2.5
Uzbekistan	0.6	4.6	3.0	—	—	2.1	1.0	-1.0	2.6	—	—	—	—	—	-2.0
Average	1.3	4.9	2.3	—	—	2.3	0.8	0.7	1.2	-2.7	-1.5	-2.0	-1.3	—	0.7
Weighted average ³	-1.3	—	-0.0	—	—	-0.2	-3.2	-2.5	-1.3	—	—	—	—	—	—

Notes:

All forecasts quoted here were published or reported to the EBRD between March and September 1999. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

1 The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

2 This column shows the difference between the highest and the lowest of the forecasts.

3 The weighted average is calculated using nominal dollar GDP in 1998 as weights.

Several institutions calculate their own weighted average. In 1999, the IMF estimates growth in eastern Europe, including Moldova, at 1.7%, Belarus and Ukraine at 1.0%, and Transcaucasus and Central Asia at 2.0%. The EU estimates the weighted average growth rate for 10 countries in central and eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 2.3% in 1999. The UN/DESA estimates the weighted average growth rate in 1999 for central and eastern Europe and the Baltic States at 1.3%, and for the CIS region at -3.3%.

4 United Nations, Department of Economic and Social Affairs, NY.

5 Institute for Economic Research, Halle, Germany.

6 Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.

7 Credit Suisse First Boston.

Table 3.1.8

GDP growth forecasts for 2000

(in per cent)

	Average ¹	Range ²	EBRD (Aug 99)	European Union (March 99)	OECD (June 99)	IMF (Sept 99)	United Nations DESA ⁴ (July 99)	Economist Intelligence Unit (July 99)	PlantEcon (June 99)	IWH ⁵ (July 99)	Kopint-Datorg ⁶ (Sept 99)	Vienna Institute (June 99)	CSFB ⁷ (Sept 99)	JP Morgan (Sept 99)	Dun & Bradstreet (July 99)
Central and eastern Europe and the Baltic states															
Albania	6.4	4.7	5.0	–	–	8.0	4.0	8.0	8.7	–	–	–	–	–	4.9
Bulgaria	2.9	3.2	2.5	4.0	–	3.0	3.0	3.0	4.7	1.5	2.0	2.0	3.0	–	2.5
Croatia	1.4	3.5	1.0	–	–	0.0	0.0	0.0	3.5	–	2.5	0.0	2.0	–	0.7
Czech Republic	1.9	2.2	2.0	1.4	2.4	1.5	1.5	1.0	2.8	1.5	1.5	2.0	3.0	3.2	1.0
Estonia	4.3	3.2	3.0	5.0	–	–	–	3.5	6.1	5.0	3.8	–	–	–	2.9
FYR Macedonia	1.9	5.6	3.0	–	–	0.0	0.0	0.0	5.6	–	–	0.0	–	–	2.0
Hungary	3.9	2.4	4.0	4.5	3.2	4.5	3.0	2.6	5.0	4.0	3.5	4.0	3.5	4.5	4.8
Latvia	3.3	3.6	3.0	4.9	–	4.0	–	2.5	4.3	3.0	3.5	–	–	–	1.3
Lithuania	3.6	2.4	2.5	4.9	–	4.0	–	2.5	4.3	4.0	4.0	–	–	–	2.5
Poland	4.3	1.3	4.5	3.9	5.0	5.0	4.0	4.2	5.0	4.0	4.5	4.0	4.0	4.0	3.7
Romania	0.4	7.0	1.5	-2.1	–	2.5	2.0	1.0	4.0	-1.0	0.0	0.0	-1.0	–	-3.0
Slovak Republic	1.4	6.9	1.5	3.4	2.0	4.9	0.0	0.0	3.1	0.0	0.5	-2.0	1.0	–	2.5
Slovenia	3.3	2.0	3.5	3.8	–	3.8	3.0	3.2	3.7	4.0	3.5	3.0	3.2	–	2.0
Average	3.0	3.2	2.8	3.4	3.2	4.1	2.1	2.4	4.7	2.6	2.7	1.4	2.3	3.9	2.1
Weighted average ³	3.1	–	3.2	–	–	3.9	–	2.6	4.4	–	–	–	–	–	2.4
Commonwealth of Independent States															
Armenia	5.7	3.7	5.5	–	–	8.0	–	8.0	4.3	–	–	–	–	–	–
Azerbaijan	5.4	4.4	3.0	–	–	7.0	–	7.0	7.2	–	–	–	–	–	7.0
Belarus	-1.2	7.9	0.0	–	–	2.0	–	2.0	-5.9	-5.0	–	–	–	–	2.0
Georgia	5.1	1.4	4.0	–	–	6.0	–	6.0	4.6	–	–	–	–	–	5.0
Kazakhstan	2.6	1.0	2.0	–	–	2.0	–	2.0	3.0	–	–	–	–	–	3.0
Kyrgyzstan	2.6	1.5	2.0	–	–	2.0	–	2.0	3.1	–	–	–	–	–	2.5
Moldova	0.8	1.3	1.0	–	–	0.0	–	0.0	1.3	–	–	–	–	–	–
Russia	0.9	3.2	1.0	–	2.0	2.0	0.0	0.0	1.0	1.0	0.5	1.0	1.0	2.2	-1.0
Tajikistan	5.1	2.0	6.0	–	–	4.0	–	4.0	5.6	–	–	–	–	–	4.0
Turkmenistan	3.7	6.0	5.0	–	–	5.0	–	5.0	4.7	–	–	–	–	–	5.0
Ukraine	-0.1	2.0	0.5	–	–	0.0	0.0	0.0	0.5	0.0	-0.5	0.0	-1.5	–	0.2
Uzbekistan	2.4	2.7	1.0	–	–	2.0	–	2.0	3.9	–	–	–	–	–	3.0
Average	2.7	4.5	2.6	–	–	2.4	0.0	3.2	2.8	-1.3	0.0	0.5	-0.3	–	3.1
Weighted average ³	1.0	–	1.1	–	–	1.8	–	0.5	1.1	–	–	–	–	–	–

Notes:

All forecasts quoted here were published or reported to the EBRD between March and September 1999. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

1. The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

2. This column shows the difference between the highest and the lowest of the forecasts.

3. The weighted average is calculated using nominal dollar GDP in 1998.

Several institutions calculate their own weighted average. In 2000, the IMF estimates growth in eastern Europe including Moldova at 4.0%, Belarus and Ukraine at 3.3%, and Transcaucasus and Central Asia at 2.9%. The EU estimates the weighted average growth rate for 10 countries in central and eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 3.2% in 2000. The UN/DESA estimates the weighted average growth rate for central and eastern Europe (excluding the Baltic states) at 2.7% in 2000.

4. United Nations, Department of Economic and Social Affairs, NY.

5. Institute for Economic Research, Halle, Germany.

6. Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.

7. Credit Suisse First Boston.

Annex 3.2: Kosovo crisis and transition prospects in south-eastern Europe

The first decade of transition in south-eastern Europe

Historically, south-eastern Europe has been the least developed region of Europe. Initial conditions at the onset of the transition process were less favourable than those in other countries in the region (in terms, for instance, of an unbalanced industrial structure, lack of traditions in institutional development, large debt burden in some countries, and distance from the west European market).

Over the past decade, the transition economies in south-eastern Europe experienced increasing divergence with the rest of Europe. Per capita GDP (on a purchasing power parity basis) drifted from 33 per cent of the EU average in 1990 to 24 per cent in 1998. As discussed in Chapter 3, the transition recession in the central European economies lasted for some three to four years, and output decline was in the order of 15 per cent of the 1989 output level. In contrast, the cumulative decline in south-eastern Europe was much greater – in the order of 30 per cent of the 1989 output level – and the recovery has been slower (see Chart 3.2.1). Across the region, growth continues to look fragile and many countries still face problems of macroeconomic stabilisation. This has been especially pronounced over the past three years, when a number of countries have experienced stark macroeconomic reversals (Albania, Bulgaria and Romania – see Chapter 3).

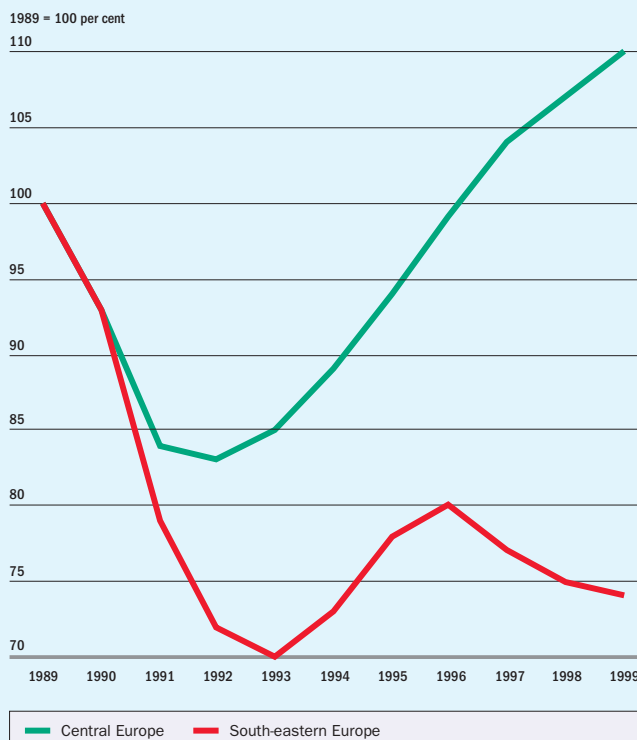
Commitment to reform in south-eastern Europe has been “stop-go”. Chart 3.2.2 shows that across-the-board structural reforms have lagged behind those of central and eastern Europe and the Baltic states (CEE), although progress has been greater than in the Commonwealth of Independent States (CIS). Considerable progress has been made in liberalising markets and trade and foreign exchange systems. With the exception of Bosnia and Herzegovina, the private sector currently generates the majority of GDP in all countries in the region. Nevertheless, many of the challenges of economic policy remain those of the early transition. This includes the privatisation of key industries and the imposition of financial discipline on enterprises and banks. Most importantly, as illustrated by Chart 3.2.2, the region has made little progress in establishing the legal and social institutions that underpin effective markets and provide the predictability, fairness and transparency required for private investment.

The slower implementation of key structural reforms (privatisation, enterprise restructuring and corporate governance) is reflected in productivity trends (see Chart 3.2.3). Whereas CEE’s productivity in 1998 was almost one-and-a-half times as high as the 1989 level, in south-eastern Europe it reached only about 90 per cent of its 1989 level. Deeper enterprise restructuring will be needed to sustain productivity improvements achieved primarily through the shedding of jobs during the first years of the transition (see Chapter 8).

Chart 3.2.1

Index of real GDP

(Weighted averages for central and south-eastern Europe)



Source: Table 3.1.1.

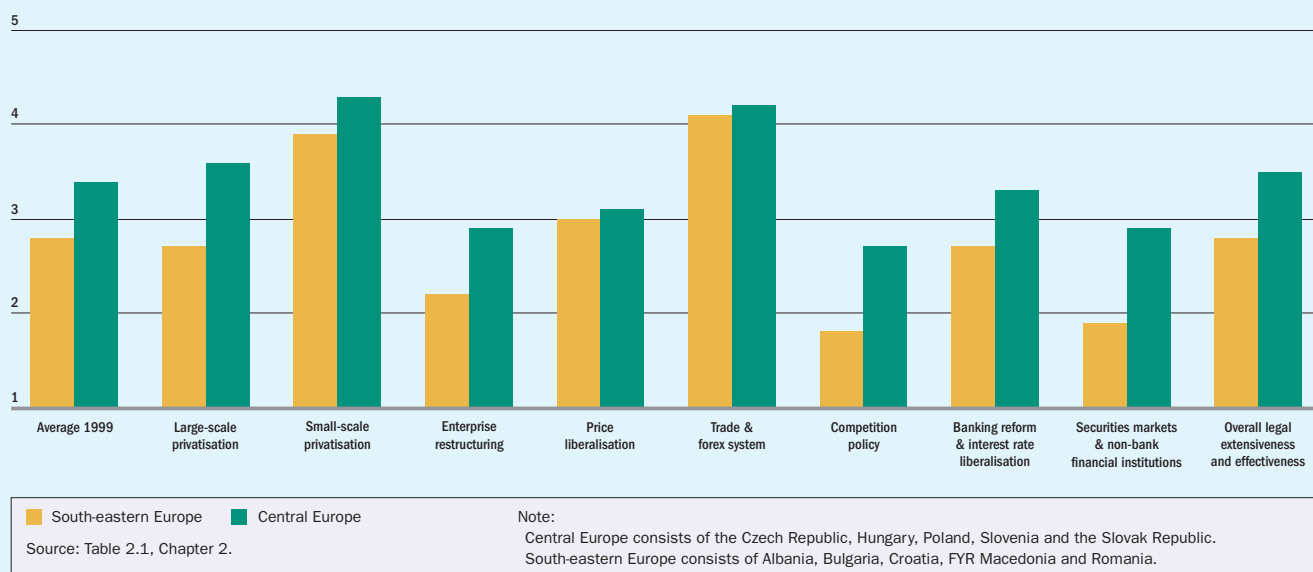
Note:

Weights are computed from GDP in US dollars in 1989 at PPP exchange rates. Central Europe consists of the Czech Republic, Hungary, Poland, Slovenia and the Slovak Republic. South-eastern Europe consists of Albania, Bulgaria, Croatia, FYR Macedonia and Romania. Figures for 1999 are forecasts.

As illustrated by Chart 3.2.4, per capita foreign direct investment (FDI) inflows have been consistently lower in south-eastern Europe than in the more advanced transition economies in central Europe. Although the economic potential of the region continues to be significant, countries have differed in their willingness and ability to unlock this potential through structural and institutional reforms. The limited FDI inflows into south-eastern Europe compared with the more advanced countries of central Europe are due to fewer privatisation-related opportunities and a relatively less favourable investment climate. Throughout south-eastern Europe, the quality of the investment climate – especially relating to corruption and the public administration – registers in the bottom half of the economies in transition (see Chapter 6). There is a perception of cronyism and unpredictability in the implementation of taxes and other acts of public administration. As in other transition economies, the burden is greatest for smaller businesses.

Chart 3.2.2

1999 transition indicators



In spite of the general trends outlined above, there are many differences between countries in south-eastern Europe. Some countries of the region have been more effective in implementing reforms than others. Following the crisis in Bulgaria in late 1996, the country has deepened its commitment to reform, and significant progress has been made with privatisation. Nevertheless, due to years of depletion of plant and equipment and low rates of investment, the economy is vulnerable to external shocks. In Romania, stop-go reform policies have not brought about sustainable macroeconomic growth. Following several years of stagnation, there was a modest economic recovery in FYR Macedonia in 1998. However, it is strongly dependent on trade, and especially vulnerable to external disturbances. Albania and Bosnia and Herzegovina are, along with the Federal Republic of Yugoslavia (FRY), probably the two poorest countries in Europe, and have been damaged by war and political chaos in recent years. They are both heavily dependent on the inflow of foreign resources. The per-capita income of Croatia is the highest in south-eastern Europe and it has implemented by far the most structural reforms of all countries in the region.

With a population of around 10 million, FRY, which is not a member of the EBRD, could be one of the larger economies in the region. However, the economy has been in decline for much of the 1990s. It is estimated that the GDP decline has been the largest of all CEE transition economies: GDP fell by more than half during the first four years of transition, and grew at an annual rate of 2.5-7.5 per cent between 1994 and 1998. Nevertheless, during the second half of the 1990s, the Yugoslav economy has continued to experience persistent and severe macroeconomic imbalances. The country has also suffered from the break-up of the former republics, leading to a loss of markets, and from years of conflict and international sanctions. Very little progress has been made in restructuring the economy and advancing the process of transition to a market economy, including the establishment of a democratic political system.

Impact of the war

The Kosovo crisis came at a time when the region was already facing challenging economic problems and worsening external conditions (global financial turmoil, the Russian crisis, falling global demand and the collapse of world commodity prices). As shown in Table 3.2.1, the Kosovo crisis has had a significant negative impact on the countries in the region. The weighted average growth forecast by the EBRD for the region for 1999 fell from 0.3 per cent before the onset of the war to -1.1 per cent in August 1999.¹ The forecasts for the current account balance and the trade deficit have also increased, and net FDI estimates are somewhat lower than six months ago.

The Kosovo crisis has affected the economies of countries in the vicinity of FRY in a number of ways:

Refugees

The temporary displacement of refugees put a heavy strain on the social and economic infrastructure of neighbouring countries, especially Albania and FYR Macedonia – which together accommodated about 700,000 refugees at the peak of the crisis. While a large part of the direct costs of providing humanitarian relief to refugees was borne by foreign agencies, the budgets of the host countries were affected, for instance by increased spending for public order, putting pressure on their already weak fiscal positions.

Trade

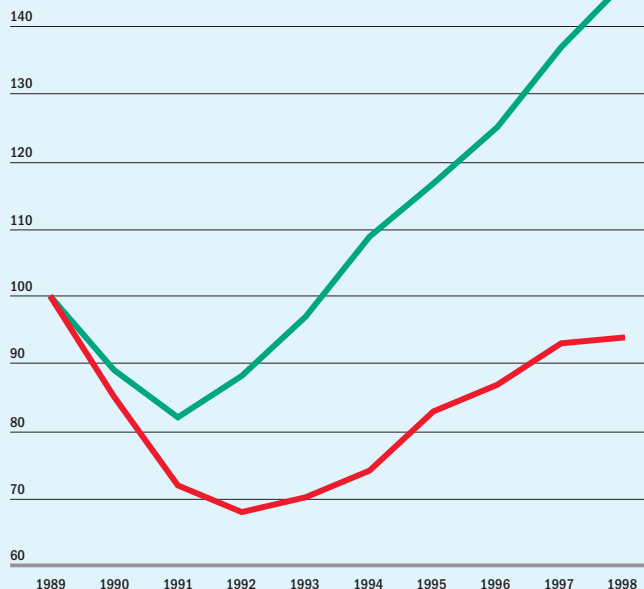
Most economies neighbouring FRY have been affected to a greater or lesser degree by disruptions to their trade. Reduced export revenues, higher costs of essential imports and in some cases trade diversion will exert pressure on current accounts across the region. The loss of the Yugoslav market has had a significant impact on FYR Macedonia, which used to send around 20 per cent of its exports to FRY. However, preliminary data suggest that, at least in the case of FYR Macedonia, exports to FRY have started to pick up again.

¹ Weights are US\$ GDP at current exchange rates, lagged by one year.

Chart 3.2.3

Productivity index

(Weighted averages for central and south-eastern Europe)

1989 = 100 per cent
150

Central Europe South-eastern Europe

Source: Table 3.1.2.

Note:

Central Europe consists of the Czech Republic, Hungary, Poland, Slovenia and the Slovak Republic. South-eastern Europe consists of Bulgaria, Croatia, FYR Macedonia and Romania.

Most countries in the region have been, and to some extent continue to be, affected by the disruption to transport routes. The River Danube and Serbian roads and railways provide key routes from south-eastern Europe to western Europe, which is the main trading partner for all countries in the region with the exception of Bosnia and Herzegovina. Re-routing has offered only partial relief as alternative routes lack capacity. This has resulted in reduced volumes, raised costs and excessive travel time (ruling out the export of some perishables including seasonal fruits and vegetables). It is estimated that the closure of Serbia raised transport costs in some cases by up to 50 per cent for exports from Bulgaria and FYR Macedonia to the EU. Although restoration work to the transport and storage infrastructure in FRY is under way, some transit trade will continue to be diverted for some time to come.

Investment

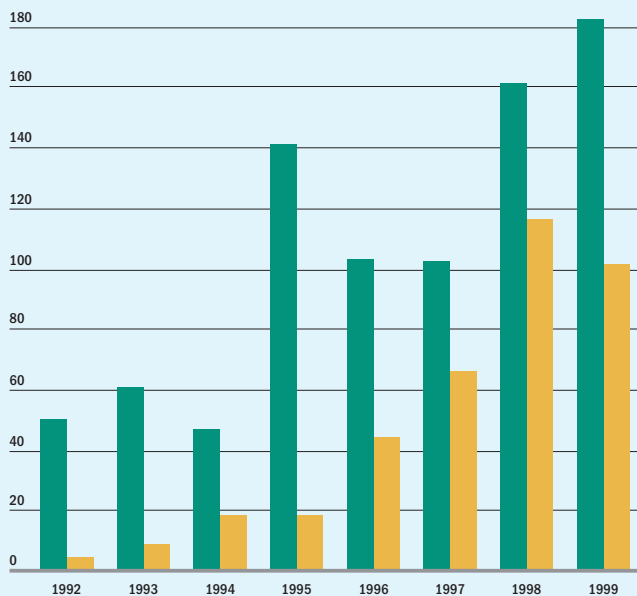
The uncertainty engendered by the crisis has had an adverse impact on the confidence of investors and consumers, affecting spending and the current and capital accounts. Initially, the conflict in FRY disrupted debt issuance by some transition economies, but conditions eased relatively quickly. In most countries spreads recovered quickly, although some borrowers (for instance, the city of Sofia) were forced to postpone Eurobond issues for a short period during the conflict.

There are no indications of a widespread collapse in FDI. A number of countries have made progress with privatisation-

Chart 3.2.4

Foreign direct investmentNet inflows recorded in the balance of payments
(in US dollars per capita)

200



Central Europe South-eastern Europe

Source: Table 3.1.6.

Note:

Central Europe consists of the Czech Republic, Hungary, Poland, Slovenia and the Slovak Republic. South-eastern Europe consists of Albania, Bulgaria, Croatia, FYR Macedonia and Romania. Figures for 1999 are forecasts.

related sales of large assets (for instance, Bulgaria and Croatia), including in finance and infrastructure. Proceeds of these sales can play an important role in helping to cover budget and external deficits.

Structural reform

There is no clear evidence that the crisis in Kosovo has affected the willingness or the pace of structural reform efforts in the region. All countries in the region have continued, and on some occasions even accelerated, difficult reforms during the course of 1999.

Tourism

Croatia has been hurt by a loss of tourism receipts.

The overall impact of each of the factors outlined above has differed from country to country, as outlined in Table 3.2.2.

The most direct and visible impact of the war is clearly the damage inflicted on FRY by months of air strikes and by the hostilities within Kosovo. Apart from the very high cost in terms of human life, the hostilities have caused extensive physical damage – estimated by the EU to be in the range of US\$ 2 billion. The greatest destruction was to the housing stock, but communications (especially the telephone system) and the power supply have also been damaged. Key equipment and personal property were looted. Following a decade of decline, rehabilitation costs are likely to be much higher than an assessment of war-related

Table 3.2.1

The impact of the Kosovo crisis

	Incremental balance of payment gap ¹	Incremental budgetary gap ¹	GDP growth ²		Current account ^{2,3}		Trade balance ²		Net foreign direct investment ²	
			April 99	September 99	April 99	September 99	April 99	September 99	April 99	September 99
	(in millions of US\$)	(in millions of US\$)	(percentage change)		in millions of US\$ (in per cent of GDP)		(in millions of US\$)		(in millions of US\$)	
Albania	133	111	5.0	8.0	-272 (-7.5)	-450 (-12.5)	-729	-1,151	94	43
Bosnia and Herzegovina	90	90	16.0	12.0	-1,044 (-22)	-990 (-22)	-1,582	-1,433	na	na
Bulgaria	98	45	2.0	0.0	-500 (-3.9)	-650 (-5.7)	-600	-1,000	1,000	700
Croatia	173	98	1.0	-0.5	-1,111 (-5.7)	-1,355 (-6.8)	-3,713	-3,526	500	750
FYR Macedonia	304	196	4.0	0.0	-258 (-8.4)	-300 (-8.8)	-400	-350	100	30
Romania	240	50	-3.0	-4.0	-1,500 (-5.0)	-2,195 (-7)	-1,100	-1,984	1,400	1,345
Total	1,038	590	-	-	-	-	-	-	-	-
<i>Average⁴</i>	-	-	0.3	-1.1	-	-	-1,354	-1,603	619	574

1 IMF estimates, July 1999.

2 EBRD forecasts.

3 The current account figure for Bosnia and Herzegovina excludes official transfers.

4 Unweighted averages, except for GDP growth. The weights used were EBRD estimates of nominal dollar-GDP lagged by one year.

damages suggests. Enterprises have lacked capital investment, banks were technically bankrupt prior to the crisis, and there were few institutions supportive of a modern market economy. Further problems are caused by the loss of economic and corporate ties with the rest of FRY, and in some cases by the departure of Kosovo Serb managers and staff.

Although there is a lack of independent and reliable information, there is no doubt that the conflict has had a significant impact on the rest of FRY, with extensive damage to the infrastructure and the productive capacity of the country. There seem to be only limited signs of recovery so far: domestic consumption is not recovering, investments are virtually non-existent and exports are not growing. According to Group 17, the decline in industrial production for 1999 is around 45 per cent and exports are estimated to be half of the total recorded in 1998. Total GDP in 1999 is estimated to have declined by over 40 per cent, bringing GDP per capita from around half of its 1989 level in 1998 to less than one-third in 1999. Furthermore, the cost of financing operations in Kosovo has put pressure on the budget and has been financed, at least partly, by an increase in the money supply. Inflation was already running at 40 per cent before the crisis and has increased subsequently.

Reconstruction and recovery in south-eastern Europe New regional initiatives

One of the broader effects of the Kosovo crisis has been to focus public attention on south-eastern Europe as a region – and its potential for instability. It has prompted the launching by the international community of a major new initiative, the “Stability Pact for South-Eastern Europe”.² This aims to support countries in south-eastern Europe in their efforts to foster peace, democracy, respect for human rights and economic prosperity in order to achieve stability in the whole region. The economic integration of the region, within itself and into the European and world

economies, is a central objective under the Pact. The EU appointed a Special Co-ordinator for the Stability Pact. The Pact's main organisational structure is the South-East European Regional Table, which meets periodically, bringing together representatives of the participant countries. The Regional Table reviews progress in implementing the Pact's projects and initiatives, and provides guidance for advancing its objectives. The Regional Table ensures coordination among three working tables on democracy, economic reconstruction and security.

In the context of the Pact, the EU has launched a Stability and Association Process. This focuses on progressive integration into EU structures as a way of promoting regional cooperation, security and development. Its main instrument will be “Stability and Association Agreements”. The process offers the eventual prospect of EU membership, and may therefore improve the confidence of foreign investors in the stability of the policy and administrative environment.

Details of the agreements remain sketchy, partly because they are to be tailored to each country's initial conditions. Albania, Bosnia and Herzegovina, Croatia, FRY and FYR Macedonia are in principle eligible. Conditions for opening negotiations relate to democracy, rule of law, human rights, economic reform, good neighbourly relations and compliance with the Dayton Accord (for Bosnia and Herzegovina, Croatia and FRY). It is likely that negotiations will begin first with FYR Macedonia and Albania.

Serbia is at the heart of the region, and the whole of south-eastern Europe would benefit from its recovery. As also recognised by the Pact, lasting peace and stability will become possible only when democratic principles and values have taken root throughout the region, including in FRY. Pact members are considering ways in which the Republic of Montenegro (part of FRY) can become an early beneficiary of the Pact.

² The “Stability Pact” is an initiative of the EU, endorsed at the Cologne G-7 summit. It was formally launched at the Sarajevo summit. Participants include the beneficiary countries in south-eastern Europe, several other central and east European countries, the EU and other main Western donors as well as a number of international organisations.

Table 3.2.2

Economic impact of Kosovo crisis on neighbouring countries, 1999

	Humanitarian	Direct trade with FRY	Transit trade through FRY	Financial (access to capital market, FDI)	Tourism	GDP growth in 1999
Albania	Very large impact: over 450,000 refugees (14% of population)	Small impact: exports to FRY were less than 3% in 1997	Negligible impact: 70% of trade goes to Italy and Greece	Small impact: private foreign investment negligible	Negligible impact	Reduction in industrial production is offset by boost to service sector
Bosnia and Herzegovina	Small impact: less than 1% of population (also from other parts of Serbia)	Small impact for the Federation but large impact for Rep. Srpska – FRY is a major export market	Small impact	Small impact: private foreign investment negligible	Negligible impact	Lower growth is driven by decline in exports to FRY
Bulgaria	Negligible impact	Small impact: 2% of exports went to FRY in 1997	Very large impact: an estimated 50% of exports used to go through FRY	Moderate impact: no decline in foreign investor interest, but municipal Eurobond issue was postponed	Moderate impact: decline in tourists from FRY is offset by increase in tourists from EU	Lower growth forecast driven by poor export performance
Croatia	Negligible impact	Negligible impact	Negligible impact: FRY was not a major transit route	Low impact: no evidence of decline in foreign investor interest	Large impact: tourism revenue is major source of foreign exchange	Lower growth forecast driven mainly by domestic factors
FYR Macedonia	Very large impact: 260,000 refugees (13% of population)	Large impact: 10% of exports went to FRY in 1997	Very large impact: nearly 60% of exports were transited through FRY	Moderate impact: some decline in foreign investor interest	Negligible impact	Lower growth forecast due to difficulty in exporting and costs associated with refugees
Romania	Negligible impact	Small impact: less than 2% of exports go to FRY	Moderate impact: curtailment of trade related to Danube traffic	Low impact: driven by domestic factors	Negligible impact	Lower growth forecast driven by domestic factors

Source: EBRD staff assessments.

Structural change in transition

The previous two chapters assessed the progress in reforms and economic performance in the transition countries. This chapter focuses on structural change as a key link between the two. Structural change has always been at the centre of the economic analysis of transition.¹ Economic reforms were generally expected to lead to a substantial reallocation of resources in transition economies, rectifying the distortions inherited from the previous regime's central planning. This reallocation in turn, while causing temporary adjustment costs reflected in the initial decline in output, would yield efficiency benefits and therefore support the subsequent recovery during the transition. This chapter reveals that those countries leading in reform have redressed most rapidly the structural distortions inherited from central planning and that this adjustment has contributed to their improved economic performance.

Structural change in transition economies has a number of dimensions, reflecting the various areas where central planning led to resource misallocation. The main dimensions considered in this chapter are the distribution of employment, the geographical orientation of trade, the growth of the private sector, the emergence of market-based finance and the development of infrastructure. All centrally planned economies had overdeveloped industrial sectors, when evaluated by their contribution to total GDP and total employment. Industrial downsizing is thus an important dimension of structural change. Trade patterns were distorted towards other socialist countries, and most centrally planned economies were not properly integrated into the world economy. The extent to which this has changed is examined here as an important dimension of adjustment. Private enterprises, commercial banks and capital markets as well as key areas of infrastructure were either completely absent in most centrally planned economies or severely stunted. Their growth is thus a key aspect of structural change during the transition. The choice of dimensions in this chapter also reflects the focus of previous *Transition Reports* and extends this previous analysis.²

It might be expected that structural change would occur simultaneously in all these dimensions once markets had been liberalised and resources redeployed to their most efficient use. However, this chapter demonstrates that significant differences have emerged in structural adjustment patterns across dimensions. While adjustment has occurred across the board (or has been uniformly slow) in some areas, in others adjustment has varied far more systematically with progress in reform. Specifically, the chapter finds that the areas most sensitive to reform are trade orientation, private

sector growth and infrastructure development, whereas adjustment has been uniform and fast in the redistribution of employment and uniform and slow in the emergence of market finance. A key difference in these two main patterns seems to be whether adjustment has involved the expansion or the contraction of activity. For example, while most employment adjustment has occurred as a result of the shedding of industrial jobs, trade reorientation has gone hand in hand with significant increases in trade with non-transition economies. Only small progress in reform is necessary to trigger the contraction of highly inefficient sectors, whereas much more consistent efforts to build competitive markets are needed to allow new opportunities to be realised.

The importance of structural change for transition goes beyond a simple process of resource reallocation from contracting to expanding sectors, however. Market economies also differ with respect to certain structural features, such as the openness to foreign trade, the nature of finance (banks versus securities markets), the size of government and the prevalence of the private sector in areas such as infrastructure, or the degree of economic inequality. These features can have significant implications for the rate of innovation, investment activity and long-term economic growth. The extent and nature of structural change can also have important effects on the political environment and the future path of structural reforms. The reallocation of resources from the state to the private sector can strengthen the demand for market institutions. However, partial liberalisation and some forms of privatisation can lead to high concentrations of economic power and to political obstacles to further reforms.³ The types of economic structures emerging in the transition economies are thus of interest much beyond the first decade of transition.

As with macroeconomic performance, the analysis of structural change in transition is fraught with measurement problems. The data employed in this chapter come from a variety of statistical sources, not always fully comparable across countries. Significant efforts have been made to adopt consistent definitions and to adjust national data accordingly, where data from a unified source were unavailable. Nonetheless, all results should be interpreted with caution. A particular problem in the analysis of structural change results from the need to benchmark the reallocation of resources to a market economy standard. This chapter builds on and extends the analysis in previous *Transition Reports* in estimating benchmark values from a cross-sectional model of economic structure in market economies, in most cases based on variations in GDP per capita.

¹ See, for instance, Blanchard (1995).

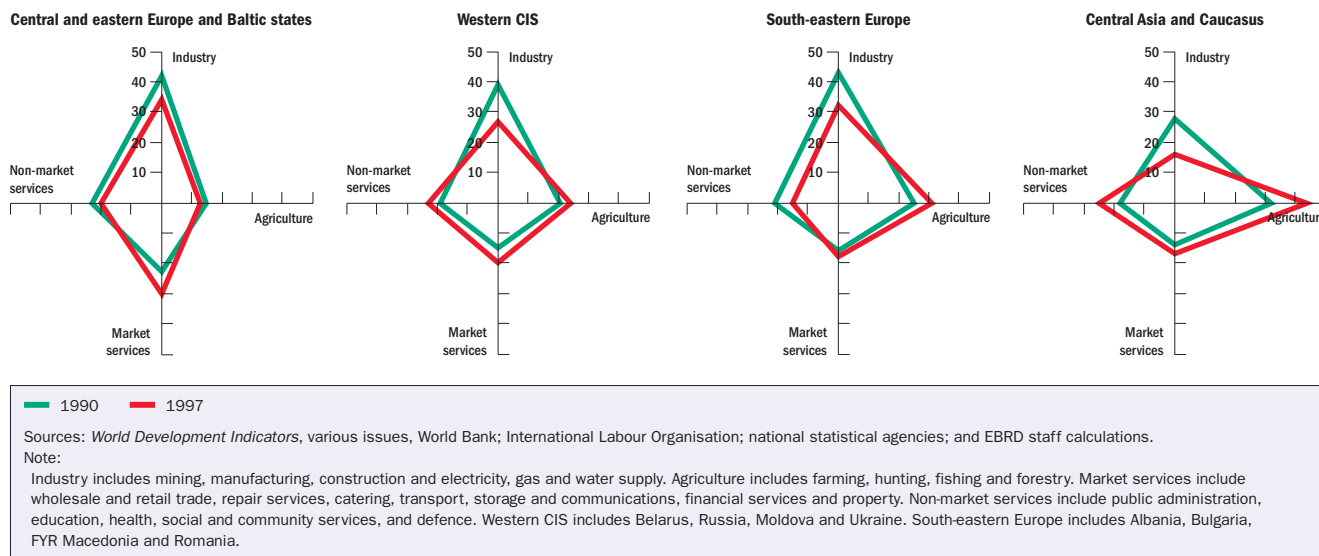
² The *Transition Report* 1996 (Part II) focused on the development of commercial infrastructure, while the *Transition Report* 1997 (Chapter 4) looked at changes in employment and at the structure of trade by product groups as well as at the development of the new private sector. The *Transition Report* 1998 (Part II) devoted a special topic to the emergence of market-oriented finance.

³ The interaction of politics and economic reform is the focus of Part II of this Report (Chapters 5 and 6).

Chart 4.1

Employment reallocation, 1990-97

(Share of employment in industry, agriculture, market and non-market services)



The chapter begins by examining five dimensions of structural change: Section 4.1 looks at changes in the distribution of employment across broad sectors of the economy (industry, agriculture and services). Section 4.2 investigates the geographical reallocation of trade. Section 4.3 looks at various patterns in private sector development. Section 4.4 examines the emergence of market-based finance. Section 4.5 reviews developments in the provision of key infrastructure services. In each of these sections an attempt is made to gauge the impact of economic reforms on the pattern of adjustment. Section 4.6 draws the evidence together and establishes clusters of structural change measures that allow the analyst to trace a country's progress along key dimensions simultaneously and to test any link to economic performance. Section 4.7 offers conclusions.

4.1 Changes in the distribution of employment

One of the distinctive features of centrally planned economies was the degree of over-industrialisation, compared with market economies at similar levels of per capita income (see *Transition Report 1997*, Chapter 4). A primary reason for this over-industrialisation was the bias of central planners in favour of the production of investment goods and the under-valuation of services.⁴ Another reason was the widening productivity gap in manufacturing between market and centrally planned economies as a result of low innovation in the latter. Consequently, more resources had to be devoted to industry to maintain the level of output growth, resulting in the well-documented extensive industrialisation pattern.⁵

With the abolition of the central plan and the demise of the Soviet trading bloc, the structure of domestic and foreign demand changed dramatically against the production of industrial goods, heavy industry in particular. The decline in investment demand with the transition recession and military cutbacks contributed an additional blow to producers of capital goods. Over the medium term, productivity improvements in industrial enterprises were also expected to lead to a reallocation of resources away from industry, although employment adjustments have typically lagged behind the decline in production.

As the process described above involves substantial changes both in relative prices and in the output of various sectors of the economy, more precise and reliable measures of the extent of structural change during the transition are likely to be obtained from changes in the sectoral composition of employment. The measurement unit, an employee, is in principle the same across all the countries and constant over time (although changes in hours worked have been considerable and do affect the precision of comparisons between different periods). Moreover, if changes in relative productivities across sectors are independent of changes in relative demand, they will be reflected in employment adjustments, but not in the structure of output. Following this reasoning, this section analyses employment adjustment in four broad sectors – agriculture, industry, market and non-market services. In each case, actual employment is compared with predicted employment based on the cross-country relationship between the employment shares of these sectors and GDP per capita, measured at PPP exchange rates.⁶

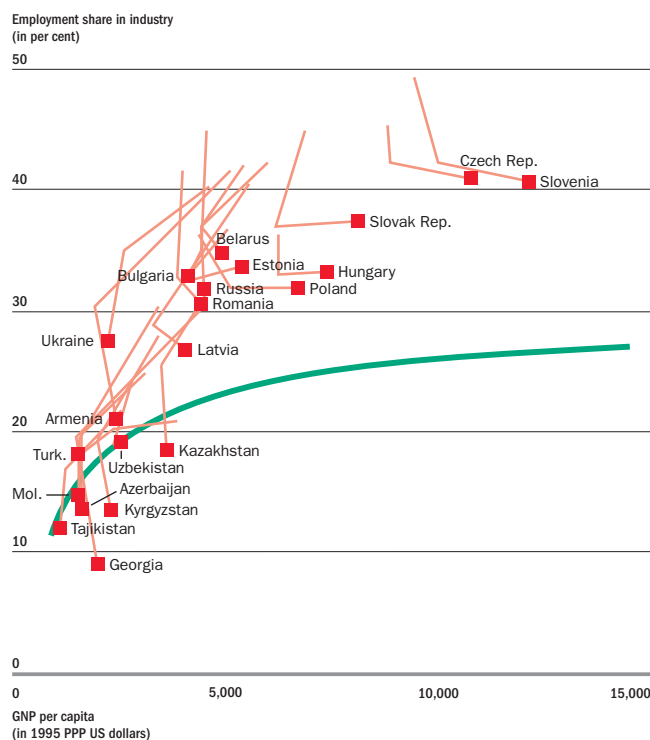
⁴ Most services (except transport and repair services) were actually absent as a category from the net material product definition of national income in centrally planned economies and hence irrelevant for economic performance measurement.

⁵ See Easterly and Fischer (1994). Raiser, Schaffer and Schuchhardt (1999) provide a stylised model of industrialisation under central planning built on distortions in patterns of demand and a productivity slow-down in industry.

⁶ The employment benchmarks are estimated by regressing the employment shares against GDP per capita at PPP exchange rates and its square. In this analysis, market services are defined to include wholesale and retail trade, repair services, catering, transport, financial services and property. The cross-country regressions for this four-sector disaggregation of employment are based on 41 largely middle and high-income market economies and may be less robust than results for a three-sector disaggregation available for 101 countries, grouping market and non-market services together. The qualitative nature of the results obtained here is not affected by the choice of disaggregation, however.

Chart 4.2

Employment adjustment towards the benchmark in industry, 1990-94 and 1994-97



— Industry benchmark ■ Actual employment share in 1997
— Change, 1990-94 and 1994-97

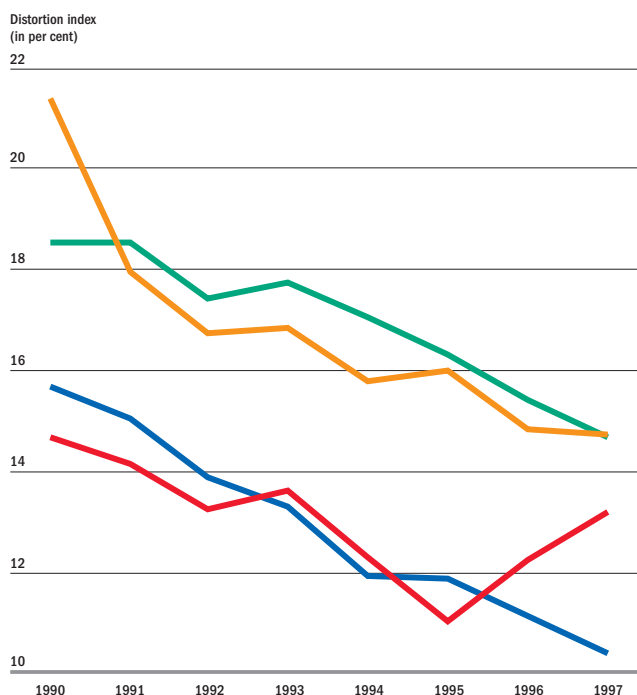
Sources: *World Development Indicators*, various issues, World Bank; International Labour Organisation; national statistical agencies; and EBRD staff calculations.

Note:
The benchmark line is based on a cross-country regression of the share of employment in industry against the log of GNP per capita and its squared value measured in US dollars at PPP exchange rates. The regression was carried out for 41 developing and developed market economies, using data for 1995. See Chenery and Syrquin (1975) for the rationale behind this benchmarking exercise.

In broad terms, two adjustment patterns can be identified (see Chart 4.1). In the first group of countries, including central Europe, the Baltic states and the western parts of the CIS, the employment share of industry has declined, while the share of services – market services, in particular – has increased. By 1997, this group had virtually closed the “service gap” amounting to around 10 per cent of total employment at the start of transition. In the remaining group of countries, including south-eastern Europe, the Caucasus and Central Asia, the reallocation has been mainly from industry to agriculture. Services have increased their share of employment in some of these countries as well, but in Armenia, Georgia, Kyrgyzstan, Tajikistan and Turkmenistan, the share of services decreased. In the first four of these countries, this was because of declines in government sector employment, whereas in Turkmenistan market services recorded falling employment shares. In the remainder of the CIS, increases in employment in services have been concentrated in non-market services, in contrast to the pattern in central and eastern Europe and the Baltic states (CEE).

Chart 4.3

Employment distortion index, 1990-97, various regions



— Central and eastern Europe and Baltic states — South-eastern Europe
— Central Asia and Caucasus — Western CIS

Sources: EBRD staff calculations based on data from *World Development Indicators*, various issues, World Bank; International Labour Organisation; and national statistical agencies.

Note:

The distortion index was calculated as half of the sum of absolute values ($s-s^*$), where s is the actual share of employment in a sector (agriculture, industry, market and non-market services) and s^* is the predicted share of employment, based on a benchmark regression against the log of GNP per capita and its square for 41 market economies, using GNP per capita measured in 1995 US dollars at PPP exchange rates. The index has a value of 100% for maximum distortions and a value of 0 for no distortions.

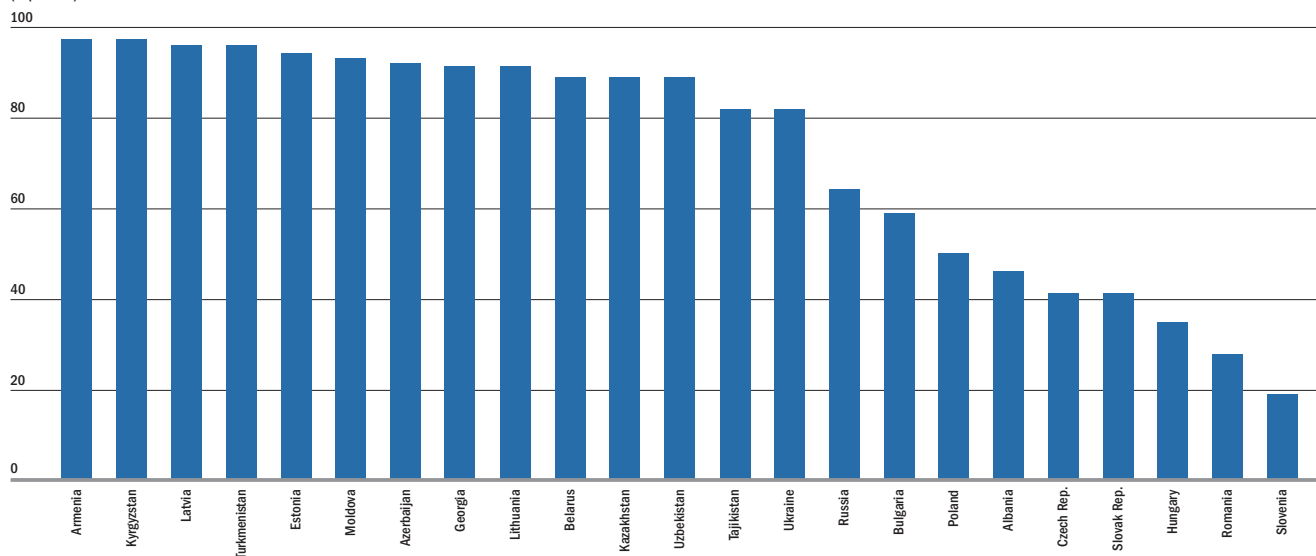
Relative to the market-economy benchmark, the share of industry in total employment remains high in most countries, but has fallen below the benchmark level in the Caucasus and in Central Asia. Indeed, tracing the adjustment of industry through each year of the transition against the level of per capita income reveals that declines in the share of industry in total employment seem to be concentrated during the period of output decline (see Chart 4.2). In much of the CIS (with the exception of Belarus), industrial employment was still falling by 1997, rapidly reaching or even falling below the benchmark level. In the more advanced central European countries, industrial employment as a share of the total had stabilised by the mid-1990s at a level above that in comparable market economies.⁷

By aggregating differences to benchmark employment levels across the four sectors, an index of employment distortions can be constructed and its development traced over time (see Chart 4.3). Initial aggregate employment distortions were higher in the western CIS and in south-eastern Europe than in CEE and in

⁷ In some respects, the central European countries are adjusting as if they had higher income levels than was actually the case. For instance, their shares of employment in agriculture are declining, although they were already below the benchmark level at the start of transition. Proximity to the EU may explain part of this pattern – industrial employment is supported by the rapid reorientation of exports to EU markets (see below), while agriculture may be downsizing in anticipation of accession-related pressures.

Chart 4.4

Exports to the CMEA, 1990

Share of exports
(in per cent)

Source: De Melo et al. (1997).

Note:

Data for the Czech and Slovak Republics are for Czechoslovakia as a whole. Data in the *IMF Direction of Trade Statistics* show much higher exports to CMEA countries for Bulgaria, Czechoslovakia, Hungary and Poland, the only countries for which IMF data date back to 1989. The cause of these differences may lie in different exchange rates used to value intra-CMEA trade conducted at so-called transfer rouble exchange rates, which were often heavily distorted.

Central Asia. However, the degree of employment distortions shows a similar decline across all sub-regions. There is no difference at the aggregate level between advanced and less advanced transition economies. The degree of liberalisation of prices and trade does not seem to have contributed to the extent of employment adjustment.⁸ Adjustment in employment shares is generally in the direction of reducing initial distortions – even the pervasiveness of soft budget constraints and the incompleteness of liberalisation in many CIS countries have not stopped this trend. Partial liberalisation has been enough to force the downsizing of unviable activities, but it is not enough to generate new viable ones.

4.2 Redirection of trade

Before the beginning of transition, centrally planned economies formed an almost closed trading block and only a small share of trade was conducted with the rest of the world. Moreover, trade within the Council for Mutual Economic Assistance (CMEA) was highly distorted towards the exchange of natural resources for consumer goods. State trading supported a system of extreme specialisation, with little regard to either comparative advantage or transport costs. On one estimate, the share of trade with other CMEA countries reached 90 per cent in the former Soviet Union, against much lower, but still considerable, values of between 20 per cent in Slovenia and 60 per cent in Bulgaria (see Chart 4.4). The collapse of the CMEA in 1991 was thus a major disruption to all transition economies. However, the subsequent

reorientation of production and trade within the CMEA and the Soviet Union (which also disbanded in 1991) imposed sharply differing adjustment costs on the various member states. This section looks only at trade flows.⁹

The liberalisation of external trade in the early 1990s led to fast and sizeable change in the geographic composition of trade. Most of this adjustment consisted of a reallocation of trade flows away from the CMEA towards the European Union. Trade with the rest of the world also increased, but by much less. Not only did geographical trade patterns change, but also the composition of trade changed to reflect more closely the specific resources and comparative advantages of the transition countries (see Chapter 9 for more detail). Although the biggest change to the geographical composition of trade flows happened early in transition and has changed little since then, the sectoral composition of trade has been changing more gradually and this process is likely to continue for many years to come.

How does the geographical structure of trade emerging after a decade of transition compare with what would be expected in market economies? Does the higher share of trade with other transition economies prevailing in the CIS reflect greater distance to the buoyant markets of western Europe and similar distance to alternative markets in East Asia? Experience from market economies suggests that a country's geographical trade orientation

⁸ In regression analyses relating the change in sectoral employment shares to the size of initial distortions and indices of internal and external liberalisation, the size of the initial distortion was always a significant factor explaining changing employment shares, whereas results for liberalisation were generally inconclusive.

⁹ Interesting analyses of net resource flows including intra-Soviet Union budgetary transfers can be found in Orlowski (1993 and 1995). These show that Central Asia has been most affected by the reduction in budgetary transfers and, with the exception of Turkmenistan, also experienced negative terms of trade shifts from the move to world market prices. The main winners were Russia and to a lesser extent the Baltic states and Belarus.

Table 4.1

Actual and predicted direction of export trade, 1994 and 1997

	1994						1997					
	Actual trade with EU	Predicted trade with EU	Actual trade with TE	Predicted trade with TE	Actual trade with RoW	Predicted trade with RoW	Actual trade with EU	Predicted trade with EU	Actual trade with TE	Predicted trade with TE	Actual trade with RoW	Predicted trade with RoW
Armenia	0.26	0.51	0.72	0.08	0.02	0.40	0.36	0.51	0.54	0.09	0.10	0.40
Azerbaijan	0.10	0.51	0.84	0.08	0.06	0.40	0.19	0.51	0.70	0.09	0.10	0.40
Belarus	0.15	0.60	0.82	0.11	0.03	0.30	0.07	0.59	0.90	0.11	0.03	0.30
Bulgaria	0.53	0.61	0.27	0.09	0.20	0.30	0.56	0.60	0.22	0.10	0.22	0.30
Croatia	0.70	0.71	0.24	0.07	0.06	0.22	0.66	0.70	0.28	0.08	0.06	0.22
Czech Republic	0.63	0.73	0.29	0.07	0.08	0.21	0.61	0.72	0.32	0.07	0.07	0.21
Estonia	0.62	0.60	0.29	0.09	0.09	0.31	0.64	0.60	0.28	0.10	0.08	0.30
Georgia	0.10	0.50	0.71	0.09	0.19	0.40	0.15	0.50	0.72	0.10	0.14	0.40
Hungary	0.71	0.66	0.19	0.09	0.10	0.25	0.70	0.65	0.19	0.10	0.11	0.25
Kazakhstan	0.12	0.44	0.77	0.09	0.11	0.47	0.18	0.44	0.66	0.09	0.17	0.46
Kyrgyzstan	0.12	0.42	0.50	0.07	0.38	0.51	0.08	0.42	0.71	0.07	0.21	0.51
Latvia	0.68	0.61	0.23	0.10	0.08	0.29	0.66	0.60	0.25	0.11	0.09	0.29
Lithuania	0.58	0.72	0.38	0.10	0.04	0.18	0.47	0.72	0.50	0.11	0.03	0.18
Moldova	0.07	0.59	0.89	0.12	0.04	0.30	0.10	0.58	0.83	0.12	0.07	0.30
Poland	0.76	0.67	0.15	0.08	0.09	0.25	0.71	0.73	0.22	0.09	0.07	0.18
Romania	0.67	0.61	0.11	0.10	0.23	0.28	0.68	0.61	0.12	0.10	0.21	0.29
Russia	0.42	0.54	0.34	0.06	0.25	0.41	0.38	0.50	0.38	0.06	0.23	0.43
Slovak Republic	0.44	0.66	0.51	0.10	0.05	0.24	0.45	0.65	0.51	0.11	0.04	0.24
Slovenia	0.75	0.71	0.17	0.07	0.08	0.22	0.69	0.71	0.23	0.07	0.07	0.22
Tajikistan	0.29	0.44	0.44	0.06	0.27	0.49	0.15	0.43	0.74	0.08	0.11	0.49
Turkmenistan	0.25	0.47	0.66	0.09	0.10	0.43	0.08	0.47	0.73	0.10	0.19	0.42
Ukraine	0.17	0.58	0.62	0.09	0.22	0.32	0.16	0.57	0.65	0.10	0.19	0.32
Uzbekistan	0.31	0.46	0.58	0.08	0.10	0.45	0.20	0.46	0.70	0.09	0.11	0.45

Sources: IMF Direction of Trade Statistics and EBRD staff calculations.

Notes:

TE refers to "Transition Economies". RoW refers to "Rest of the World", including USA, Japan, and around 30 other market economies, mainly from OECD countries. Data for Albania, Bosnia and Herzegovina and FYR Macedonia were not available in the IMF Direction of Trade Statistics.

The predicted values were obtained from a gravity model, relating bilateral trade flows to geographical distance and the size of the economy of trading partners.

The model has the form: $VT_{ij} = \alpha Y_i^\beta Y_j^\gamma N_i^\delta N_j^\epsilon d_{ij}^\mu$

where VT_{ij} = bilateral volume of trade between countries i and j

Y_i = GNP for country i measured at current US\$ exchange rates

N_i = population for country i

d_{ij} = geographical distance between countries i and j , measured as kilometres between capitals.

The estimated elasticities, obtained from a benchmark regression for 38 market economies, are used to compute predicted bilateral trade volumes for transition economies. Bilateral trade flows were computed for the largest trading partners only, accounting for more than 95% of total trade.

can be predicted relatively well by considering a combination of geographical distance to, and the size of, the market of the trading partner.¹⁰ An estimation of such a relationship was carried out for 38 market economies, using average trade flows from 1988 to 1992. It shows that the market size of the trading partner is more important than geographical distance, a finding that is consistent with low transportation costs. For the transition economies, this result implies that trade should have increased most with the three economic hubs of western Europe, North America and Japan, while trade with other transition economies should have contracted. In the following, the analysis focuses on export trade, although the same rationale applies to imports.

Complete and reliable statistics for the direction of trade for all transition economies are only available since 1994. Table 4.1 reveals that the central and east European countries (with the exception of the Slovak Republic) had by that date largely achieved levels of exports to the EU predicted by their location

and relative income levels. However, their trade with the rest of the world (mainly the USA and Japan) was still below predicted levels. Estonia and Latvia had similarly adjusted their direction of exports, whereas Lithuania was still exporting considerably less to the EU than predicted. In each of these countries, trade with other transition economies was still above predicted levels, at around 25 per cent of total exports on average, although the share of Russia did not exceed 10 per cent in most cases (see also Chapter 3).

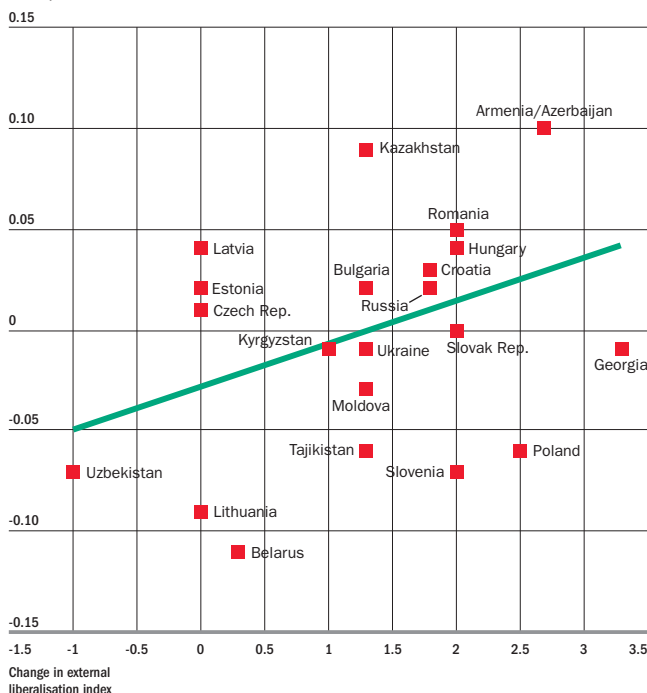
The most striking feature of Table 4.1 is the extent to which CIS countries are still dependent on trade links with other transition economies. In large measure, this reflects dependence on the Russian market rather than an intensification of intra-regional trade. For instance, trade among Central Asian countries was only around 3-5 per cent of the total in 1997. Trade with the EU and the rest of the world (including China) remained far below predicted levels. Geographical distance alone clearly does not

¹⁰ See Anderson (1979) for a theoretical justification of this approach, commonly called the "gravity model" of trade.

Chart 4.5

Change in exports to the EU and pace of liberalisation, 1994-97

Change in share of total exports to the EU



Source: EBRD staff calculations.

Note:

The chart reports the partial correlation between the change in the export share destined to the EU and the change in the EBRD's rating on external liberalisation, after controlling for the initial difference between actual exports to the EU and predicted exports, as well as the initial value of the EBRD external liberalisation index, both in 1994. The cross-country regression has an R-square of 0.44 and both the initial level of liberalisation and its change over the 1994-97 period are significant at the 5 per cent level. The liberalisation index is a modified version of the EBRD's rating in Table 2.1, Chapter 2, combining trade liberalisation, WTO membership and current account convertibility. It has a maximum value of 6 and a minimum value of 0. See Table 4.1 for details on the calculation of predicted exports to the EU.

explain the different trade adjustment patterns. Rather, other barriers to trade with the EU and other market economies seem to have had an influence, including lack of competitiveness and, sometimes, restrictive trade policies by the transition economies themselves.¹¹

In order to test whether trade liberalisation has benefited the adjustment in the directions of trade, the change in the share of exports to the EU between 1994 and 1997 was compared to the change in external liberalisation, as measured by EBRD's transition indicators. To take into account initial differences in the level of trade distortions as well as the extent of liberalisation achieved by 1994, regression analysis was used. Both the initial level of external liberalisation and the way it has developed are closely linked to the change in exports to the EU (see Chart 4.5). However, the size of the initial difference between actual and predicted export levels to the EU bears little relation to how the direction

of exports has changed subsequently. In other words, the CIS countries, which in 1994 were significantly below the benchmark level of trade with the EU, did not experience rapid adjustment in the subsequent period.

In contrast to employment adjustment, liberalisation has had a significant effect on the adjustment of trade. This has important implications for understanding how reforms affect economic performance. For instance, trade with the EU may be an important channel for the development of technology. As Chapter 8 shows, external competition is one of the main factors that have encouraged innovation in transition economies. A high level of trade with the EU also puts transition economies in a better position to withstand crises in the region, most notably the recent crisis in Russia. As this section has shown, CIS countries are not forced to trade among themselves for geographical reasons. While regional trade should be encouraged for the long term, a significant challenge for these countries over the coming years will be to complete the integration into the world market.

4.3 Private sector development

The transfer of economic assets and activity from the state into private ownership is clearly at the very heart of the transition process.¹² Judging by the increase in the share of GDP produced by the private sector, transition is well advanced in most transition economies, with the few exceptions of Belarus, Tajikistan and Turkmenistan (see Chart 4.6). Yet, in the majority of countries, privatisation rather than a shift of resources into new private businesses has been the predominant way in which the private sector's contribution to GDP has increased. This has important implications, because ownership change by itself has rarely been sufficient to improve enterprise performance. Moreover, as subsequent chapters of this Report will show, the state has continued to intervene in privatised firms, albeit in different ways than under central planning.

When looking more closely at the composition of the private sector, considerable variation is evident across the region. First, in many of the poor transition economies of the Caucasus and Central Asia, the private sector's share in GDP has increased simply because of the growing importance of agriculture during this period, which in many cases has been at least partially privatised. Progress in the privatisation of industry in these countries has been more uneven. Second, even where privatisation in industry has advanced, the different rate at which new private firms have been formed has led to very different structures in the private sector. Thus, according to one estimate, the new private sector in 1995 accounted for 50 per cent of GDP in Albania, Estonia and Poland, compared with only 20 per cent in Russia and Kazakhstan – despite similar shares of aggregate private sector output in GDP.¹³ These differences are paralleled by the wide differences in the importance of small and medium-sized enterprises for output and employment (see Chapter 7). While the

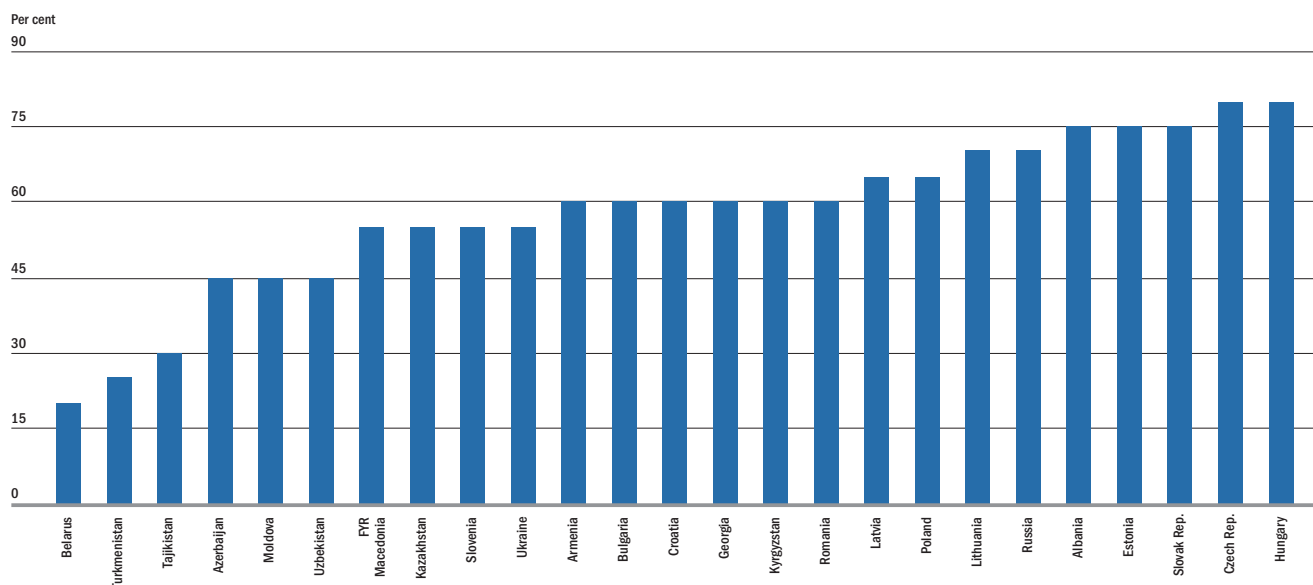
¹¹ Another important aspect could be the dysfunctional nature of existing transport infrastructure, which particularly for CIS countries remains predominantly geared towards Russia, with little existing links to adjacent important trading partners, such as Turkey, Iran or China. Much of the trade with these countries, moreover, is not recorded by customs statistics. Both factors would tend to lead to an upward bias in the estimation of trade distortions for the CIS.

¹² See Aghion and Blanchard (1994); Blanchard (1995).

¹³ See Johnson et al. (1997).

Chart 4.6

Private sector share in GDP, 1999



Source: EBRD staff estimates.

Note:

Estimates are based on a variety of sources, including national statistical agencies, independent economic institutes and staff extrapolations based on information for sub-sectors of the economy.

distribution of output and employment in central Europe is rapidly approaching EU patterns, the bulk of output and employment in the more industrialised CIS countries remains concentrated in large companies.

Entrepreneurial initiative in many less advanced transition economies remains stifled by weaknesses in the investment climate (see Chapter 8). Where the provision of public services is low and where taxes and regulations impose arbitrary burdens on enterprises, entry of new firms is weak. But many enterprises may also choose to operate informally, since formal registration has few benefits to offer. In this respect, a notable feature of transition in many less advanced countries has been the dramatic rise of the unofficial economy. While precise estimates are difficult to obtain, most available figures suggest that the largest increases in the unofficial economy since the start of transition have been recorded by countries where enterprise entry has been limited.¹⁴ The state's command over resource allocation has weakened throughout the region, but while the new private sector has benefited in the advanced transition economies, resources in many CIS countries have been dissipated into unofficial production with few economy-wide benefits.

4.4 The emergence of market-based finance

The financial sector has undergone radical change during the transition.¹⁵ The original monobank system has been replaced by two-tier banking systems across all countries in the region, although very

different approaches have been taken in the creation and regulation of commercial banks. Also, as privatisation progressed, stock exchanges have been introduced and gradually gained in importance. Yet, the financial systems across the region remain fundamentally underdeveloped and particularly the provision of market-based financial services to the private enterprise sector.

To examine the extent to which market-based finance has emerged in the transition economies, this section compares the size of the financial sectors (relative to GDP) in the region with those typical of market economies at similar levels of per capita income. Because financial data during the early transition years are not compatible with common definitions of monetary aggregates, only the period 1994-98 is studied. Chart 4.7 shows values of the ratio of broad money to GDP for the transition economies relative to market benchmarks, based on GNP per capita. Chart 4.8 repeats the same analysis for the share of private sector credit in GDP.

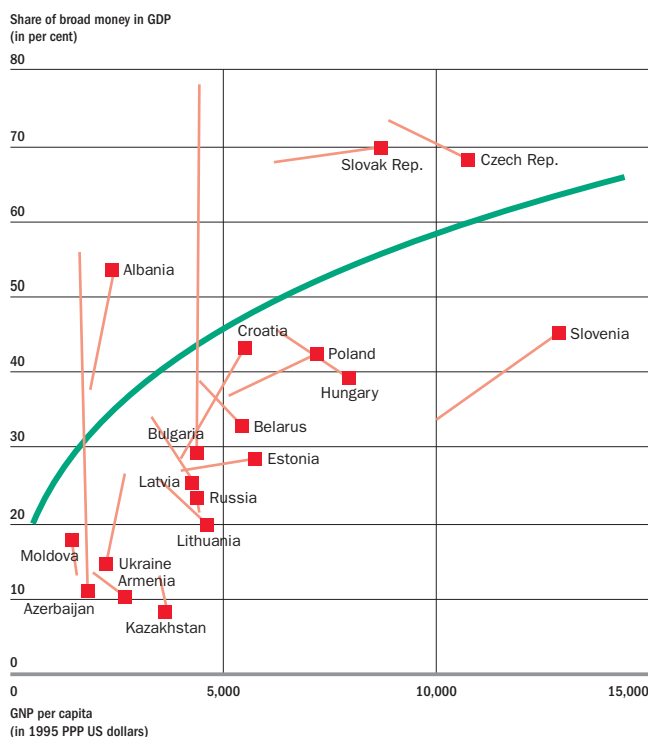
On both counts, the transition economies in 1998 continued to lag behind their market economy counterparts (exceptions are Albania and the Czech Republic for broad money and Croatia and the Czech and Slovak Republics for private sector credit). Moreover, adjustment patterns have not generally been towards the benchmark. In fact, adjustment in some cases has been perverse, following years of high inflation that wiped out the monetary overhang still present in 1994. Moreover, where the financial system has expanded, governments have often been the main benefici-

¹⁴ Kaufman and Kaliberda (1997) suggest measuring the unofficial economy by comparing electricity consumption with changes in GDP. For a refined approach in this vein, see Lacko (1999). These authors find a share of unofficial production in GDP of between 35 and 55 per cent for the CIS and around 20-35 per cent for CEE. In spite of problems with this methodology in countries experiencing simultaneous growth and improvements in energy efficiency (leading sometimes to negative estimates of the unofficial economy) these magnitudes have been confirmed by country-specific studies often based on extensive survey work.

¹⁵ See also *Transition Report 1998*, which featured a special part on the financial sector in transition.

Chart 4.7

Broad money in GDP, adjustment towards the benchmark, 1994-98



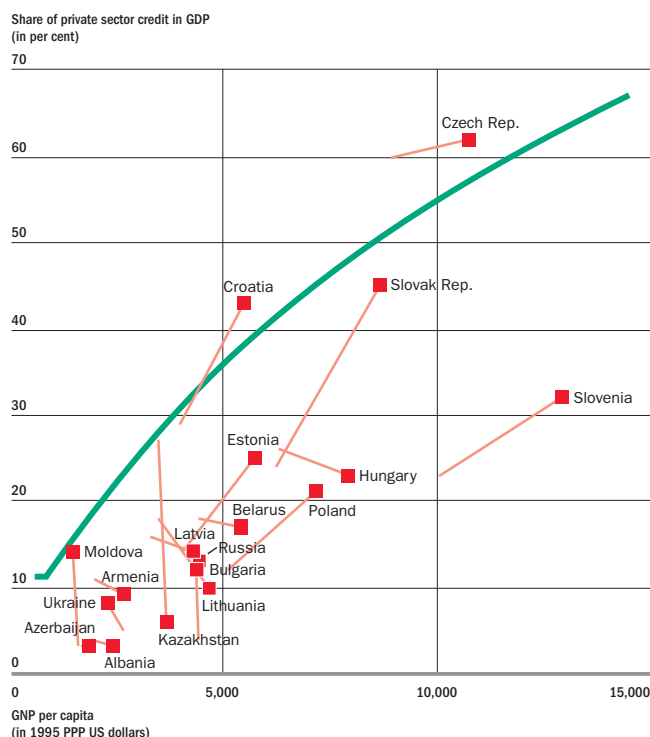
— Broad money benchmark
— Change, 1994-98

Sources: *International Financial Statistics*, IMF; *World Development Indicators*, various issues, World Bank; and EBRD staff calculations.

Note:
The benchmark line is based on the fitted values obtained from a cross-country regression of broad money in GDP against the log of GNP per capita and its squared value, measured in US dollars at 1995 PPP exchange rates estimated for 132 market economies.

Chart 4.8

Private sector credit in GDP, adjustment towards the benchmark, 1994-98



— Private sector credit benchmark
— Change, 1994-98

Sources: *International Financial Statistics*, IMF; *World Development Indicators*, various issues, World Bank; and EBRD staff estimates.

Note:
The benchmark line is based on the fitted values obtained from a cross-country regression of private sector credit in GDP against the log of GNP and its squared value, measured in US dollars at 1995 PPP exchange rates estimated for 132 market economies.

aries of increased financial intermediation. With a few exceptions among the large corporates in the countries of central Europe, the enterprise sector has continued to remain starved of access to bank finance in advanced and less advanced transition economies alike. In spite of increasing stock market capitalisation in many countries in recent years, only companies in central Europe and the Baltic region have access to equity markets (see Chapter 8).

In order to assess how reforms have influenced the development of market finance observed so far, the changes in the ratios of broad money and private sector credit to GDP (1994-98) were regressed against the size of the initial distance from the benchmark in 1994 and the EBRD's measure of banking sector reforms (see Table 2.1 in Chapter 2). The results show that banking sector reforms have no effect on changes in broad money, which were driven primarily by divergent macroeconomic developments during this period. Changes in private sector credit are positively related to banking sector reforms once initial distortions are controlled. The correlation is strongest for the level of reform achieved in 1994, which basically singles out countries in CEE from those in south-eastern Europe and the CIS, where banking reform started much later but had to some extent caught up by 1998. Yet, several more years of

credit expansion at robust rates will be needed before even the countries in CEE would reach a level of financial intermediation in line with their overall level of development.

4.5 Development of commercial infrastructure

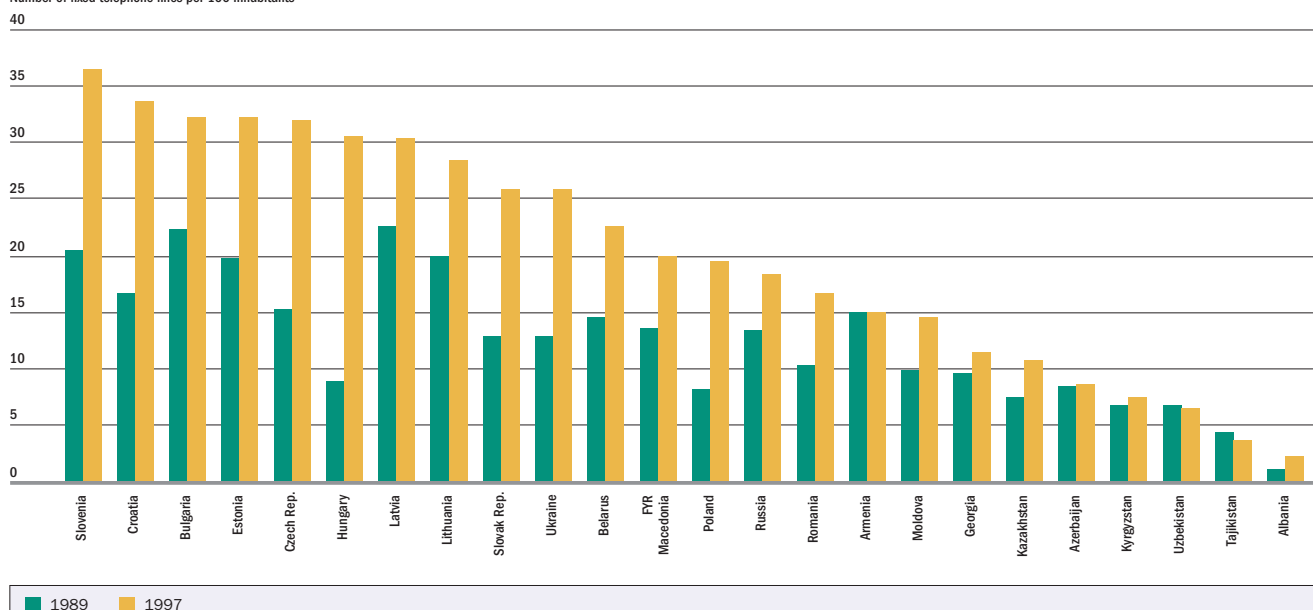
The transition economies inherited a severely distorted physical infrastructure from central planning (see *Transition Report 1996*). The problem was not so much the underprovision of services, but their bias towards the needs of heavy industry, the lack of decentralised transport systems and telecommunications, and their disregard of resource costs and the environment.

The reform of physical infrastructure in the transition economies since 1989 has been built on the principles of gradually introducing cost accountability, commercial management approaches and environmental standards, and attracting private investment (predominantly foreign) to limit the fiscal burden of the huge modernisation investments required. While a review of this reform progress is provided in Chapter 2 and in Annex 2.3, the focus here is on the output of physical infrastructure and, in particular, on two simple measures – the number of telephone connections per capita and energy intensity. Telecommunications was the one area in

Chart 4.9

Telephone penetration in transition economies, 1989 and 1997

Number of fixed telephone lines per 100 inhabitants



Sources: World Telecommunications Development Report, ITU; and World Bank.

Note:

Telephone penetration does not include the provision of mobile phone services, which has grown considerably in all countries across the region.

infrastructure that suffered from severe underprovision of services under central planning. Energy intensity – measured here as the ratio of power consumption to GDP – was high in all centrally planned economies and improvements could be expected over the medium term as a result of relative price increases for energy.¹⁶

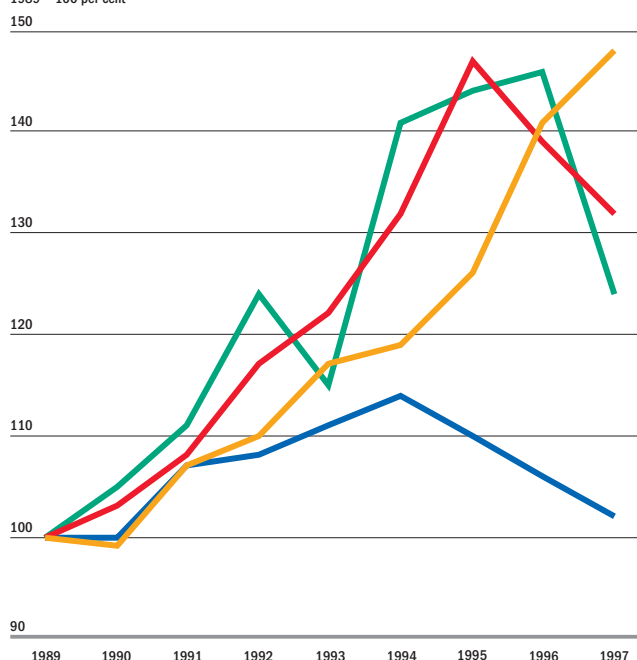
Charts 4.9 and 4.10 reveal a rather different pattern across these two dimensions. While the number of telephone connections per capita seems to have generally increased across the region, reflecting the recovery in telecommunications from neglect under central planning, energy intensity has increased (from already high levels) as output collapsed. The increase in the number of telephone connections has been particularly significant in the countries of central Europe and the Baltic states, corresponding with progress in privatisation in this sector. For example, Hungary privatised its fixed line operator MATAV in 1994. Since then, the new foreign owner has installed around 1.5 million new telephone connections, virtually doubling the number of telephone connections per capita in half a decade.

Energy intensity has remained relatively stable in CEE, but has increased dramatically in the Balkans and followed a U-shaped pattern in most CIS countries, reflecting relatively closely differences in reform progress and economic performance. To some extent, increases in energy intensity could be expected in the context of dramatic output falls, as experienced in many CIS countries. Relatively fixed demands, such as for heating, may have to be

Chart 4.10

Energy intensity during transition, various regions, 1989-97

1989 = 100 per cent



Central Europe and Baltic states South-eastern Europe
Central Asia and Caucasus Western CIS

Sources: International Energy Agency and EBRD staff calculations.

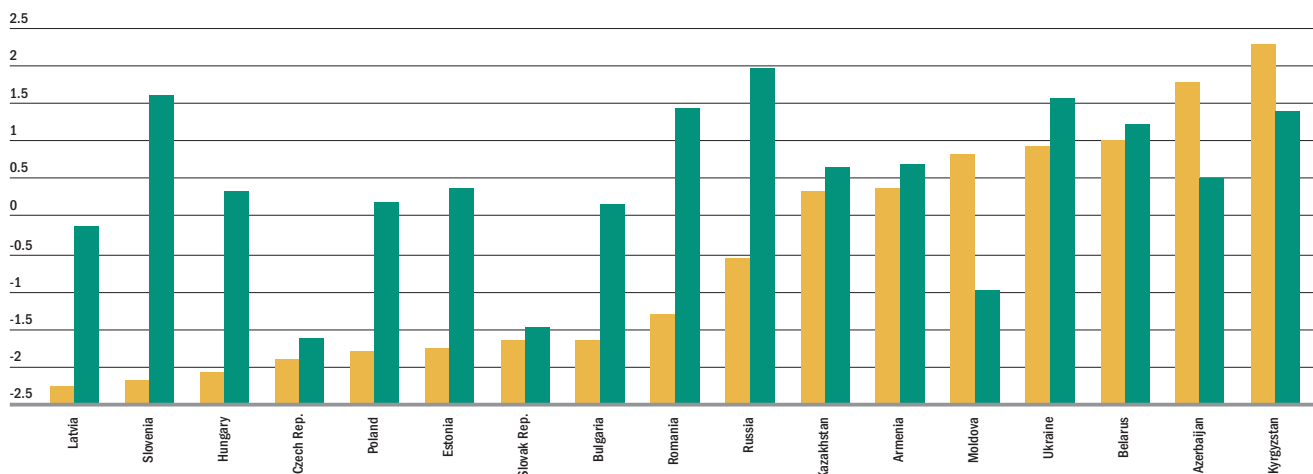
Notes:

Energy intensity is measured as the ratio of electricity consumption to GDP, indexed to 100 for 1989. Central Europe and Baltic states includes Croatia. Western CIS includes Belarus, Moldova, Russia and Ukraine. South-eastern Europe includes Albania, Bulgaria, FYR Macedonia and Romania.

¹⁶ This effect could be compensated for if other energy sources experience larger price increases than electricity, leading to substitution effects. The improvements in energy efficiency are not instantaneous either and energy intensity may even increase in the short term, due to reductions in capacity utilisation not being matched by lower energy consumption. See Annex 2.4 for a more detailed analysis of energy efficiency in transition.

Chart 4.11

Indexes of structural distortions: first two common factors, 1997



Common factor 1 Common factor 2

Source: EBRD staff calculations. For sources to the underlying data, see Charts 4.1 to 4.10.

Note:

The common factors are weighted average indexes derived from a statistical analysis using the correlations across countries and time of the following variables: employment reallocation index, export reorientation index, private sector credit in GDP relative to market benchmark, broad money in GDP relative to market benchmark, private sector share in GDP relative to market benchmark, telephone penetration rate and energy intensity index. The first common factor gives large weights to trade reorientation, the private sector share in GDP, telephone penetration and energy intensity, and small weights to financial depth. The second common factor, in turn, emphasises broad money in GDP and private sector credit in GDP relative to benchmark.

satisfied even when capacity utilisation falls significantly. It is noteworthy, however, that output falls in CEE, albeit more moderate, did not lead to a similar increase in energy intensity during the early 1990s. A primary reason has been the much better record of power utilities in CEE in enforcing tariff payments and rebalancing tariff structures. As a result, the waste of energy has been curbed and efficiency improvements have been realised. Kazakhstan provides a good example of a CIS country that has made significant progress with power sector reforms and that has reaped significant benefits from increasing energy efficiency. In 1995 energy intensity stood at 113 per cent of the 1989 level, but dropped by 23 percentage points during 1996-97 when major tariff reforms and the privatisation of distribution companies were initiated.

4.6 Structural change and economic performance during transition

The review of structural change across various dimensions has revealed some relatively uniform patterns – such as the reduction of industrial employment or the persistent under-development of market finance – as well as large cross-country differences. It has been argued that these differences could be directly related to the impact of reforms. Thereby, reforms are particularly relevant for the extent to which resources are redeployed to new productive uses, while they have relatively little impact on how quickly unviable sectors contract. Can this argument be generalised across the reform dimensions reviewed so far? This section attempts to group the various dimensions of structural change together, and to relate the findings to a country's reform pattern and its economic performance over time.

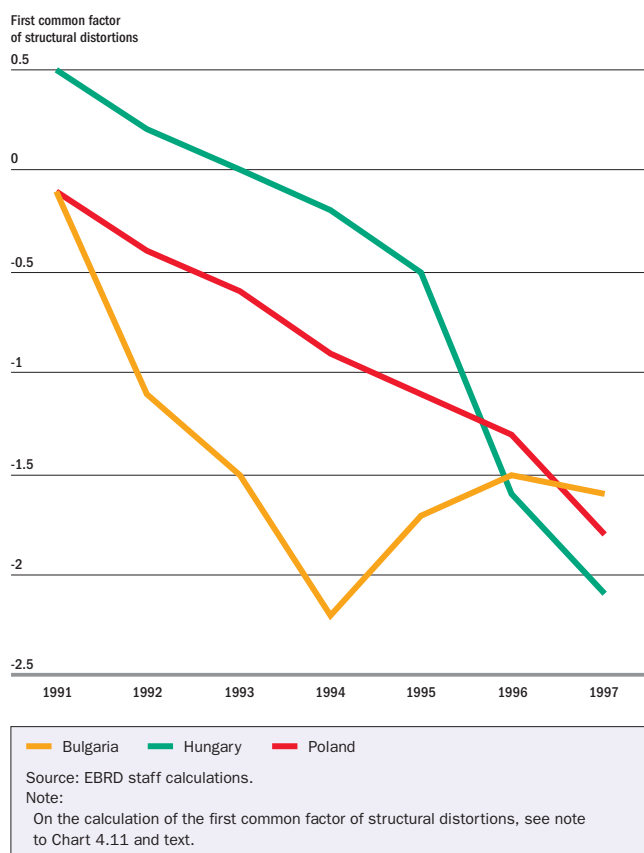
One useful way in which the measures of structural change presented so far can be aggregated is factor analysis (see also Box 2.1 in Chapter 2). This approach calculates the correlations among all the indicators under consideration and then constructs weighted average indexes (common factors), where the weights for each index are chosen to explain as much of the common variation among indicators as possible. The resulting indexes can be used as composite measures of structural change within a country. The method of aggregation chosen is useful, because the estimated weights for the indexes indicate which sub-dimensions are particularly important for explaining the common variation in structural change across all dimensions.

Such indexes were constructed using most of the variables introduced above for 1994-98. However, the private sector share in GDP was used as a proxy for the share of the new private sector in output. The dimensions thus covered include: i) changes in the distribution of employment; ii) export reorientation; iii) the private sector share in GDP; iv) the emergence of market-based finance; and v) the efficiency of infrastructure. The index calculated from the data has high weights for four of these variables – export reorientation, the private sector share in GDP, telephones per capita and energy intensity. Countries with a distribution of exports close to the predicted structure, a large private sector, high levels of telephone ownership and low energy intensity score low on this common factor. The second index has high weights for employment reallocation and the size of the financial sector.

Chart 4.11 shows the emerging clusters of countries along the two indexes, reporting their value in 1997. The dominant importance of export reorientation and telephone ownership in the first index

Chart 4.12a

Structural change 1991-97: first common factor – Bulgaria, Hungary, Poland

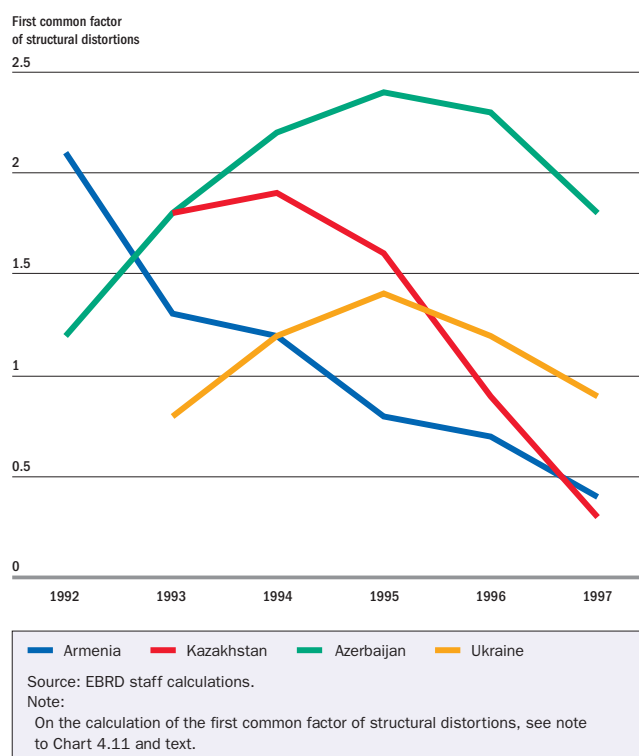


clusters countries mainly into a CEE group and a CIS group. The second index seems to group countries in various parts of the region together, depending mainly on their position in market finance relative to the benchmark.

Further interesting insights may be gained by tracing the scores on the first index over time. Chart 4.12a focuses on Bulgaria, Hungary and Poland among the CEE countries and Chart 4.12b on Armenia, Azerbaijan, Kazakhstan and Ukraine in the CIS. In the first group, Bulgaria stands out for its rapid gains in structural change up to 1994 and the subsequent stagnation. In contrast, structural change has been more gradual but also more consistent in Poland and in Hungary, the latter experiencing an acceleration in 1995 (coinciding with the change in government and an acceleration of reforms). In the CIS, Armenia and Kazakhstan have shown relatively rapid and consistent structural change, whereas Azerbaijan and Ukraine display an inverse U-shaped pattern, indicating initial increases in structural distortions and subsequently very gradual improvements (see Chart 4.12b). The remainder of the countries in the region fall into three distinct groups: i) countries with consistent improvements from a relatively good starting position (all of CEE); ii) countries with consistent improvements from a very distorted initial level (Kyrgyzstan and Moldova in addition to Armenia and Kazakhstan);

Chart 4.12b

Structural change 1992-97: first common factor – Armenia, Azerbaijan, Kazakhstan, Ukraine



and iii) countries with very limited improvements (Belarus and Russia join Azerbaijan and Ukraine in this group). Bulgaria's reversal midway is an exception among the countries for which data was available over a sufficient number of years.

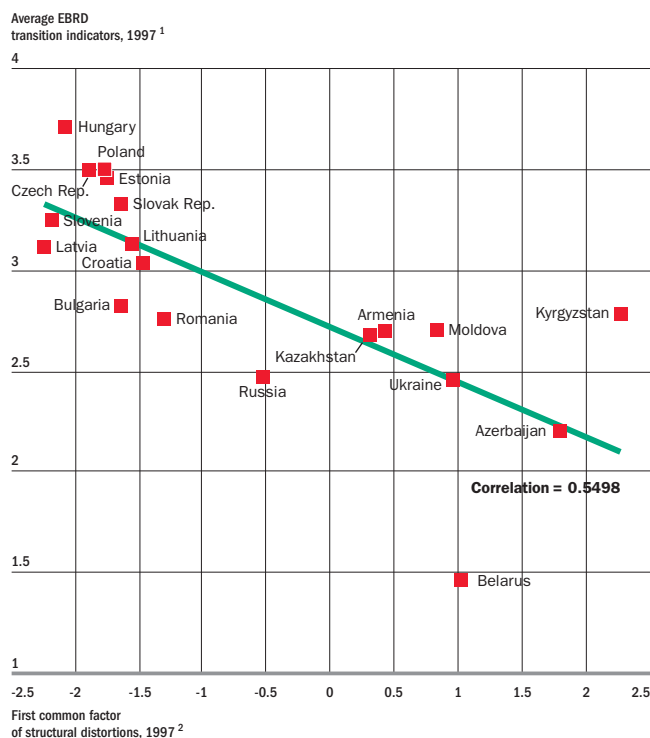
The clusters of countries emerging from the analysis above overlap strongly with the group of countries pursuing consistent reforms on the one hand and the group of countries with partial reforms or reversals on the other (see Chapter 2). Chart 4.13 demonstrates the strong link between country scores on the first common factor of structural change achieved in 1997 and the average of EBRD transition indicators for this year. In statistical analysis, the significantly positive impact of reforms on structural change between 1994 and 1997 is confirmed, even once differences in initial values of the structural change index are taken into account.¹⁷ Moreover, the structural change index also correlates positively with data on the new private sector share in GDP in 1995, which was excluded from the analysis for lack of time-series data. This suggests an important connection between the dimensions of structural change highlighted by the factor analysis above and the degree of private sector entry, which is a crucial aspect of building competitive markets during transition.

Does structural change in turn contribute to better economic performance, as suggested at the beginning of this chapter? An analysis of the relation between the structural change described by the summary index and average growth rates during

¹⁷ The simple cross-country regression has an adjusted R-square of 0.79, implying that two-fifths of the variation in changes in structural distortions during this period can be explained by initial distortions and reform progress alone. This evidence adds weight to the findings of Chapter 3 on the benefits of economic reform for macroeconomic performance.

Chart 4.13

Structural distortions and progress in reforms



Source: EBRD staff calculations.

¹ EBRD transition indicators include ratings for markets and trade, enterprise reform and privatisation, financial sector reforms and overall legal extensiveness and effectiveness. See Chapter 2 for details.

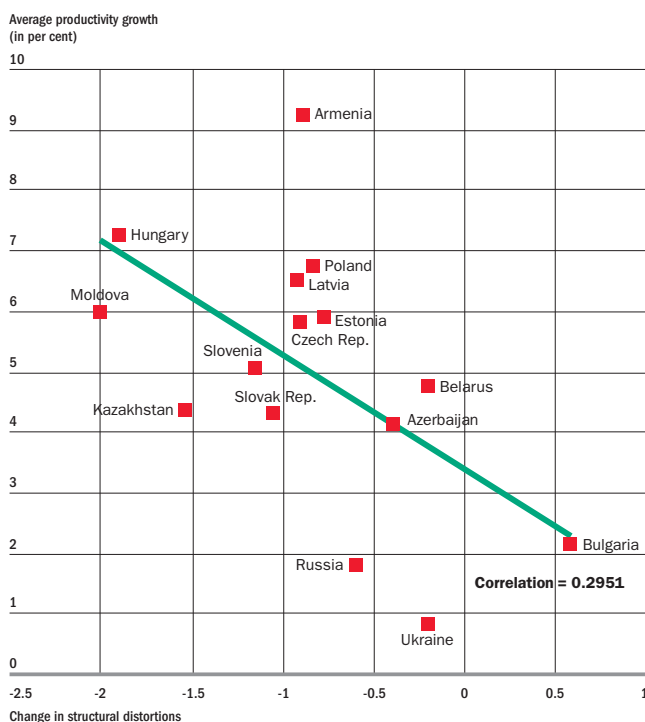
² On the calculation of the first common factor of structural distortions, see note to Chart 4.11 and text.

1994-97 indicates that both the level of initial economic distortions and the extent of structural change are relevant for growth during this period. Transition economies with relatively good starting positions had higher growth rates, which could be further increased by reducing initial distortions (the former effect dominates the latter in importance). However, the link is not particularly strong. This is not surprising given the importance of other factors in growth performance during this period, such as macroeconomic stability, the exposure to contagion effects from crises in neighbouring countries, and efficiency improvements unrelated to reallocation gains, as discussed in Chapter 3.

Similar results are obtained for changes in labour productivity in industry. Industry is the sector most exposed to international competitive pressures; it is the sector where the experiences of privatisation have been most uneven, and which could be expected to benefit significantly from improvements in infrastructure and financial services. As shown in Chart 4.14, labour productivity growth in industry is strongly linked to structural change during 1994-97, once account has been taken of initial distortions. Countries with double-digit average productivity growth during this period include Armenia, Hungary, Latvia and Poland. Countries experiencing declining productivity in industry include Azerbaijan, Russia and Ukraine.

Chart 4.14

Productivity growth in industry and change in structural distortions, 1994-97



Sources: National statistics, for productivity data; EBRD staff calculations and Chart 4.11, for structural distortion index.

Note:

The chart shows the partial correlation of changes in the first common factor of structural distortions to productivity growth in industry, controlling for the level of structural distortion in 1994. The corresponding regression has an R-square of 0.55 and both initial structural distortions and the change in structural distortions are significant at the 5 per cent level.

4.7 Conclusions

This chapter has argued that structural change is at the core of the transition from centrally planned to market economies in CEE and the CIS. The analysis has established considerable variation in the extent of structural change across countries, but also across its various dimensions. Specifically, the chapter has examined the shift in employment from industry to agriculture and services, the reorientation of exports from the CMEA to the markets of western Europe and the global economy, the development of the private sector, the emergence of market-based finance and infrastructure services, and developments in income inequality.

Export reorientation, the emergence of a new private sector and the development of commercial infrastructure are the three dimensions of structural change that are closely linked to progress in reform. For these dimensions a positive relationship between the extent of reforms and the degree of structural change could be established across countries, and a cluster of countries with consistent reductions in initial economic distortions could be distinguished from those with little or no improvements. By contrast, changes in the distribution of employment and in the level of market-based finance compared with market economy benchmarks are not closely linked to the extent of economic reforms.

The chapter has also found that the extent of structural change seems to have a positive influence on economic performance, at least during 1994-97, when most of the initial adjustment costs may have been already largely absorbed by the transition economies. This result strengthens the findings of Chapter 3 that economic reforms have a positive influence on macroeconomic performance during the transition by uncovering an indirect link in this relationship, connecting reforms with structural change, and structural change with performance. This link is likely to become stronger over time, as the divergence between the advanced reformers in CEE and the less advanced countries of the CIS widens. The overall conclusion from this chapter is to reinforce the view that reforms pay off.

The results of the analysis also help to refine this message and to relate it to specific sectors. The two areas where reforms produce rapid benefits are: (i) integration into the world market; and (ii) improvements in the provision of infrastructure services. Against this background, recent restrictions to foreign trade and currency convertibility introduced in Russia and some other CIS countries are likely to further dampen structural adjustment and growth prospects. The key to achieving both external balance and much-needed structural change is to continue with enterprise reforms that make domestic businesses competitive on the world market, not just in trade with old CMEA partners. As EBRD project experience amply demonstrates, a commercial approach to the provision of infrastructure services can achieve rapid efficiency gains and thus contribute to reducing structural distortions in this sector, without placing a heavy burden on public investment. Reform of the financial sector is also a priority, but this sector's development has been and will continue to be gradual.

Introducing the required reform measures will require strong political commitment. This chapter has not examined in detail how the patterns of structural change affect political decisions on economic reforms, by shifting the balance of economic power. The next two chapters focus on the connections between reforms, initial economic conditions, structural change and the formation of political interest groups. The interaction of these factors is likely to significantly determine both reform patterns and economic performance during the next phase of transition.

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Part II

The state and economic reform

Chapter 5

The politics of economic reform

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Chapter 6

Governance in transition

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The politics of economic reform

Previous chapters have shown that while a number of transition economies (principally those in central Europe and the Baltic states) have made sustained progress in economic reform, the majority of countries (including most of the economies of the Commonwealth of Independent States) have been unable to sustain reform. A smaller group of countries (Belarus, Turkmenistan and Uzbekistan) has effectively failed to embark on any serious reform path.

Yet if economic reform is beneficial – and there is ample evidence that it is – then why has it proven so hard to make progress? One common answer is that politics is to blame. Narrow interest groups, populist politicians and obstructive bureaucrats are often viewed as blocking reforms that would benefit the entire society. This is the classic problem of specific interests dominating the policy-making agenda.¹ Equally, the lack of progress might be due to the inability of groups favouring reform to organise and coordinate their activities, allowing opponents the opportunity to obstruct reform.

This chapter focuses on the political factors contributing to the variation across the transition economies in the implementation and sustainability of reforms. The chapter argues that essential to successful reforms is increased competition in both the realm of politics and in product and other markets directly affecting the behaviour of firms. Reform failures have been consistently associated with weak political competition, which reduces the incentives for politicians to introduce new policies and increases the likelihood that governments will be “captured” or be unduly influenced by narrow vested interests. Such groups often gain from the market distortions and corrupt practices associated with partial reforms.

Two themes emerge from the analysis. First, in a significant number of transition countries, the ability of vested interests to influence the state and modify policy to their advantage has been a primary threat to economic reform. Second, economic reforms at the early stages of transition have a significant effect on the distribution of power among interest groups at a later point in the process. Where initial policy choices have concentrated economic power in particular groups, this power has been used to distort or stall reforms later in the transition.

The analysis is conducted at two levels. The first takes a cross-country approach and looks at factors that help to explain these differences. The analysis suggests that many commonly held views about the connection between politics and economics, based on

the experience of economic reform in other parts of the world, have not been borne out in practice in the transition economies. Rather, five political factors have influenced economic reform across the transition countries: the initial turnover of political elites following the collapse of communism; the extent of social cohesion at the early stages of the reform process; the strength of vested interests; the extent of organised political competition; and the role of external factors. At the same time, the chapter also provides a more detailed analysis of a key component of the reform process – the political economy of privatisation – in four countries with a prolonged pattern of inconsistent reforms.

5.1 The political economy of reform: the conventional wisdom

There is a conventional wisdom that guides most work on the politics of economic reform and this has influenced policy choices as well. Put simply, while reforms lead to large gains for society as a whole in the long term, they may impose substantial social costs in the short term. Reforms will therefore inevitably generate political opposition from special interest groups and sections of the population that bear the brunt of these short-term costs. To withstand the political pressure and to introduce reforms successfully, countries need to concentrate political power in the hands of committed reformers and insulate them from the constraints of political competition as far as possible.

In this approach, the most opportune time to implement economic reform can be described as a period of “extraordinary” politics, when the lack of normal constraints on decisive action creates a “window of opportunity” for reforms.² Because such windows tend to be brief, the implementation of reforms needs to take place quickly and comprehensively, not least because delay allows time for opposing interests to be mobilised.³

This emphasis on extraordinary politics coincides with the broader lessons on the political economy of reform derived from the experience of other regions of the world. In brief, existing studies suggest that the concentration of political power, limited political competition and rapid implementation enhance the prospects for the successful adoption of economic reforms.⁴

Consequently, much of our current thinking about the political strategy of economic reform is based, often implicitly, on a simple model. Committed reformers (in most cases, technocrats) should be given the power to implement a set of economic reforms as comprehensively as possible during the window of opportunity

¹ See Olson (1965).

² See Balcerowicz (1995).

³ Those favouring gradualism invert the argument, suggesting that going slow can help build support for reform. See Dewatripont and Roland (1996).

⁴ There is debate, however, as to whether these same characteristics of the political system promote the sustainability of reforms once adopted. See Haggard and Kaufmann (1995) and Williamson (1994).

when likely opponents are too weak or disorganised to obstruct the process. The very success of the initial programme will create the constituency necessary to sustain and advance the reform process once the period of extraordinary politics has passed. Indeed, one of the reasons for external assistance has been to provide support for these reformers in the period between the initial adoption of reforms and the point at which the benefits of reforms make the process self-sustaining.⁵

The following section will examine whether this description of the politics of economic reform is borne out by recent experience in the transition economies.

Rapid versus gradual reform

The political arguments in favour of rapid reforms are threefold. First, speed can prevent opposing groups from mobilising and blocking reforms. Second, the period of uncertainty is much shorter. Third, rapid reforms do not require the state to engage in constant fine-tuning of reforms in contrast with a more gradual approach.⁶

The case for gradual reform, on the other hand, is based largely on the need to build sustainable political support for economic reform. It is argued that piecemeal measures, by introducing potentially popular measures first, can build a foundation of political and social support for more difficult and costly reforms later in the transition.⁷ Gradual reforms are also assumed to entail lower costs in the short term because they avoid the massive disruption to the status quo caused by the simultaneous introduction of reforms in many different sectors of the economy.

The experience of the transition countries shows that the distinction between rapid and gradual reform largely disappears on closer inspection. To date, no country has implemented a rapid, across-the-board programme of reforms, nor has there been a clear case of a staged strategy picking popular reforms to build momentum for further measures. Instead, transition countries have shown a wide variety in both the pace and sequencing of the different components of reform. For example, Poland liberalised prices and stabilised the currency at a very early stage of the transition, but conducted partial large- and medium-scale privatisation much later. Indeed, if privatisation were used as the benchmark for the success or failure of reforms, Poland would certainly not emerge as a rapid reformer.

A gradual approach has too often been used as a rhetorical cover for preserving the status quo, as in Ukraine, rather than a strategic plan for sequencing the numerous components of reform. In such cases the consequences of this approach have been unambiguously adverse. Lack of progress with privatisation has left firms in limbo and allowed incumbents to seize assets. It has also continued to result in bail-outs from the public budget. Far from reducing the costs of transition, such an approach has imposed high costs on the population.⁸

Table 5.1

The window of opportunity

Country	Most serious stabilisation effort	Months from start of transition	Months since change of government	Months before(-)/after election
Albania	8/92	18	2	2
Armenia	12/94	39	39	-21
Azerbaijan	1/95	40	15	15
Belarus	11/94	38	6	6
Bulgaria	2/91	13	3	-9
Croatia	11/93	30	30	15
Czech Republic	1/91	13	13	13
Estonia	6/92	9	9	-3
FYR Macedonia	1/94	36	36	-3
Georgia	9/94	36	23	14
Hungary	3/90	6	21	-1
Kazakhstan	1/94	28	27	-22
Kyrgyzstan	5/93	21	21	-29
Latvia	6/92	9	9	-12
Lithuania	6/92	9	1	-5
Moldova	9/93	24	24	-5
Poland	1/90	6	6	6
Romania	9/93	45	1	12
Russia	1/95	40	38	-11
Slovak Republic	1/91	13	13	13
Slovenia	2/92	8	8	-10
Tajikistan	2/95	41	3	3
Ukraine	11/94	38	4	4
Uzbekistan	11/94	38	38	38

Sources: Fischer, Sahay and Vegh (1996) and EBRD estimates.

Timing of reforms

The window of opportunity for introducing potentially unpopular economic reforms is generally assumed to be after critical elections that bring in a major change of government. New governments are thought more likely to have the capacity to introduce reforms when faced with a weakened opposition without provoking a broad backlash. Yet an examination of the timing of serious stabilisation efforts, as shown in Table 5.1, suggests that reforms have been introduced at a variety of points in the transition. Many successful reforming governments pursued stabilisation shortly after coming to power, but a number of consistent reformers, such as Estonia and Lithuania, introduced stabilisation packages just before elections and after the fall of the first post-communist government. This suggests that it may be politically viable to adopt stabilisation packages at different points in the transition.⁹

The concentration of political power

The experience of the transition countries also runs counter to the conventional wisdom that the successful adoption of reform requires strong political executives (that is, presidents or prime ministers) with the power to act swiftly and decisively against the opponents of reform. Chart 5.1 suggests that there is a negative correlation between the power of political executives, as measured

⁵ See Sachs (1993).

⁶ See Rodrik (1995).

⁷ See Dewatripont and Roland (1995).

⁸ For a broader discussion of the social costs of reform, see Annex 1.1.

⁹ However, the evidence in Chapter 2 suggests that countries that adopt stabilisation early have proven to be better able to sustain this stabilisation over time.

Chart 5.1

The power of political executives and economic reform



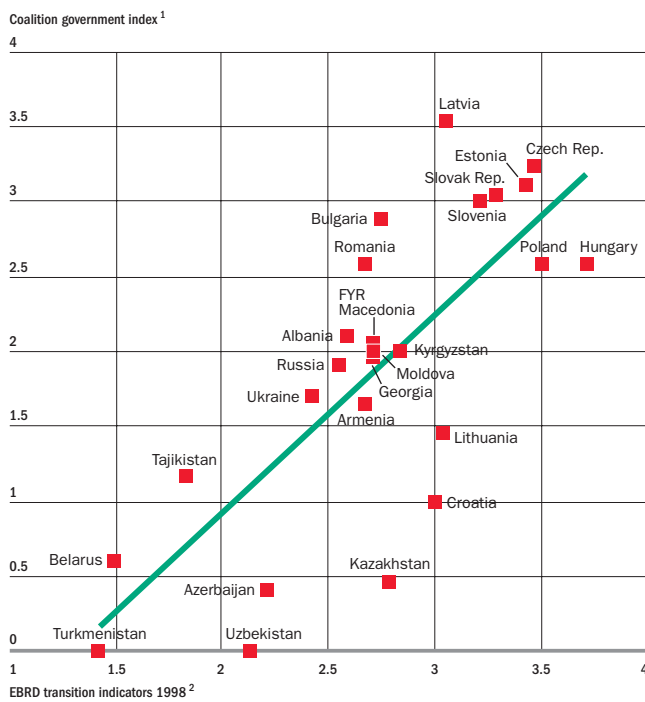
by a standardised index of formal political powers,¹⁰ and progress in economic reform, as measured by the EBRD's transition indicators.¹¹ Estonia, Hungary and Latvia have all made very significant progress in economic reforms with relatively weak prime ministers. By contrast, Azerbaijan, Belarus, Kazakhstan and Russia – countries that have constitutions conferring very strong presidential powers – have largely failed to adopt and sustain reforms. Those reforms that have been implemented have been substantially manipulated by vested interests. In some cases, such as Russia and Ukraine, efforts to grant temporary decree-making power to the president in order to break existing legislative deadlocks on economic reform had little apparent impact on the pace of reform.

Coalition governments

The idea that governments with dispersed political power should have greater difficulty in conducting economic reform is also not confirmed by the experience in transition economies. The argument is that broad-based, multi-party governments must often make costly compromises with coalition members in order to retain office. Yet, Chart 5.2 demonstrates that countries with more fragmented political systems (as measured by a common index of the number of parties represented in government) have made

Chart 5.2

Political coalitions and economic reform



greater progress in economic reform than those with more concentrated political systems.¹² Indeed, broad-based, multi-party coalitions have generally been the rule among the countries sustaining reform.

Backlash and policy reversals

As already indicated, arguments about the respective merits of rapid or gradual reforms have focused on sustainability and the implications of the likely reversal of policies. In the transition countries, reforms have tended to generate a political backlash in a majority of cases. In 14 of the 21 countries in the region that held competitive elections, incumbents lost control of the government in the second election. Yet these electoral reversals have not led to reform reversals, nor have they generally halted further progress in reform. For example, governments in Estonia, Hungary, Latvia, Lithuania, Poland and Slovenia – countries that have sustained reforms – were expelled from office in the second election of the transition period.¹³ Countries in which the incumbent government

¹⁰ Here a slightly modified version of a standardised scale of presidential power by Shugart and Carey (1992) is used. In parliamentary countries, the power of the prime minister is measured using the same scale.

¹¹ Of course, it is impossible to measure and compare the actual strength of presidents and prime ministers. As a proxy, the index of executive powers looks at the formal powers of the political executive as defined in the constitution and any other relevant laws. It should be seen as a very rough indicator of cross-country differences that underestimates the actual variation given the considerable informal powers exercised by the executives in many countries of the region.

¹² This chart uses a slightly modified version of the Roubini and Sachs (1989) scale.

¹³ Incumbents retained power in the 1992 elections in the Czech and Slovak Republics but in newly independent states, rather than in Czechoslovakia. They both lost power in the next round of elections.

Table 5.2

The politics of stabilisation

Country	Most serious stabilisation effort	Executive who conducted it	Previous position	Initially campaigned as market reformer	Type of government
Albania	8/92	Meksi	Artist	Yes	Multi-Party
Armenia	12/94	Ter-Petrossian	Academic	Mixed	One-Party
Azerbaijan	1/95	Aliiev	CP official ¹	No	One-Party
Belarus	11/94	Lukashenka	Farm manager	No	Non-Party
Bulgaria	2/91	Popov	Lawyer	–	Multi-Party
Croatia	11/93	Tudjman	Retired General	Mixed	One-Party
Czech Republic	1/91	Klaus	Economist	Yes	Popular Front
Estonia	6/92	Vahi	Factory manager	Mixed	Multi-Party
FYR Macedonia	1/94	Crvenkovski	Engineer	Mixed	Multi-Party
Georgia	9/94	Shevardnadze	CP official	No	One-Party
Hungary	3/90	Nemeth	CP official	Mixed	Interim
Kazakhstan	1/94	Nazarbaev	CP official	Yes	Non-Party
Kyrgyzstan	5/93	Akaev	Academic	–	Non-Party
Latvia	6/92	Godmanis	Political activist	Mixed	Popular Front
Lithuania	6/92	Abisala	Academic	Mixed	Interim
Moldova	9/93	Snegur	CP official	No	Multi-Party
Poland	1/90	Mazowiecki	Journalist	Yes	Popular Front
Romania	9/93	Vacariou	Bureaucrat	Mixed	Multi-Party
Russia	1/95	Yeltsin	CP official	Mixed	Non-Party
Slovak Republic	1/91	Klaus	Economist	Yes	Popular Front
Slovenia	2/92	Peterle	Economist	Mixed	Multi-Party
Tajikistan	2/95	Rakhmonov	CP official	No	–
Ukraine	11/94	Kuchma	Factory manager	Mixed	Non-Party
Uzbekistan	11/94	Karimov	CP official	No	One-Party

Sources: Fischer, Sahay and Vegh (1996), Tykov (1994) and EBRD assessments.

¹ Communist Party official.

lost the second post-communist election have sustained substantially greater reform than countries in which the government won re-election. Therefore, political backlashes and electoral reversals have not prevented progress in market-oriented reforms.

The fear of reversal has also been closely linked with the idea that the new communist parties would, if elected, try to limit or reverse reforms. Yet this fear turns out to be only partially warranted. Strong reformist credentials do not seem to be a necessary condition for successful economic reform.

Table 5.2 shows the date on which each country introduced its most serious macroeconomic stabilisation programme, the leader who introduced the programme and his previous position. It is evident that there is no simple pattern.¹⁴ Rather, many different types of governments have introduced stabilisation packages. Furthermore, governments run by reformed communist parties, including those elected in apparent backlash against reformists, have had considerable success in sustaining reform in some countries. The experience of Hungary, Lithuania and Poland suggests that reformed communist parties can extend economic reforms once they have been introduced. Support for, or opposition to, reforms prior to holding office is not a good indication of the subsequent policies of governments once in power. Rather, once reforms are under way, communist parties have generally not

reversed key decisions. In some countries, the prospect of European Union accession and the need to meet strict accession criteria has helped to lock in reforms.

This has been particularly true in central Europe and the Baltic states.¹⁵ For example, even communist parties who returned to power in Hungary, Lithuania and Poland have been ardent supporters of integration with international financial institutions and accession to the EU. The commitment to join the EU has had important policy consequences as these countries have taken initial steps towards meeting strict accession criteria. For example, Poland created a new layer of regional governments in 1998 so that it would be able to take advantage of the EU's regional policy on becoming a member. Accession targets on budget deficits, trade and immigration have helped pro-European political parties gain support for their policies in domestic political battles.¹⁶

Why have the politics of economic reform in the post-communist countries contradicted the conventional wisdom derived from past experience in Asia, Europe and Latin America? Two factors seem particularly important and are rooted in the difficulty of building states and markets simultaneously – the key challenge of post-communist transition.

¹⁴ Fischer, Sahay and Vegh (1996) polled World Bank country economists to determine the timing of the introduction of the most serious stabilisation programme.

¹⁵ The Czech Republic, Estonia, Hungary, Poland and Slovenia embarked on membership negotiations with the EU in 1998.

¹⁶ This will be particularly important in some areas, such as harmonising agriculture and telecommunications policies, which have been opposed by powerful interest groups.

First, the weak post-communist state is not only overseeing the redistribution of wealth, it is also the source of great wealth. The state nominally owns firms, land and natural resources that are suddenly up for grabs. The rewards for firms and lobby groups that manage to gain influence over the state are extremely high, creating powerful incentives.

Second, because markets and states are being built simultaneously, there have been fewer formal political constraints on the state and private business than were typically found in the countries of Latin America and western Europe. In many of the transition countries, political parties, labour unions and lobbies do not yet effectively represent collective interests as in other systems. As a result, demands have generally not been filtered through organisations with broad mandates. Instead, groups of firms and often individual firms have lobbied the state directly to serve their own specific interests. In some cases, firms have even been able to put their representatives in high public office. This leaves politicians vulnerable to capture by interest groups who became wealthy early in the transition.

These initial political conditions are important because they have an influence on the choice of reform strategy. These policy choices in turn affect each country's path of development because economic reforms have important repercussions. The policy choices made by the first government help to establish the distribution of economic power in later rounds of reform. Some countries, such as Hungary, Poland and the Baltic states, made economic choices early in the transition that created sufficiently broad benefits for society at large to sustain further reforms. In other countries, such as Bulgaria, Romania and Ukraine, initial policy choices created or strengthened vested interests that would not benefit from further efficiency-enhancing reforms. These initial policy choices therefore merit special attention. How have some states managed to avoid being influenced by powerful vested interests that block economic reform?

5.2 Explaining variation in patterns of reform

Economic reforms are typically blocked at two points. First, politicians may lack the incentive or the support to change existing policies and institutions, preventing the introduction of reforms. Second, once reforms are introduced, they can be reversed or distorted by groups reacting to the initial costs of large-scale change. To understand the progress of reform, an analysis needs to be made of why reforms are introduced and how they are sustained. No single answer can explain what drives the reform process in any single country, nor the considerable variation in reform across the region. Moreover, political factors can contribute only to a broader explanation that would incorporate a wide range of "initial conditions", as outlined in Chapter 2. These include geographical location, economic structure, initial macroeconomic imbalances and many other factors. The goal in this chapter is to

identify political institutions and political processes that systematically affect whether a country is likely to initiate and sustain economic reforms.¹⁷

The analysis begins at the initial stages of transition. Two important political conditions that immediately followed the collapse of the communist regime are examined across all the transition countries: the extent of change in political elites and the degree of social cohesion, as expressed in the first post-communist elections. These factors not only shape political strategies, but also shape the structure of interest groups in post-communist political systems and affect the capacity of such groups to capture parts of the state and thereby have an effect on economic policy choices. The analysis also examines the factors that have helped to reduce undue influence by vested interests in many transition countries, in particular the role of political competition.

The turnover of political elites

The collapse of communism is usually associated with the revolutions of 1989 in central and eastern Europe, but many of the transition processes, especially further east in the CIS, were initially (and even remain) led by the same political elites that ruled the country in the communist era. A change of power in the first post-communist government and associated turnover in the broader elite are linked with early progress in the adoption of economic reforms. Chart 5.3 shows that progress in liberalisation during the first year of transition, as measured by a standard index of liberalisation,¹⁸ was twice as high in countries where the political executive was replaced as in those where the incumbent from the communist era remained in office.

Incumbent politicians have tended to prefer the status quo, believing that economic reforms would undermine their interests. When placed under pressure by external agencies, principally the international financial institutions, such politicians often implemented reforms in ways that preserved or even extended the privileges available to the existing elites. In these countries, both liberalisation and stabilisation were delayed until the incumbent was finally removed in subsequent elections, as was the case in Albania, Bulgaria, Moldova and Ukraine. Those countries that are still ruled by the same political leader from the communist era, such as Turkmenistan and Uzbekistan, have tended to adopt little or no reform.¹⁹

In contrast, new political leaders, and the new elite that support them, have had greater incentives to introduce reforms, if only to weaken their political opponents. New governments used liberalisation and stabilisation to limit the power of bureaucrats, most of whom had remained in their positions throughout the transition, and to curb the interests of loss-making industrial sectors. Consequently, many new leaders saw economic reforms as an important means of strengthening their political position.

¹⁷ This is not to suggest that less systematic factors, such as the commitment and talents of key individuals and the political agreements and compromises they forged, did not also play an important role in the success or failure of reforms in any given country. For an enduring account of the role of the individual reformer in the process of "reform-mongering", see Hirschman (1968). Aslund (1995) provides an account of the reform process in Russia, for all its successes and failures.

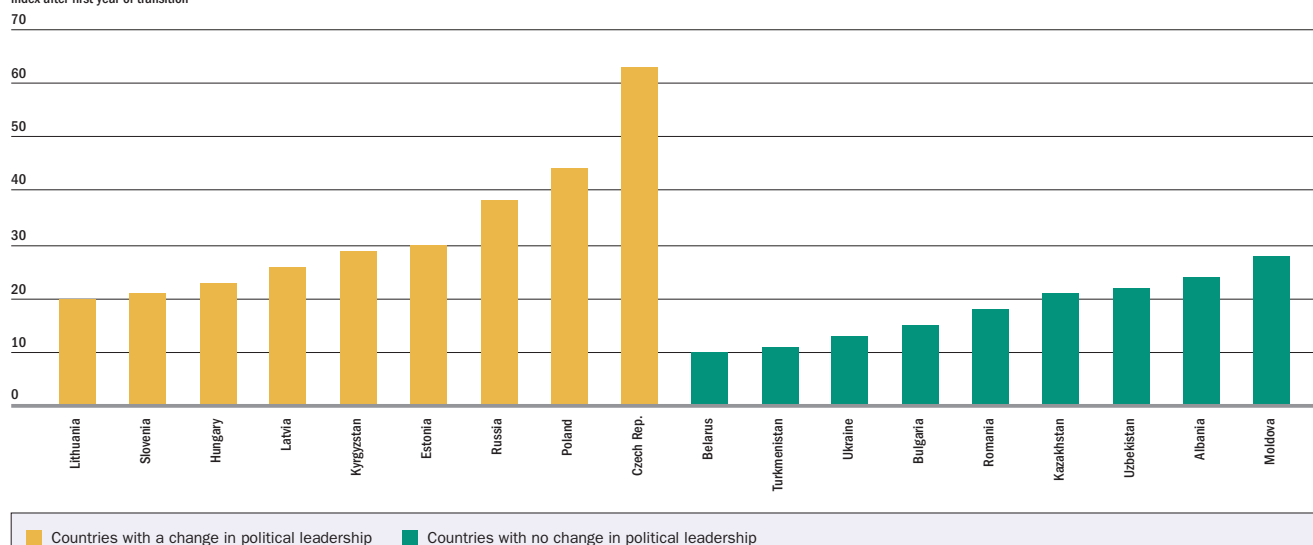
¹⁸ The liberalisation score used is the World Bank's cumulative liberalisation index. See De Melo, Denizer and Gelb (1996).

¹⁹ Though there is still variation in the level of reform adopted in such countries, as shown by Kazakhstan, which has implemented more reforms than other countries in this group.

Chart 5.3

Political change and liberalisation

Percentage change in liberalisation index after first year of transition ¹



Source: Tykov (1994).

¹ The liberalisation index was developed by the World Bank. See De Melo, Denizer and Gelb (1996).

However, a change of political power neither guarantees the successful adoption of economic reforms nor the ability to sustain them. New leaders in Armenia and Georgia were unable to introduce effective programmes of liberalisation and stabilisation in the early stages of transition. Clearly, the preferences, skills and commitment of new leaders play an important role in shaping their policies. However, there are other factors, discussed below, with deeper roots in the political system that help to explain initial reform choices.

Social cohesion

A change in political power may provide an incentive for new governments to introduce reforms, but other political factors affect their ability to fulfil their plans. A high degree of social cohesion early in the transition – that is, a consensus within society on the broader goals of transition – eased the implementation of reforms and weakened any subsequent pressures for reversal or backlash. Lack of cohesion, demonstrated by a polarisation of the political preferences of the electorate, created significant obstacles in the reform process. Politicians in polarised systems were often forced to make greater compromises to win support from their opponents for a reform package.

From the point of view of firms, political polarisation increased uncertainty as it threatened to generate large swings in policy. To guard against these swings, firms were inclined to devote more

resources to lobbying the state as a form of insurance against potential policy changes. Moreover, greater uncertainty reduced the incentives of firms to invest in restructuring.

One simple, albeit crude, measure of the degree of social cohesion at the early stages of transition is the division of the electorate between non-communist and new communist parties in the first post-communist elections. Votes for the latter suggest the existence of residual support for elements of the previous regime.²⁰ Chart 5.4 compares the number of seats won in each country by the new communist party and the largest non-communist party in the first elections of the transition period.

In the upper-left quadrant of the chart are those countries where a non-communist party or movement won close to a majority of seats in the first post-communist election, while the communist party received a much smaller portion of seats (less than 25 per cent). This group includes some of the most consistent reformers in the region: the Baltic states, the Czech Republic, Hungary and the Slovak Republic.²¹ Even when returned to power at a later stage, as in Hungary and Lithuania, the new communist parties had adapted their political programmes by moving closer to west European social democracy and continued to pursue a reform-oriented agenda.²² The extent of initial social cohesion around the key goals of transition in these countries reduced the likelihood of sharp swings in policy.

²⁰ However, this interpretation of the split between non-communist and new communist parties must be treated with some caution. Experience has shown that not all new communist parties are alike. In some of the central European countries that had tolerated greater reform and decentralisation within the communist party prior to the fall of communism, reformers worked within the framework of new communist parties. Consequently, residual support for new communist parties is not always an indication of support for the previous system.

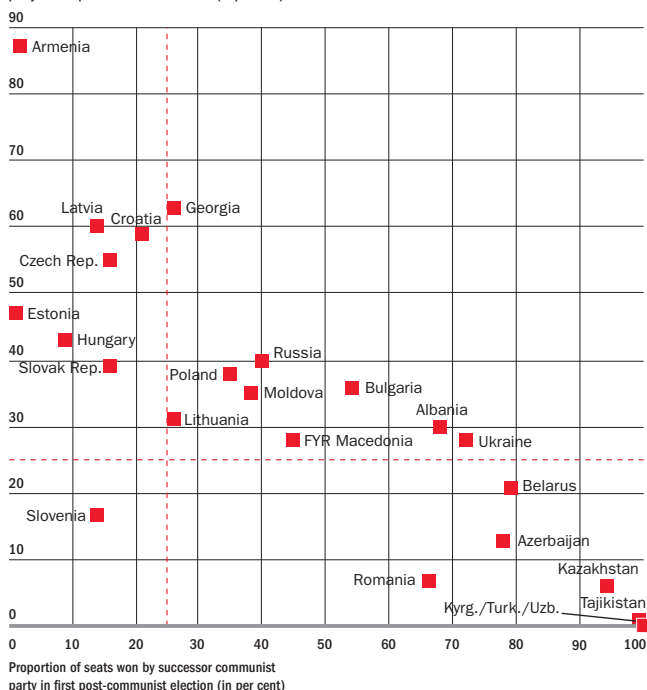
²¹ In the course of the roundtable negotiations in Poland, Solidarity agreed to a power-sharing arrangement that guaranteed the communist party a share of the seats in the legislature. However, Solidarity's landslide victory in the first elections reveals a much greater degree of initial social cohesion around the goals of transition than the distribution of seats in the legislature suggests.

²² Each of these parties shed their more hard-line elements when out of power and faced a coordinated opposition on the left. See Ishiyama (1999).

Chart 5.4

The extent of social cohesion

Proportion of seats won by largest non-communist party in first post-communist election (in per cent)



Sources: International Foundation for Electoral Systems web site (www.ifes.org); CIA World Fact Book web site (www.odci.gov/cia); and central election commissions.

In contrast, the countries in the upper-right quadrant of the chart were far more polarised in the initial stages of transition, almost evenly dividing votes between the non-communist and communist parties in the first election. In many of these countries, the division of votes would appear to reflect a greater divide within society about the goals of transition. Among these countries are some of the most inconsistent reformers in the region, including Albania, Bulgaria, Moldova, Russia and Ukraine. In many of these countries, far-reaching reform programmes were initially proposed, but were quickly reversed, distorted or otherwise blocked in the process of implementation, often following changes in government.

A high degree of political polarisation has often resulted in the over-provision of social support for losers from reforms. In a number of countries (for example, Bulgaria) this is evident in the maintenance of relatively generous support for the newly unemployed and in substantial social benefits programmes. In the CIS, social spending has not been maintained at such levels, but substantial state support, through both explicit and indirect channels, has been directed towards firms. Indeed, political polarisation has been a key factor in explaining the inability of certain countries to enforce difficult restructuring choices on firms.

Countries in the lower-right quadrant of Chart 5.4 were still dominated by communist parties in the initial stages of transition and most have continued to be dominated by such parties to the

present day.²³ The degree of unity suggested by the dominance of communist parties might not reflect a broad social consensus but the lack of political competition in these systems. Not surprisingly, many of these countries (Azerbaijan, Belarus, Tajikistan, Turkmenistan and Uzbekistan) have been among the slowest reformers in the region.

Taken together, the turnover of political elites and the extent of social cohesion around the key goals of transition at the early stages of the process have played an important role in shaping progress in transition in the post-communist countries. These political factors shape the decisions of politicians to introduce reforms as well as the decisions of economic actors to support these changes. Countries with high turnover and social cohesion have tended to introduce stabilisation packages quickly, to adopt policies of privatisation that included a role for outside investors, and to liberalise more extensively than other countries in the region. Politicians in these countries came to power with few ties to the old regime and had strong incentives to introduce reform quickly, if only to weaken opponents. Once reforms were introduced, the greater social consensus on policy provided momentum for further reforms and made policy reversals less likely. This was partly a result of the reduced bargaining power of groups favoured by the old regime.

In contrast, countries that began the transition with the same political elite in power and a greater degree of political polarisation have been particularly prone to capture by interest groups opposed to reform. Incumbents with strong ties to the old regime and clear social divisions over the reform agenda have tended to be reluctant to introduce and sustain reform. Instead, their policies have favoured redistribution to existing vested interests at the expense of policies that would promote efficiency gains for society in general. Stabilisation packages in these countries were introduced later in the reform process, privatisation rewarded enterprise insiders, and liberalisation remained partial so as not to threaten politically favoured groups. The next section examines the role of these vested interests in the reform process in greater detail, with a particular focus on the consequences for privatisation.

Vested interests

Initial policy choices early in the transition can alter the balance of power among interest groups with important repercussions for the sustainability of any particular pattern of reform. Social groups that are made powerful in the initial stages of the transition can create significant barriers to reform. Such groups might include parts of the former *nomenklatura* who feared that reform would lead to the loss of their privileges. Equally, workers displaced by restructuring and firm closures might be expected to resist reform. In many countries, the response to entrenched interests has been to try to enlist their support or to fail in the pursuit of reform. Yet the problem with co-opting opponents is that they can modify reforms to such an extent that the promised efficiency gains are ultimately undermined. The discussion of privatisation below highlights this danger.

²³ Romania is an exception here. The original dominance of the National Salvation Front was eventually overturned, leading to much higher levels of polarisation in subsequent legislatures.

Table 5.3

Privatisation menu

	Privatisation approach	President/Dominant political group
Bulgaria		
1990-92	Spontaneous privatisation	Bulgarian Socialist Party (BSP)
1992-93	Direct sales	Union of Democratic Forces (UDF)
1994-96	Mass Privatisation (for selected firms)	BSP
	Direct sales	–
1997-99	Second Mass Privatisation (vouchers)	UDF
	Direct sales	–
<i>Dominant privatisation method (1990-99): Management-employee buy-outs (MEBOs).</i>		
Romania		
1990-92	Spontaneous privatisation	Iliescu/National Democratic Salvation Front (FDSN)
1991	State Ownership Fund (SOF) established	–
1993-94	Mass Privatisation Programme (tradable vouchers)	Iliescu/FDSN
1995-96	Second Mass Privatisation Programme (non-tradable vouchers)	Iliescu/FDSN
1997-99	Direct sales	Constantinescu/Democratic Convention
<i>Dominant privatisation method (1990-99): MEBOs.</i>		
Russia		
1990-91	Spontaneous privatisation	Gorbachev/Communist Party
1992-94	Mass Privatisation Programme (tradable vouchers)	Yeltsin/no clearly dominant party
1994-96	Cash sales of shares	Yeltsin/no clearly dominant party
1995	“Shares-for-loans” privatisation	Yeltsin/Communist Party and Agrarian Party
<i>Dominant privatisation method (1990-99): MEBOs.</i>		
Ukraine		
1990-91	Spontaneous privatisation	Gorbachev/Communist Party
1992-93	Leasing to employees	Kravchuk/Communist Party
	MEBOs	–
1994	Privatisation suspended by Parliament	Kravchuk/Communist Party
1994-97	Mass Privatisation Programme (non-tradable vouchers)	Kuchma/Communist Party
1998-99	Direct sales	Kuchma/Communist Party
<i>Dominant privatisation method (1990-99): MEBOs.</i>		

Source: EBRD.

To determine how vested interests have affected privatisation, it is necessary to analyse the policy options open to reformers. As such, three main options were available when designing privatisation plans: mass or voucher privatisation; outsider privatisation – through sales to foreigners or other investors; and insider privatisation, with insiders being defined as the managers and employees of the firm. Insider privatisation occurred through direct sales or transfer of title as well as through mass privatisation schemes. Incumbents, such as managers, could have been expected to favour insider privatisation, while reformers would usually have preferred mass or outsider privatisation to promote improvements in corporate governance. However, experience in central and eastern Europe suggests that a mix of approaches has generally prevailed.

Among countries with inconsistent reforms, communist parties or presidents with strong links to the previous system maintained control over major parts of the privatisation agenda. The exceptions to this were the short-lived Union of Democratic Forces (UDF) government in Bulgaria in 1991-92 and the control of the

government by reformers in Russia in 1992. The influence of vested interests, often through a combination of electoral success and control of the executive, and their success in influencing the timing and manner in which structural reforms were tabled and enacted in some of the countries is evident from Box 5.1 and Table 5.3. These focus on four cases where reforms have been stalled or remain incomplete: Bulgaria, Romania, Russia and Ukraine. The table shows that privatisation was placed at a relatively early stage on the reform agenda. Part of this can be attributed to persistent pressure from international financial institutions. However, privatisation generally proceeded at a slow pace – with the exception of Russia – and in a manner that ultimately was at odds with significant improvements in productivity. Box 5.1 reviews the progress of the privatisation in these four countries.

In countries with inconsistent reforms, not only was there widespread reluctance among the political leaders and major political groupings toward privatisation, but when the process actually got going it was consistently skewed towards the interests of

Box 5.1

The politics of privatisation in four countries

Bulgaria

A reform-minded government (UDF) emerged in 1991 with a small majority. Its position was fragile from the outset. Prior “spontaneous privatisation” had strengthened the grip of politicians associated with the communist party, while high uncertainty over the consequences of reform, exacerbated by the long-term decline in soft loans from Russia, meant that popular support for reform was weak.¹ Public opinion polls showed that Bulgarians strongly favoured a large state role in the economy and the maintenance of subsidies for loss-making firms, while they were substantially opposed to privatisation.² The rapid return to power of the Bulgarian Socialist Party (BSP) stalled further privatisation.

Under external pressure, opportunities for MEBOs were expanded through a mass privatisation scheme in 1996. This was designed in a way that favoured insiders, and implementation remained slow. Control over major parts of the economy became highly concentrated and was acquired in very non-transparent ways. It was only after the economic crisis in 1997 – largely triggered by the maintenance of soft credits to non-privatised firms – and the electoral ousting of the BSP that an attempt was made to accelerate privatisation. To date, it has still had only partial success. However, the actual process has remained dominated by management-employee buy-outs (MEBOs).

Romania

A Mass Privatisation Programme (MPP) was finally set in motion in Romania in 1993 after considerable delay. A second MPP was launched in 1995, this time with non-tradable vouchers. Both ultimately favoured MEBOs so that by early 1996 over 80 per cent of privatisation in Romania had been achieved by this method. The election of a more reform-minded president – Constantinescu – and a subsequent change in the balance of political parties in the parliament in late 1996 led to an announced acceleration in the pace of privatisation, including a greater emphasis on the role of strategic investors. However, progress has been significantly slower than expected.³

The slow pace of privatisation cannot simply be attributed to a lack of political will. Rather, political interests and, indeed, institutions continued to benefit from the stalled reforms. For example, the key agency established in 1991 to manage the privatisation process – the State Ownership Fund – was set up as a closed fund controlled in practice by its own politically appointed managers, who responded primarily to the demands of politicians. Despite changes in control and incentives in 1997, privatisation carried out since 1991 has been heavily reliant on insider deals.

Russia

Despite control over the government and a powerful presidency after the constitutional changes of 1993, Yeltsin and his reformers faced a hostile parliament and frequently hostile regional interests. Mass privatisation was implemented relatively rapidly but, in the face of powerful political constraints, explicitly favoured insiders. The overwhelming bulk of privatisation was undertaken by the so-called “Option 2”, a procedure that effectively conferred majority ownership rights on employees. This satisfied the immediate political constraints but also allowed for a subsequent resale and combination of ownership and control rights, with greater scope for outsider participation.

Following the initial burst of rapid privatisation, there has been a relatively small redistribution of control rights towards outsiders. Moreover, under the “shares-for-loans” scheme implemented in 1995, many of the key resource-based companies fell into the hands of a small group of financiers, the so-called “oligarchs”. This has led to very sharp increases in wealth and income inequality – by 1997 the Gini coefficient for income in Russia was around 0.5, a level comparable with those in Colombia or Malaysia. It has also helped to create an investment climate marked by corruption, non-transparent business practices – including barter – and cronyism.

The consequences of the privatisation strategy adopted in Russia have been highly adverse for the governance of enterprises and the allocation of resources, not least because of the clear failure to break the political constraints on restructuring and company closures. The regime of the soft budget constraint has commonly been maintained.

Ukraine

Initially, politicians were preoccupied with nation and state-building, given the previous high degree of centralisation in decision-making in the Soviet Union. The principal advocates for privatisation were the international institutions and donors. In 1992-93, some tentative steps were taken towards a limited insider privatisation of a small number of firms. A second stage of privatisation was launched in principle in 1994-95 by a new president – Kuchma – using vouchers but this was effectively blocked by the parliament, which was dominated by parties opposed to market-based reforms. Thereafter the pace of privatisation accelerated although a minority of firms were offered on a cash or strategic tender basis and the vast majority of firms were effectively privatised through management buy-outs. In addition, a significant number of proposed privatisations were blocked by the parliament.

¹ Demographics did not help. In Bulgaria over a third of the population was over 50 years of age and hence either in actual or imminent receipt of state benefits. The older population has tended to provide an important voting bloc against reform.

² See Nenova (1999) for a discussion of preferences as measured by opinion polls.

³ See Zaman (1999).

incumbents. In much of the CIS, for example, protracted periods of “spontaneous privatisation” in 1989-91 helped to consolidate the control of incumbents while weakening the state by reducing revenues and blurring the distinction between firms and the bureaucrats who should have regulated them. This strengthened the opposition to any organised privatisation procedures that attempted to bring in outside interests. As a result, privatisation in much of the CIS has reflected the interests of incumbents, even when using methods that were notionally fair.

One result was that compromise solutions that could have led to greater outsider participation have mostly been blocked. Where privatisation has not even proceeded, managers and politicians have used firms to extract public resources and to redistribute assets. This is particularly clear in the case of Bulgaria where subsidies to, and stealing by, firms ultimately led to an economic crisis.²⁴ The lack of integrity of commercial and other practices has led to adverse consequences, as Chapters 6 and 7 demonstrate through their analysis of the business environment and its links to restructuring.

²⁴ See Nenova (1999).

Chart 5.5

Reform and inequality

Percentage change in Gini coefficient 1988-94



The experience of countries with inconsistent levels of reform suggests that privatised firms have maintained their appetite for subsidies, particularly in the CIS, where large firms can dominate a particular region or town.²⁵ Continuing support for soft loans cannot be simply attributed to a benevolent concern for employment. Indeed by 1999, labour force survey data for several countries with inconsistent reforms showed that unemployment was generally in excess of 10 per cent.²⁶ Rather, it underlines how payments are consistently made to particular interest groups under the guise of employment protection. Rent-seeking and corruption have also been critical factors in the persistence of soft budgets and have provided politicians and entrenched interests with regular flows of private benefits, generally at the expense of the exchequer. Box 5.2 examines one prominent example that illustrates this dynamic: the rise of Multigroup in Bulgaria.

Several adverse and long-lasting effects of privatisations dominated by vested interests can be identified. One consequence has been far more rapid increases in inequality than in those countries that have sustained reforms, as depicted in Chart 5.5. In Russia, for example, not only has income inequality increased substantially but spending on social benefits has actually become regressive over the course of the transition.²⁷ This highlights the effects of the capture of the state by narrow interest groups. The result has been not only the redistribution of public expenditure towards such groups but also a significant decline in the efficiency of public goods provision.

This process of redistribution further entrenches the power of vested interest groups in the political system. In countries where political parties remain underdeveloped and collective associations do not yet serve as intermediaries between the state and firms, these vested interest groups can eventually wield tremendous influence on government policy-making. Their influence is directed towards protecting their privileged position in the developing market economy, which often leads such groups to oppose efficiency-enhancing reforms that would threaten these privileges.

Not all lobby groups oppose reform. Groups that benefit from reform, however, are not usually well-positioned to lobby the state. Often they are geographically diverse (consumers, for example) or not politically powerful, such as small and medium-sized enterprises. Yet newly created firms can provide significant support for reform. In Poland, regions with a high number of new private businesses provided a high proportion of votes for pro-reform parties.²⁸ This underlines the political importance of creating new private sector companies at an early stage in the transition so that they can provide sustained support for reform. By contrast, in Russia, evidence suggests that the structure of fiscal relations has contributed to predatory and unpredictable taxation that has prevented the entry of new companies and ultimately restricted the emergence of a new private sector lobby.²⁹ Indeed, when privatisation has been dominated by entrenched interest groups, a common outcome has been to limit the space in which a new private sector could grow. This has had severe consequences for growth in the long term.

²⁵ For analysis of the problems in one-company towns or where employment is highly concentrated, see the papers in Worgotter and Rein (1997).

²⁶ For Russia, the unemployment rate was crudely estimated at around 14%, in Romania at around 10.5%, in Bulgaria in excess of 12%.

²⁷ See Commander and Lee (1998).

²⁸ See Jackson et al. (1996). This logic also seems to hold in Russia, but the number of new businesses is far smaller in Russia than in Poland.

²⁹ See Zhuravskaya (1999).

Box 5.2

The case of Multigroup

The Bulgarian conglomerate – Multigroup – provides an interesting example of the way in which assets have been accumulated in a period when explicit privatisation was largely shunned and when the power of informal contacts became paramount. First registered in 1990 in Liechtenstein, Multigroup rapidly established interests in a wide range of sectors, including sugar, metals, insurance, electronics, tourism, gambling and the financial sector. The management of the firm is believed to have had links with a number of influential politicians who were associated with the Bulgarian Socialist Party (BSP), in particular with the former Prime Minister, Andrei Lukhanov. Prior to 1991, the group acquired a privileged position in foreign trade, particularly with respect to the export of metallurgical products. But it was in 1990-94 that the group expanded enormously, building up its large and diverse portfolio of interests across most sectors of the Bulgarian economy. In addition, the group entered into commercial links with key Russian energy providers, particularly Gazprom. As such, Multigroup was heavily involved in the establishment in 1995 of a new joint Russian-Bulgarian firm that would be involved in the supply and sale of natural gas, including transmission to other countries. Multigroup's stake in this firm – Topenergy – increased over time at the expense of the original Bulgarian partner, Bulgargas, and with the support of Gazprom.

From 1995-96, there is evidence of some consolidation as well as some further acquisitions through the Mass Privatisation Programme launched by the government of the BSP. When that government fell and a pro-reform administration was elected, a number of its privatisation bids failed and its links to the Russian natural gas industry were severed. Gazprom, after bilateral government negotiations, bought out Multigroup's stake at the end of 1997. Shortly afterwards, Multigroup's executive director left for the USA, from where the group is currently managed.

The case of Multigroup shows how links to powerful politicians and firms at home and abroad were key to securing a very rapid expansion of the conglomerate. This expansion proceeded in a highly non-transparent manner, with preferential deals concluded outside the public gaze. Although it is difficult, if not impossible, to gauge the actual size of the conglomerate at its peak – due to its non-transparent accounting and other business practices – this example shows the way in which the Bulgarian Socialist Party's rhetoric of social justice and hostility to privatisation was nevertheless able to sanction an extraordinary concentration of assets and bargaining power and how these links spilled over into cross-border deals, particularly with Bulgaria's key trading partner, Russia.

The following section now turns to the effects of political competition on vested interests and the reform process.

Political competition

Transition countries with the most competitive political systems have tended to achieve greater progress in economic reform. Box 5.3 discusses a number of explanations of the mutually reinforcing relationship between democracy and economic reform. Chart 5.6 looks more narrowly at the effects of political competition, depicting the relationship between the average tenure of governments in each country (in number of months) and the EBRD's transition indicators. Frequent changes in government have been associated with greater progress in economic reform. Poland and the Baltic states, for example, have had relatively

Chart 5.6

Political competition and economic reform



Sources: International Foundation for Electoral Systems web site (www.ifes.org); CIA World Fact Book web site (www.odci.gov/cia); and central election commissions.

¹ The EBRD transition indicators range from 1 (little progress) to 4 (substantial progress).

frequent changes in government. Indeed, Estonia has had seven prime ministers since the start of transition.

Political competition may help to promote and sustain reform in several ways. Periodic changes in government may make it more difficult to create the kinds of patron-client relationships that allow vested interests to exert undue influence on policy. The most competitive political systems identified in Chart 5.6 have avoided the worst examples of state capture that have plagued other countries in the region.³⁰

The threat of a change in power may also deter governments from providing special privileges to narrow interest groups that could provoke a negative response from the electorate at the polls. The public aspect of political competition is particularly important in this regard. For example, vigorous reporting in the media may dissuade politicians from making insider deals with their supporters. This is a serious problem in countries such as Russia, where the ownership structure in the media has become concentrated in the hands of groups that have benefited most from cronyism.

Concerns that political competition would increase the likelihood of backlashes against reform in the short term have proven unfounded. Governments that introduced reforms have fallen in the next election at a rate similar to governments that introduced few reforms. As discussed above, the majority of reform-minded

³⁰ Even among relatively successful reformers, lack of government change has inhibited reform. The Czech Republic, the Slovak Republic and Croatia had governments with long tenures. While their economies performed well early in the transition, economic reform has stagnated amidst allegations of corruption and cronyism in recent years.

Box 5.3

Democracy and economic reform

After ten years of transition, there is a clear positive correlation between economic reform and the consolidation of democracy, as depicted in the chart. The countries most advanced in economic reform are also those most advanced in the consolidation of democracy.

However, an association between democracy and economic reform does not explain how each is related to the other. Does democracy create the conditions necessary for the implementation of economic reform? Or is a market economy a key pre-condition for the successful consolidation of democracy? Experience has shown that democracy and the market are mutually reinforcing. Each has “feedback effects” that tend to benefit the other.

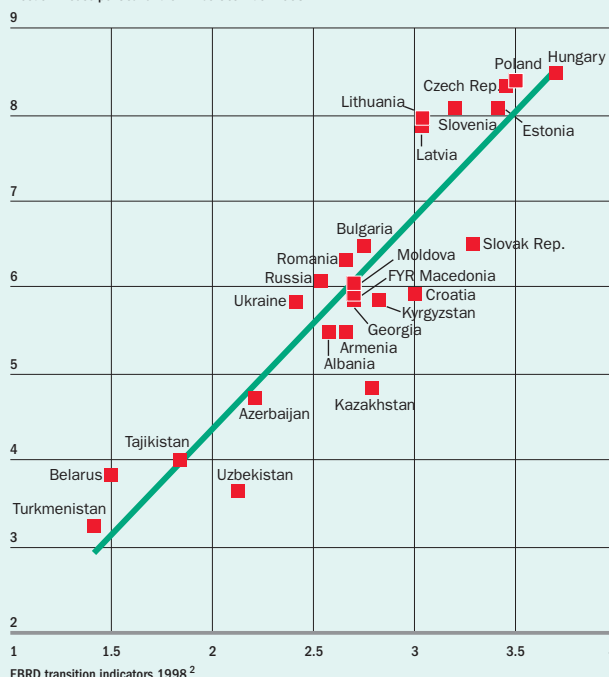
A number of explanations have been proposed to explain the positive impact that democracy has on the development of markets, as outlined below:

- Democratic systems can constrain the capacity of narrow elite groups that exercise undue influence on government.
- Property rights have to be broadly accepted as legitimate in order to become safe and secure. A market economy cannot function without solid protection of well-defined property rights. Democracy tends to guarantee their legitimacy in the long term.
- Democracy requires transparency in public transactions. It enhances this transparency and therefore promotes trust in public institutions. Transparency and trust are essential pre-requisites for the proper functioning of market-oriented institutions as well.

Some potential explanations for the ways in which markets reinforce democracy are provided below:

- Markets are vital for developing a robust civil culture, which is a pre-requisite for true democracy. They are especially needed in countries where civil society is poorly developed as a result of the legacy of communism and its culture of dependency, distrust and deception.
- Markets can teach the benefits of cooperation based on self-interest. The same attitude is also required for democracy to take root.
- It is difficult to establish a democracy in the absence of a broad middle class. A middle class, which is confident about its rights, can be created only through the effective functioning of markets.

There is a very close connection between the evolution of a market economy and the evolution and consolidation of democracy, though any conclusions about the relationship between markets and democracy must remain tentative. Nevertheless, this again points to the way in which a virtuous circle can result from the growth of political and product market competition.

Democracy and economic reformFreedom House political and civil liberties index 1998¹

Sources: EBRD and Freedom in the World 1998-99 (www.freedomhouse.org/survey99/).

¹ The index ranges from 1 (low) to 10 (high).

² The EBRD transition indicators range from 1 (little progress) to 4 (substantial progress).

governments were voted out of office in the following election, but the electoral reversals have not necessarily sparked reform reversals or otherwise halted further progress in reform.

5.3 Conclusions

The politics of economic reform in the post-communist era challenge the conventional wisdom that has emerged from analysis of reforms elsewhere in the world. This chapter has identified a number of particular features that have been central to explaining variations in reform across the transition economies. They can be summarised as follows.

First, political competition and changes in political elites appear to have promoted economic reform in many countries by weakening the power of vested interests that might otherwise have captured key elements of public policy and manipulated reforms to their own advantage. Without competition, reforms have been conducted in ways that ultimately impose heavy costs on the society.

Second, initial political conditions have had an important bearing on politicians' strategies for conducting economic reform. In particular, the change of political elites, particularly at the outset of the reform period, and a large degree of social cohesion, as reflected in a low level of political polarisation over the content of economic policy, have been associated with a greater ability to introduce and sustain reforms. Communist governments that retained power into the post-communist era have tended to be reluctant to introduce reform, despite considerable and obvious evidence of economic decline. It has usually taken changes in political power to allow the introduction of an economic reform package in the post-communist world. In addition, countries divided over the direction of economic policy have also had difficulty sustaining reforms. In the absence of a strong commitment to reform, powerful vested interests, including the *nomenklatura*, have imposed a heavy imprint on the content of reform and its timing.

Third, the redistribution of assets prior to, and early in, the transition has tended to create powerful interest groups that can constrain progress in economic reform at a later stage. Insider privatisation, delayed stabilisation and partial liberalisation have redistributed assets to groups that generally have a limited interest in promoting further reforms. Therefore, even explicit attempts to co-opt vested interests – as was partly attempted in Russia – have floundered when faced with interest groups that have adapted the new rules of the game to their objectives. These dynamic aspects of reform suggest the crucial importance of initial policy choices.

Fourth, early on in the transition it was widely assumed that rapid privatisation was critical. While ownership change has indeed proven essential, it has done so in a far more subtle way than expected. Instead, it has been the interaction of policies designed to change ownership in existing firms with the entry of new private firms that has been crucial. In political terms, the absence of a substantial number of new companies has resulted in a lack of political voice for reforms that open markets and increase competition.

These findings highlight the major challenges for policy that lie ahead. In particular, for the countries with inconsistent levels of reforms, it will be essential, though difficult, to move away from a situation in which vested interests have established control over major parts of the policy process. Key to this will be the promotion of more effective political and product market competition. An essential component of this strategy should be a greater entry of new private firms and products that can challenge incumbents. For those economies that do not have the pressure to commit to policy reforms through the prospect of EU accession, it is essential to take steps to open trade and to stimulate the market for resale of equity and control rights in insider-privatised firms. At the same time, measures that move key institutions, such as the judiciary, towards greater protection of commercial and other rights can help break down, albeit gradually, the stranglehold of interests that continue to gain from restricting competition.

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Governance in transition

The challenge of transforming the state's role in the economy remains central to further progress in transition. Although there is no single model of governance in market economies, the state in many transition countries has still not fully adapted to the functions and tasks necessary for a developed market system. Legacies of central planning still shape the relationship between the state and firms in parts of the region. Key state institutions for protecting property rights and enforcing contracts are still functioning poorly. In many transition countries, the state has proven unable to provide an adequate social safety net for its citizens. Despite the considerable achievements of the transition over the first decade, the promise of good governance remains largely unfulfilled.

This chapter examines the extent to which the transition has transformed the role of the state and the nature of governance in the post-communist economies. It reports on the results of a major new survey of over 3,000 firms in 20 transition countries, conducted by the EBRD in collaboration with the World Bank. The Business Environment and Enterprise Performance Survey asked entrepreneurs and managers about the extent and nature of their dealings with the state and the associated obstacles to their business. It included questions on difficult issues, such as corruption, organised crime, state intervention and the influence of firms on governments. These are crucial determinants of the business environment that are rarely reflected in standard measures of country performance. Consequently, the survey provides an opportunity to assess and compare the quality of governance across countries from the viewpoint of those most directly affected. In addition, the focus on enterprises provides an opportunity to examine differences across firms within a given country to see how the relationship with the state depends on characteristics that vary across firms.

The survey results have important implications for an understanding of the factors that advance or impede the development of good governance. The chapter presents five key findings:

1. The relationship between governance and economic reform (in terms of liberalisation and privatisation) is not uniform. Firms in the most advanced and least advanced transition economies have more favourable assessments of governance than those in countries that have adopted partial reforms.
2. An important factor in explaining differences across countries in the quality of governance is the extent to which the state is prone to “capture” – or undue influence – by powerful vested interests in the economy. “High-capture” states tend to focus on providing specific advantages to influential firms and lobbies, while under-providing the institutions essential to improving governance.
3. The effects of privatisation on the quality of governance differ sharply according to the degree of state capture. Privatisation is associated with improved governance in countries where the state has been less subject to undue influence through capture by vested interests. However, in high-capture states, privatisation is associated with a lower quality of governance.
4. Progress in economic reform has not been synonymous with the elimination of state intervention in enterprise decision-making, although it has affected the types of decisions in which the state intervenes.
5. The initial hopes that economic reforms would largely eliminate the state's role in the operations of enterprises – a process that has been referred to as “depoliticising” firms – have not been fully realised in most transition economies. States and firms continue to be tied together in a web of interactions in which the state provides a wide range of direct and indirect subsidies to firms, while firms provide public officials with some combination of control over company decisions and bribes.

The chapter documents each of these findings. Section 6.1 compares the level of governance across the transition economies and relates this to progress in economic reform. Section 6.2 shows the relationship between the quality of governance and the degree of state capture, based on a unique measure of state capture constructed from the survey. Section 6.3 demonstrates how the effects of privatisation on the quality of governance depends critically on the degree of state capture. In Section 6.4, various aspects of the state's relations with businesses are examined, focusing on costs to the firm in terms of state intervention, time spent dealing with officials and the extent of bribery. The benefits received from the state in terms of direct and implicit subsidies are examined in Section 6.5. The nature of the dealings between the state and firms are analysed both across countries and across different types of firms in the overall sample. The final section draws conclusions on the quality of governance in transition.

6.1 The quality of governance

The state performs many different roles in market economies, but there is general agreement on a list of basic services that need to be provided by the state for the proper functioning of markets. The list includes law and order, infrastructure, macroeconomic stability, and a transparent and fair tax and regulatory structure. The extent to which the state provides these services in an efficient and non-discriminatory manner is a measure of the quality of the state's governance of the economy.

Table 6.1

The quality of governance

Country	Microeconomic governance	Macroeconomic governance	Physical infrastructure	Law and order	Governance index
Hungary	0.92	1.72	2.42	2.34	1.98
Slovenia	1.17	1.73	2.26	2.23	1.95
Estonia	1.25	1.74	2.38	2.17	1.95
Uzbekistan	1.40	1.44	2.11	2.16	1.83
Armenia	0.55	1.15	2.21	2.32	1.72
Poland	0.96	1.53	2.37	1.82	1.69
Slovak Republic	0.88	1.68	2.11	1.70	1.65
Czech Republic	0.80	1.35	1.57	1.97	1.59
Belarus	0.67	0.77	2.18	2.25	1.57
Lithuania	0.69	1.70	2.19	1.48	1.54
Azerbaijan	1.02	1.59	1.73	1.56	1.53
Croatia	0.67	1.18	2.13	1.62	1.43
Bulgaria	0.90	1.25	1.77	1.49	1.38
Kazakhstan	0.75	0.72	1.85	1.68	1.27
Georgia	0.67	0.93	1.78	1.47	1.24
Ukraine	0.34	0.77	1.76	1.68	1.24
Russia	0.47	0.65	1.91	1.54	1.16
Romania	0.45	0.60	1.49	1.48	1.07
Kyrgyzstan	0.46	0.48	1.85	0.98	0.85
Moldova	0.52	0.35	1.42	1.10	0.82

Source: Business Environment and Enterprise Performance Survey.

Notes:

Firms were asked how problematic nine factors were for the operation and growth of their business. Answers were on a scale ranging from: 0 (major obstacle) to 3 (no obstacle). The factors are grouped into four broad sub-categories: microeconomic governance – including taxes and regulations; macroeconomic governance – including policy instability, inflation, exchange rate; physical infrastructure – no sub-categories; law and order – including judiciary, corruption, street crime, organised crime. The governance index is constructed as the average of the country scores across all nine factors.

The survey asked firms to assess how these different functions of the state affect their business. From their responses, it was possible to develop a measure of how businesses view the quality of governance in transition economies. Nine key functions of the state were rated by firms. The functions fall into four main areas: macroeconomic governance, microeconomic governance, physical infrastructure, and law and order. The average of the ratings across these categories provides an index of how firms view the quality of governance in their countries, as reported in Table 6.1.¹

The table shows substantial variation in the quality of governance not only across countries but also across the various dimensions of the state's role in the economy.² For the vast majority of firms in the region, the problem of taxes and regulations in the microeconomic environment tops the list of obstacles to their business.³ A number of macroeconomic problems – inflation, exchange rate and policy instability – are also identified as significant obstacles. In contrast, problems associated with physical infrastructure and with the strength of law and order are generally considered to be less serious than the other obstacles. Surprisingly, firms regard the functioning of the judiciary as a less significant obstacle to their business. However, this may reflect low expectations of the role of the judiciary, since under the old system legal institutions were subordinated to the communist party and the state.

Regardless of their general impressions of the legal system, firms across the region do not have much confidence in the ability of the system to defend their property and contract rights. Chart 6.1 shows the proportion of firms in each country that have doubts that their property and contract rights will be defended in business disputes. The variation across countries is dramatic. Nearly three-quarters of the firms surveyed in Kyrgyzstan, Moldova, Russia and Ukraine mistrust their property rights, while only a quarter of the firms expressed similar concerns in Azerbaijan, Estonia, Hungary, Poland and Uzbekistan. Confidence in the security of property rights is closely linked with the firms' overall assessments of governance, suggesting that poor governance weakens property rights.

The diversity among transition economies in both the quality of governance and the security of property rights follows an unexpected pattern. There is no simple division between central and eastern Europe, on the one hand, and the CIS, on the other, as in many indicators of economic performance. Nor is there a clear geographical pattern to the rankings of countries. Countries that are normally considered among the most advanced transition countries, such as Estonia, Hungary and Slovenia, are ranked alongside some of the least advanced, such as Azerbaijan and Uzbekistan. In other countries that have been praised for early reform efforts, such as Kyrgyzstan and Moldova, businesses have

¹ The rankings of countries on this governance index do not change substantially when the size and industrial sector of firms are controlled for statistically.

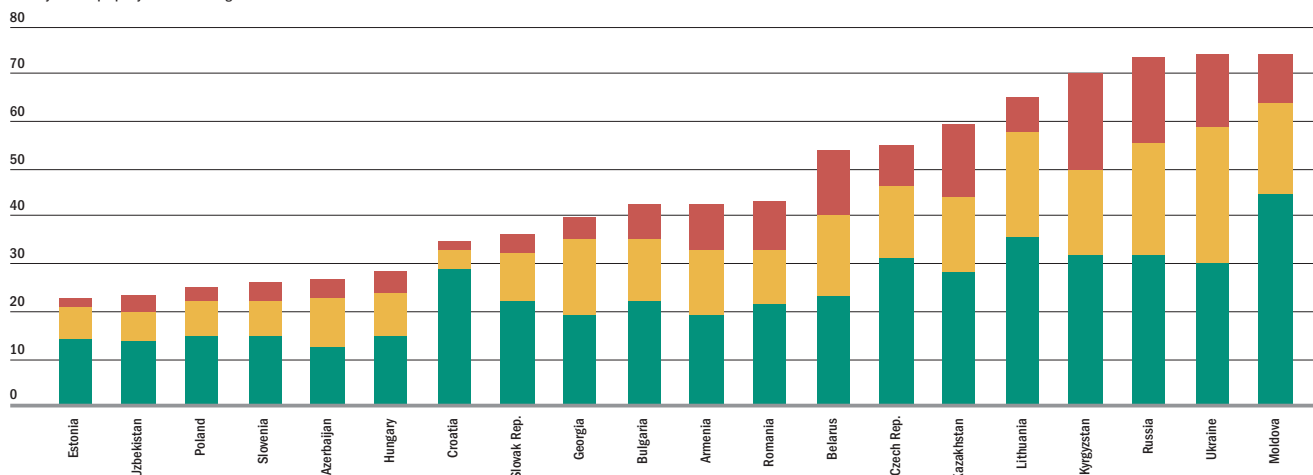
² Some caution must be used in comparing these ratings across countries. Firms presumably assess the quality of governance in their countries relative to their own past experience and expectations, which may depend on the progress in market-oriented transition. Nevertheless, the cross-country comparisons provide an indication of the relative severity of different obstacles among countries at different stages of the transition.

³ For a more detailed analysis that discusses the assessment of taxes and the assessment of regulations separately, see Chapter 7.

Chart 6.1

Security of property and contract rights

Percentage of firms with doubts about the security of their property and contract rights



Strongly disagree Disagree in most cases Tend to disagree

Source: Business Environment and Enterprise Performance Survey.

Note:

Firms were asked to what degree they agreed with the view that the legal system would uphold their contract and property rights in business disputes. Response categories comprised: Fully agree, Agree in most cases, Tend to agree, Tend to disagree, Disagree in most cases and Strongly disagree.

given low ratings on both governance and the security of property rights. Chart 6.2 compares governance rankings by country with the EBRD's own transition indicators, which measure the overall progress of economic reforms in each country. The relationship resembles a U-shaped pattern, in which the most advanced and least advanced countries show higher scores for governance than those countries that have maintained partial progress in reforms.⁴

One explanation for this relationship is that it reflects how the capacity of the state to govern the economy has changed in different ways within each country. The least advanced countries have made the slowest progress in dismantling key aspects of the state's control over the economy and therefore continue to preserve much of the state control inherited from the previous system. Firms in these countries do not see the state as a major obstacle, since it continues to perform many of the functions that it carried out under the old regime in an economy that still bears strong resemblance, in many respects, to the previous system.

In contrast, countries that have introduced partial reforms have begun the process of dismantling the state's capacity to govern the economy according to the requirements of the command system without developing the new institutions on which a market-based form of governance could be established. In this setting, firms might see the state as unable to provide the services it once did and incapable of meeting the demands of the emerging market economy. Advanced countries have made more progress in improving the state's capacity to meet these new demands, which

explains why firms in these countries provided more positive assessments of the quality of governance. While this interpretation is consistent with the facts, it does not provide an explanation as to why states differ in their willingness and capacity to undertake the institutional and behavioural reforms necessary to enhance market-oriented governance. The next section focuses on the effects of state capture on the quality of governance.

6.2 Governance and state "capture"

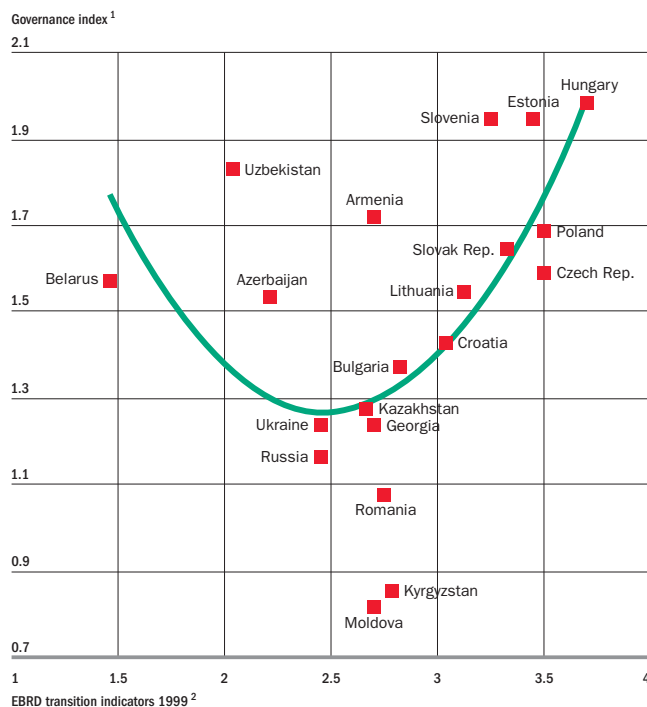
Previous chapters argued that states "captured" by powerful vested interests in the economy have a tendency to side-step reforms that might improve governance while at the same time reducing distortions in the economy that work to the benefit of such interests. State capture commonly refers to the extent to which government policy-making is unduly influenced by a narrow set of interest groups in the economy who provide private benefits to politicians. Russia's governance problems, for example, are often blamed on the so-called "oligarchs", who urge the state to grant them a range of special privileges and exemptions that undermine market-oriented institutions at a high cost to the rest of the economy.

To date, there have been no studies that attempt to measure and compare the degree of state capture across countries. The survey provides a unique opportunity to construct a measure that allows one to compare the degree of state capture across different transition economies. Firms were asked to assess the impact on their business of the sale of parliamentary legislation and presidential decrees to

⁴ The U-shaped relationship between governance and economic reforms is preserved, even when Belarus, an apparent outlier, is removed from the sample. One possible explanation of this unexpected pattern is that one part of the curve is dominated by authoritarian states (namely, Azerbaijan, Belarus and Uzbekistan) where the respondents might be reluctant to give critical assessments of the quality of governance in their countries. But this argument is not consistent with the fact that firms in Azerbaijan and Uzbekistan are willing to report high levels of bribery and corruption, as shown below, despite the sensitivity of such issues.

Chart 6.2

Governance and economic reforms



Source: Business Environment and Enterprise Performance Survey.

¹ The governance index ranges from 0 (low) to 3 (high). See Table 6.1.

² The EBRD transition indicators range from 1 (little progress) to 4 (substantial progress). See Table 2.1, Chapter 2.

private interests.⁵ The capacity of private individuals or firms to buy government legislation to suit their own interests is a very strong indication of the degree to which a state is subject to capture. Chart 6.3 shows the proportion of firms in each country that report that state capture has a significant impact on their business. The differences across the transition countries as well as the sheer extent of the problem in particular cases are striking. In Moldova, Russia and Ukraine, more than 40 per cent of the firms feel a significant impact from the sale of government legislation, reaching nearly 60 per cent in Azerbaijan. By contrast, fewer than 10 per cent of firms in Slovenia and Uzbekistan report a similar impact.

The survey also provides an opportunity to measure the degree to which influence on government policy-making is concentrated in a small number of enterprises. Firms were asked to assess how much influence they have at various government levels – executive, legislature, ministry and regulatory agency – on pending legislation that could have a substantial impact on their business.⁶ While many firms reported that their business is affected by state capture (see Chart 6.3), only a small share – not exceeding 5 per cent in most countries – reported that they actually exercise a significant influence on government policy-making, as depicted in Chart 6.4.

This evidence suggests that in most transition countries a small group of firms exercises influence over state policies that affect the activities of many firms across the economy. In countries such as Azerbaijan, Bulgaria, Moldova, Russia and Ukraine, there appears to be a greater concentration of power over the state among key vested interests. In other countries, such as Estonia, while a large proportion of enterprises report that they are able to influence government decisions, a relatively small proportion of firms claim that state capture significantly affects their business. This survey evidence suggests that greater competition among firms for influence on the government may mitigate the extent and effects of state capture.

When firms report that they have influence, it is most likely to be on the political executive. In transition countries with a relatively high degree of state capture, as reported in the survey data, firms are more likely to opt for direct links with government officials as opposed to more formal organisational links with state institutions. This is also apparent in the pattern of government lobbying. In countries with a lower degree of state capture, firms are more likely to act collectively in approaching the government. Nearly 30 per cent of the firms surveyed in “low-capture” countries belong to formal intermediate organisations, such as trade associations or lobby groups, as opposed to only 18 per cent in states prone to higher levels of capture. When issues arise that could potentially have an impact on their business, 70 per cent of the firms that belong to intermediate organisations in low-capture countries rely on them to express their voice. In high-capture countries, only 56 per cent of the collective association members use these organisations to influence the government on particular issues.

The reliance by certain firms on direct ties to individual government officials is likely to encourage bribery and corruption. These ties are less transparent and harder to monitor than institutional ties. They focus on the interests of individual firms rather than broader sectors, regions or groups. In high-capture states, therefore, it is less likely that businesses will engage in collective action to urge the government to provide public services that could improve overall economic governance. Instead, lobbying is undertaken to address the particular interests of specific firms.

How does state capture and the concentration of vested interests affect firms’ assessments of the state’s role in the economy? High-capture states are likely to be more responsive to the interests of a small group of powerful firms than to pressures to improve governance. As Chart 6.5 demonstrates, higher levels of state capture are strongly associated with weaker systems of governance. According to the enterprises in transition economies, high-capture states tend to tax and regulate more heavily, extract more bribes, mismanage the macroeconomic environment, and prove less effective at preserving law and order. The survey shows that greater capture of

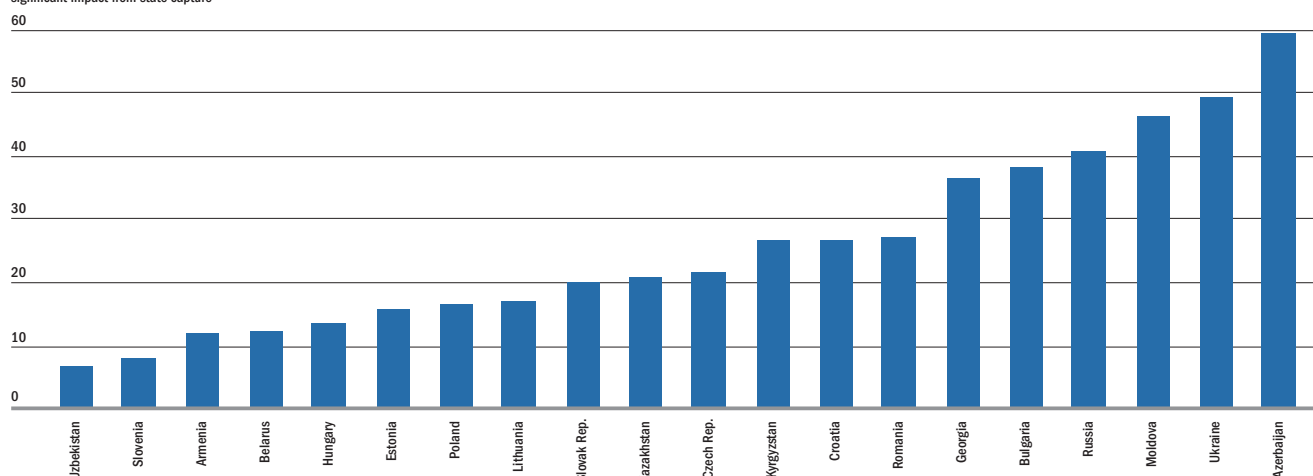
⁵ Responses to this question should not be construed as suggesting that the firms themselves actually pay for parliamentary legislation or presidential decrees. The question was designed to elicit responses both from firms that gained from, and those that were harmed by, such activities. Given the sensitivity of these questions, respondents were assured that their answers would be used only in an aggregated form for research purposes and would not be attributed to any individual or firm.

⁶ Influence was measured exclusively at the national level of government, with the exception of Russia where firms were also asked about the extent of their influence at the regional government level. Nearly twice as many Russian firms report having influence at the regional level than at the federal level. Influence is particularly strong with regional executives, with nearly a quarter of the Russian firms reporting influence at this level.

Chart 6.3

State capture

Percentage of firms reporting significant impact from state capture



Source: Business Environment and Enterprise Performance Survey.

Note:

Firms were asked whether the sale to private interests of parliamentary votes or presidential decrees had an impact on their business. Response categories comprised: No impact, Minor impact, Significant impact and Very significant impact. The chart reports the percentage of firms responding that such sales had a Significant or Very significant impact on their business.

the state by vested interests has a powerfully negative impact on the quality of governance in transition economies.⁷ Chapter 7 provides evidence on how poor governance, along with other obstacles in the investment climate, impedes enterprise restructuring and weakens performance.

6.3 Governance and privatisation

One of the expected benefits of privatisation was that it would lead to a deeper transformation of the role of the state in the economy. By shifting ownership rights from the state to private individuals and institutions, privatisation aimed to reduce the state's direct role in enterprise decisions and thereby to "depoliticise" the firm. Moreover, privatisation was expected to create private sector pressure on the government for further reforms to strengthen the security of property rights and improve the business environment. In other words, privatisation promised to create the players who would, over time, hold the state accountable for improvements in governance.⁸ There has been considerable research and debate on the proper timing, sequence and methods of privatisation and on the effects of privatisation on enterprise restructuring and performance. However, little empirical research exists on the broader effects of privatisation on the quality of governance in transition economies.⁹ The survey provides an important opportunity to address these issues.

The simple correlation between the extent of privatisation and the quality of governance (as constructed from the survey; see Table 6.1) does not reveal any significant relationship. Yet if this relationship is examined separately for both high-capture and low-capture transition economies, a striking difference in the relationship between privatisation and governance is revealed. Chart 6.6 plots the correlation of privatisation (as measured by the EBRD's transition indicators) and the quality of governance for the high-capture and low-capture states separately. The red line shows the positive correlation between privatisation and governance in the low-capture states. Progress in privatisation is associated with a higher quality of governance in these countries. But the relationship is reversed in high-capture states, as represented by the green line.¹⁰ The chart also suggests that for any given level of privatisation, high-capture states exhibit a lower quality of governance than low-capture states.

These results should not be interpreted to suggest that privatisation worsens the quality of governance in countries with states prone to capture by vested interests. Such a claim could be supported only by comparing governance in these countries prior to and after privatisation. Advocates of privatisation have argued that the benefits of privatisation must be evaluated against the environment of high uncertainty, poorly defined property rights

⁷ Of course, correlation does not necessarily signify causation. State capture itself could be a function of weak governance overall. However, this begs the question of what prevents the state from undertaking reforms that would lead to improvements in the quality of governance. The argument suggested above is that high-capture states have weaker incentives and fewer constraints that might lead them to make the necessary investments to improve governance.

⁸ See, for example, Boycko et al. (1995).

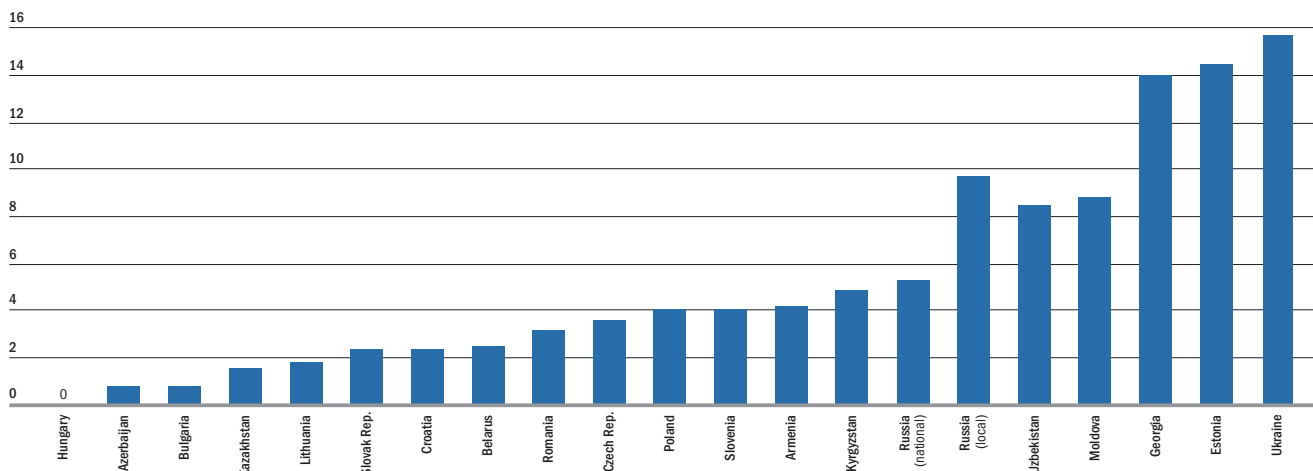
⁹ See Frydman et al. (1998).

¹⁰ These conclusions do not change substantially if key outliers are removed from the correlation. The results are also confirmed in a statistical analysis of the enterprise data, in which the firms' assessment of governance depends upon the degree of privatisation and state capture at the country level, and their interaction, as well as the relevant characteristics of firms.

Chart 6.4

Influence of firms on the state

Percentage of firms with influence on the state



Source: Business Environment and Enterprise Performance Survey.

Note:

Firms were asked whether they have influence over the national executive, legislature, ministries and regulatory agencies on the content of new laws, rules, regulations or decrees that could have a substantial impact on their business. Response categories comprised: Never influential, Seldom influential, Influential, Frequently influential and Very influential. Firms responding Frequently or Very influential with respect to any of the branches of government were classified as influential. Russian firms were also asked separately about their influence over local government.

and so-called spontaneous privatisation (or more simply, theft of state assets) that preceded it in most countries. The results indicate, nevertheless, that the success of privatisation in improving governance depends on the characteristics of the state and its relationship with key interests within the economy.

It is possible that the different effects of privatisation in the high- and low-capture countries reflect systematic differences in the timing and method of privatisation adopted in each group of countries. Yet a comparison of the timing and methods of privatisation within each group does not reveal any consistent patterns.¹¹ Each group contains countries that pursued both early and late privatisation as well as the full diversity of privatisation methods, including direct sales, vouchers and management-employee buy-outs. Moreover, there are no significant links between the timing and method of privatisation, on the one hand, and the quality of governance, on the other.¹²

The survey results support the idea that privatisation can lead to improved governance, but its influence depends on the nature of the state or, more specifically, on the extent of state capture. Where the state is prone to undue influence by powerful vested interests, the effectiveness of reforms in improving governance and securing property rights has been diluted. As the analysis above suggests, this could reflect weaker demand for better governance due to the lack of collective action on the part of businesses. Alternatively, such reforms could be blocked by vested interests with the capacity

to influence government policy-making, who profit from the market distortions associated with partial economic reforms.

6.4 The relationship between the state and the firm

The quality of governance in any country is rooted fundamentally in the state's dealings with firms. Under the previous economic system, the state directed the activities of enterprises through a formal system of plans and commands. Informally, however, firms engaged in a complex bargaining process with state planning agencies, party officials, and local and central authorities to influence the setting and implementation of plan targets. Although the formal system of central planning has been abandoned, the bargaining between the state and firms has not ceased but rather changed form, as the survey shows. In the transition economies, states and enterprises engage in a web of interactions beyond the standard provision of public goods in exchange for taxes. The state gives a wide range of benefits to firms, in the form of state financing, explicit subsidies and implicit subsidies, including tax-related benefits (for example, offsets) and tolerance of arrears. Firms provide state officials with political and private benefits in the form of control rights over company decisions and bribes. An illustration of these exchanges is provided in Chart 6.7.

The most interesting fact about these dealings between the state and firms is the way in which they differ across the transition economies and across different types of firms within each country.

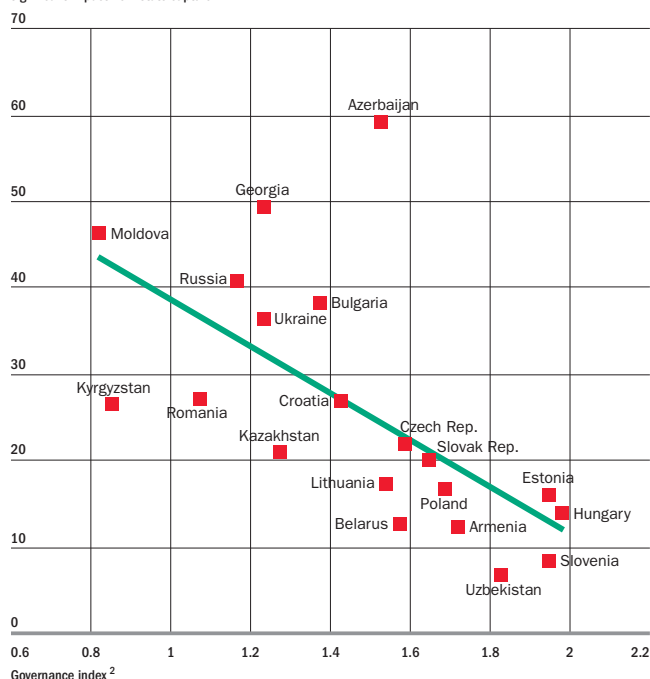
¹¹ An identification of the primary method of privatisation, as well as the timing of privatisation, is available in the summary tables and timelines in the transition assessments at the back of this Report.

¹² See Chapter 2 for a more detailed analysis of the extent to which liberalisation and privatisation create the demand for further institutional reforms at a later stage of transition based on an analysis of the EBRD's transition indicators over time.

Chart 6.5

State capture and governance

Percentage of firms reporting significant impact from state capture¹



Source: Business Environment and Enterprise Performance Survey.

¹ See note to Chart 6.3.

² The governance index ranges from 0 (low) to 3 (high). See Table 6.1.

How do states with different characteristics structure their dealings with firms in terms of the exchange of benefits and costs? How do differences in the characteristics of firms – such as ownership, control, origin and size – influence their relationship with the state? The survey provides evidence to examine both questions. The emphasis on enterprises also provides an opportunity to investigate how different forms of privatisation affect the nature of dealings between the firm and the state. Given that the goal of privatisation is to reduce political interference, examining the consequences of these different forms of privatisation is an essential way of assessing the benefits of privatisation, which has not been incorporated into previous research.¹³

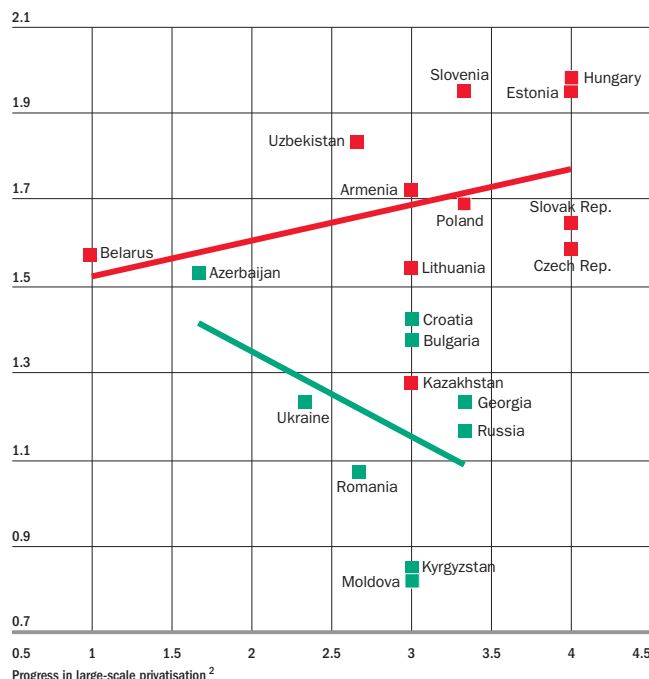
The extent and form of state intervention

In comparison with the degree of state control over firms under the command system, ten years of liberalisation and privatisation have led to a dramatic decline in the level of state intervention throughout the region. Chart 6.8 shows the percentage of all firms in the survey that say they face state intervention in several aspects of their operations. State intervention is most common in pricing, with 36 per cent of firms reporting some degree of intervention. In some countries, the level of reported price intervention is extremely high: Belarus (88 per cent), the Slovak Republic (64 per cent), Moldova (54 per cent) and Ukraine (44 per cent).

Chart 6.6

Privatisation, governance and state capture

Governance index¹



■ High-capture states³ — Regression line (high-capture states)
 ■ Low-capture states — Regression line (low-capture states)

Source: Business Environment and Enterprise Performance Survey.

¹ The governance index ranges from 0 (low) to 3 (high). See Table 6.1.

² The EBRD's rating of progress in large scale privatisation ranges from 1 (little progress) to 4 (substantial progress). See Table 2.1, Chapter 2.

³ High- and low-capture states are defined with reference to the index reported in Chart 6.3.

On investment, sales and wages, around a quarter of all firms report some state intervention. The small share of firms reporting state intervention in employment – just 16 per cent – is rather surprising given the state's previous commitment to full employment under communism. Although much reduced, state intervention in company decisions is still a prominent feature of transition economies.

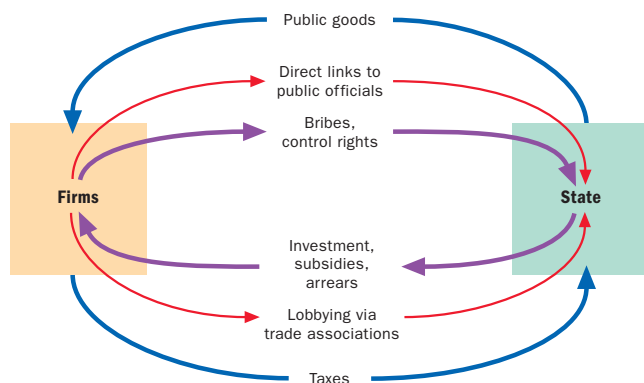
There is considerable diversity across the transition countries both in the level of state intervention and the types of decision-making in which the state intervenes. One might expect declines in state intervention to be directly related to the progress in liberalisation and privatisation across the region, since these reforms are intended to reduce the role of the state in enterprise decision-making. Yet, as Table 6.2 suggests, a comparison of the level of state intervention across the transition countries does not appear to be consistent with a simple distinction between advanced and less advanced transition countries.

Surprisingly, the highest levels of state intervention are reported in some of the most advanced transition countries, such as Hungary,

¹³ See Barberis et al. (1996), Pinto et al. (1993) and Pohl et al. (1997).

Chart 6.7

Flow of costs and benefits between the state and firms



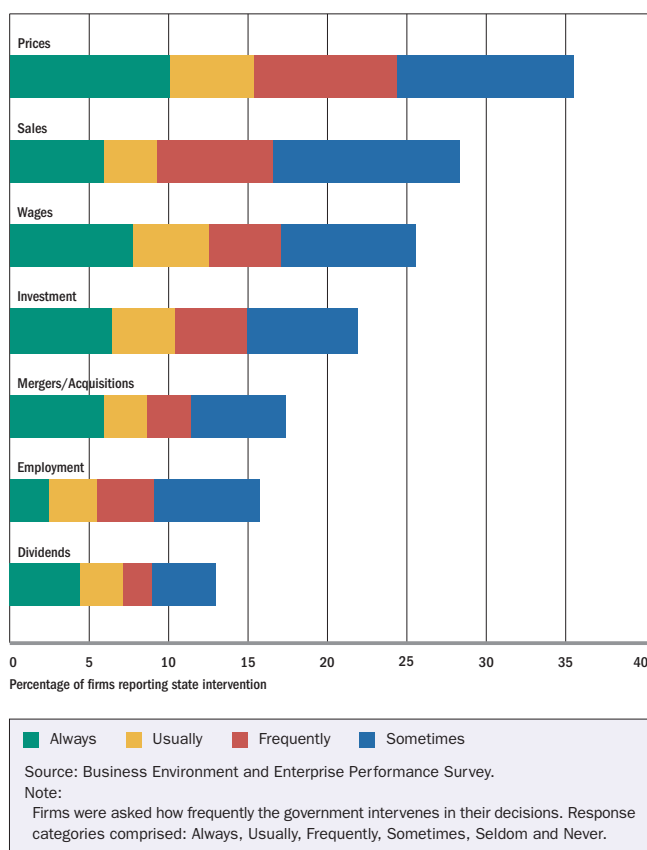
the Slovak Republic and Slovenia, and in the least advanced countries, such as Belarus, Ukraine and Uzbekistan.¹⁴ Yet despite the similarities, there are clear differences in the types of decisions in which these states choose to intervene. In Hungary, the Slovak Republic and Slovenia, for example, there are higher reported levels of intervention in employment and wages than in some of the less advanced economies with similar levels of intervention. States in less advanced countries tend to focus on intervention in prices and sales, with minimal intervention in employment. While the advanced economies appear to intervene to support the workforce, the less advanced countries are more likely to intervene in enterprises' decisions as a tool for macroeconomic management, as they did under central planning. Differences in the pace of market reform do not necessarily lead to clear distinctions in the level of state intervention, but they have a more significant effect on the type of state intervention.

There are also important differences in the pattern of state intervention within the group of advanced economies. Estonia and Poland report some of the lowest levels of state intervention in the region. The divergence in the extent of state intervention is striking. More than three times as many firms in Hungary as in Estonia report state intervention across the seven dimensions surveyed. Standard measures of progress in economic reform mask important differences in the strategy of these states regarding the state's role in the emerging market economy.

There is also no simple relationship between state intervention and the quality of governance across countries. Some of the countries with the highest levels of state intervention, such as Hungary and Slovenia, have the strongest governance ratings in the region. At the same time, other high-intervention countries, such as Ukraine and Kyrgyzstan, are near the bottom of the governance rankings. Estonia, with its extremely low level of state intervention, has a governance rating on a par with Slovenia. These differences demonstrate that it is not merely the extent of state intervention that weakens governance and creates obstacles in the business environment but also, more importantly, the nature of that intervention.

Chart 6.8

State intervention in enterprise decisions



The pattern of state intervention also varies across different types of firms. As expected, large firms, given their strategic importance, are much more likely to face state intervention than medium-sized or small firms. The state also intervenes more frequently in state-owned firms than in private firms: nearly twice as many state-owned firms (over 40 per cent) as opposed to private firms reported some intervention. Thus, privatisation has helped to depoliticise firms in terms of the degree of state intervention. Surprisingly, there is no significant difference between the level of state intervention in privatised firms versus new entrants. Previous links with the state do not predispose privatised firms to a higher probability of state intervention. Similarly, the extent to which private firms are controlled by inside or outside owners does not have a significant influence on state intervention.

In summary, the pattern of state intervention in enterprises in the transition economies reveals some important features of the transition process. First, although the dismantling of central planning and privatisation have sharply reduced the level of state intervention throughout the region, progress in transition is not necessarily synonymous with a reduction in state intervention in enterprises. Despite similarities in the general progress of reform, there are strong differences in the strategic choices that countries have

¹⁴ It is possible that assessments of the extent of state intervention in different countries are influenced by different expectations of what the state's role should be in light of the progress of market-oriented reforms. For example, the same level of state intervention might be perceived as excessive by firms in more advanced market systems, while viewed as too little by firms in unreformed economies more accustomed to the command system. Nevertheless, the variation within each group of countries is interesting and suggests that there is no simple relationship between assessments of the level of state intervention and the progress of reforms.

Table 6.2

State intervention in enterprise decisions

(Percentage of firms reporting state intervention)

Country	Investment	Employment	Sales	Mergers/ acquisitions	Dividends	Wages	Prices	State intervention index ¹
Armenia	7.7	5.3	11.7	8.4	6.4	7.4	13.2	8.6
Azerbaijan	23.1	19.7	24.0	13.7	15.3	11.2	17.2	17.7
Belarus	32.6	17.4	69.8	24.6	12.3	53.3	87.8	42.5
Bulgaria	17.0	12.3	17.1	14.0	11.4	15.0	25.8	16.1
Croatia	18.4	9.5	15.3	20.2	6.8	20.6	15.2	15.2
Czech Republic	23.7	20.3	21.7	14.3	8.8	24.0	27.1	20.0
Estonia	10.2	6.9	10.9	17.0	10.2	15.4	15.4	12.3
Georgia	17.9	10.3	16.0	10.5	13.1	15.0	17.6	14.3
Hungary	37.9	38.2	40.0	27.6	45.4	59.6	44.0	41.8
Kazakhstan	24.7	14.0	27.4	21.5	13.3	17.6	41.7	22.9
Kyrgyzstan	25.9	15.0	30.9	25.3	12.6	14.9	44.2	24.1
Lithuania	15.7	13.0	19.8	22.4	22.4	31.6	23.8	21.2
Moldova	17.0	11.0	31.4	25.3	22.0	22.2	53.7	26.1
Poland	17.3	13.0	13.8	14.3	8.8	26.9	10.8	15.0
Romania	30.9	16.0	19.5	17.6	20.0	31.7	27.5	23.3
Russia	15.9	10.1	30.2	13.4	5.4	10.3	42.1	18.2
Slovak Republic	52.2	42.7	54.6	19.2	13.3	57.9	63.6	43.4
Slovenia	23.1	31.7	24.0	20.6	16.1	47.2	23.1	26.5
Ukraine	25.6	19.6	36.3	21.6	15.9	40.2	44.4	29.1
Uzbekistan	28.7	9.9	47.0	20.0	15.5	34.7	51.2	29.6

Source: Business Environment and Enterprise Performance Survey.

¹ The state intervention index is calculated as the average across all the above dimensions of intervention of the percentage of firms reporting intervention sometimes or more frequently.

made about the role that the state will play in the economy. Second, economic reforms have an impact on the types of company decisions in which the state chooses to intervene, shifting the focus from macroeconomic management towards social support. Lastly, the extent of state intervention does not have an unambiguous impact on the quality of governance. It is the type, and not the quantity, of state intervention that shapes enterprises' perceptions about governance.

The “time tax”

The level of state intervention in company decisions, although vastly reduced from the era of central planning, still places substantial demands on the time of senior managers. Chart 6.9 shows the average time spent by senior enterprise management in each country in dealing with government officials. Again, there is considerable variation across countries in this “time tax” on management. In Kazakhstan, Moldova and Ukraine, over 14 per cent of management time is spent with officials, while this figure drops by half to under 6 per cent in Azerbaijan, Bulgaria, Croatia, the Czech Republic and Slovenia.

Privatised firms report a lower level of management time spent with officials, but not by a large margin. While managers of state firms report on average that 12 per cent of their time is spent with officials, this share drops to around 10 per cent in privatised firms. New entrants are also subject to this demand on management time, and report levels of around 10 per cent. In some countries, reported management time spent with officials is particularly high for new entrants, such as in Moldova and Ukraine, where it

reaches more than 17 per cent. The burden affects small, medium-sized and large firms relatively equally.

The time tax for state-owned firms is one measure of the degree of state involvement in such firms. In some countries, the high share of management time spent dealing with officials suggests that the state is still playing an active management role in state-owned firms. In Russia, for example, more than a quarter of senior management time in state-owned firms is spent dealing with officials. Similarly high levels (above 15 per cent) are also reported by state-owned firms in Armenia, Georgia, Kazakhstan, Ukraine and Uzbekistan. In contrast, managers of state-owned firms in Bulgaria, Croatia, Estonia and Hungary have much less interaction – less than 7 per cent of senior management time – with government officials. The results show that the extent of participation by state officials in the management of state-owned companies differs widely across the transition economies.

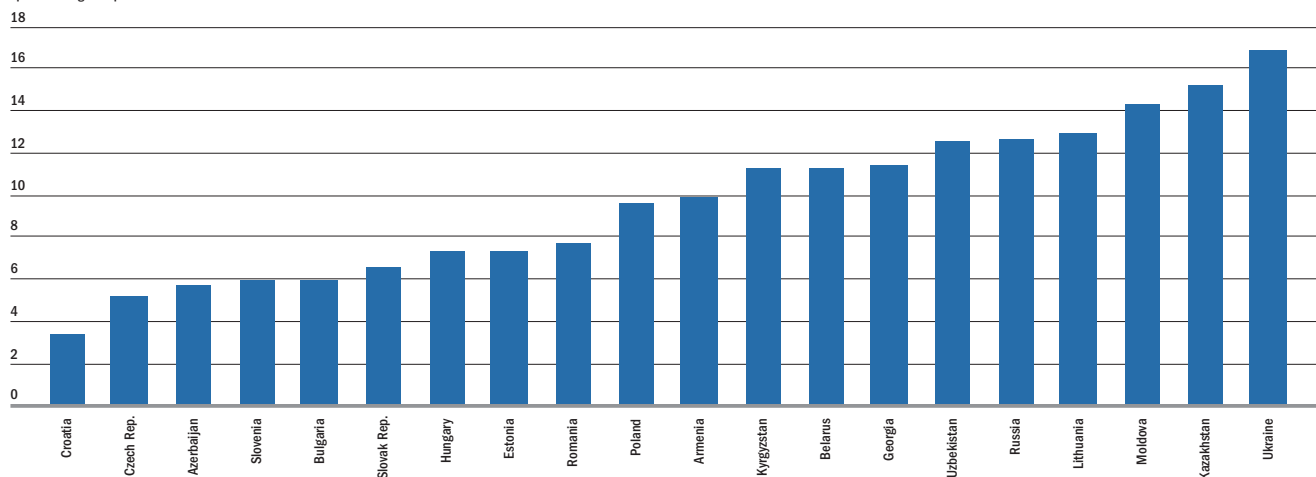
The “bribe tax”

In addition to time spent with officials and state intervention in company decisions, firms also pay direct private benefits to public officials in the form of bribes. These may be paid for a variety of purposes, such as to obtain public services, to avoid or alter existing regulations and taxes, to gain government contracts, to obtain subsidies or other state financing, to win influence, and to appease “predatory” officials. Firms can consider bribes as a cost to be paid for obtaining advantages or preferences from government or as an unofficial tax on their business due to weaknesses in the system of governance.

Chart 6.9

Time tax on management

Percentage of senior management time
spent dealing with public officials



Source: Business Environment and Enterprise Performance Survey.

The survey demonstrates that the frequency and size of bribe payments – or what might be referred to as the “bribe tax” on firms – varies substantially among the transition economies.¹⁵ Table 6.3 presents the proportion of firms that pay bribes frequently and the size of the bribe tax for firms in each country calculated as a share of the firm’s annual revenues. Firms in the region pay an average bribe tax that ranges from a low of 2 per cent of annual revenues¹⁶ in Croatia to a high of 8 per cent in Georgia.¹⁷ When added to what is already considered by firms to be an extremely high level of official taxation, the bribe tax imposes a severe burden on enterprises in the region.

The average bribe tax in the CIS countries – 5.7 per cent of revenues – is almost twice the level reported in central and eastern Europe – 3.3 per cent of revenues. Within the CIS, firms in the Caucasus countries consistently report the highest rate of bribe tax, followed by Ukraine and Moldova. In Central Asia, the level of bribe tax is somewhat lower, but the proportion of firms reporting that they pay bribes frequently is considerably higher in Uzbekistan than in other countries. Firms in Belarus and Russia report the lowest level of bribe tax in the CIS but the frequency of bribe payments differs quite substantially.

In central and eastern Europe, the bribe tax represents less than 3 per cent of annual revenues in a number of countries, such as Croatia, Estonia and Poland. Fewer than 20 per cent of the firms in these countries report paying bribes frequently. Firms in Bulgaria, the Czech Republic, Lithuania and Romania report a similar rate of bribe tax, but there are sharp differences in the frequency of bribe payments.

Bribery in the transition economies constitutes an extremely regressive tax, as depicted in Chart 6.10. While large firms report an average bribe tax of 2.8 per cent of annual revenues, the average bribes for small firms are nearly double at 5.4 per cent. There is also a major difference in the frequency of bribe payments. While 16 per cent of large firms report paying bribes frequently, the proportion of small firms rises to 37 per cent.

The regressive nature of the bribe tax is especially pronounced in a number of CIS countries. In Moldova, for example, small firms report paying an average bribe tax of nearly 9 per cent of annual revenues, which is more than four times higher than the level for large firms. Similarly, small firms in Armenia, Ukraine and Uzbekistan report bribe levels nearing or exceeding 8 per cent. In addition, the high frequency of bribe payments for small firms in these countries contributes to the extremely high level of senior management time spent dealing with government officials. In Ukrainian small firms, for example, this reaches up to 18 per cent of management time. For small firms, in particular, the combination of the bribe tax and the time tax has had a severe impact on the development of new private sector companies, as Chapter 8 shows, targeting the most dynamic sector in the economy.

Private sector firms pay a larger share of their revenues in bribes than state companies, as Chart 6.11 shows, yet this result is due primarily to the higher bribe tax for new entrants (5.1 per cent).¹⁸ The difference in the bribe tax between state and privatised firms is small (3.9 per cent versus 4.2 per cent, respectively). The frequency of bribes follows a similar, if more pronounced, pattern.

¹⁵ Measuring bribes is extremely difficult, for obvious reasons. As firms are reluctant to admit to paying bribes directly, they were asked to estimate, in a personal capacity, annual bribe payments as a share of revenue typically paid by “firms like yours”. Respondents were assured that their estimates would be used only in aggregate form for research purposes and would not be attributed to any individual or firm. Several questions on bribery were included in the survey to allow for consistency checks of the responses. Extensive piloting of the survey was also employed in each of the 20 countries to ensure that respondents properly understood the questions.

¹⁶ Using revenues as opposed to profits to compute the bribe tax is preferable given that data on revenues is more reliable. There are strong incentives for misreporting profits in many transition countries, which would add another source of measurement error into the computation of the bribe tax.

¹⁷ The ranking of countries on the size of the bribe tax does not change significantly when statistically controlling for the size and sector of firms.

¹⁸ Part of the explanation for the difference is that new entrants tend to be small firms. However, in statistical tests that control for firm size, the origin of the firm – new entrant versus privatised – has a statistically significant effect on the level of the bribe tax.

Table 6.3

The frequency and extent of the bribe tax

Country	Percentage of firms bribing frequently or more ¹	Average bribe tax as a percentage of annual firm revenues ²
Armenia	40.3	6.8
Azerbaijan	59.3	6.6
Belarus	14.2	3.1
Bulgaria	23.9	3.5
Croatia	17.7	2.1
Czech Republic	26.3	4.5
Estonia	12.9	2.8
Georgia	36.8	8.1
Hungary	31.3	3.5
Kazakhstan	23.7	4.7
Kyrgyzstan	26.9	5.5
Lithuania	23.2	4.2
Moldova	33.3	6.1
Poland	32.7	2.5
Romania	50.9	4.0
Russia	29.2	4.1
Slovak Republic	34.6	3.7
Slovenia	7.7	3.4
Ukraine	35.3	6.5
Uzbekistan	46.6	5.7

Source: Business Environment and Enterprise Performance Survey.

¹ Firms were asked to what extent the following statement is true: "It is common for firms in my line of business to pay some irregular 'unofficial payments' to get things done". Response categories comprised: Always, Mostly, Frequently, Sometimes, Seldom and Never. The standard error of the percentage of firms reporting frequent bribes is 0.045 (averaged across countries). Thus the statistical margin of error (with 95% confidence) is 8.8%.

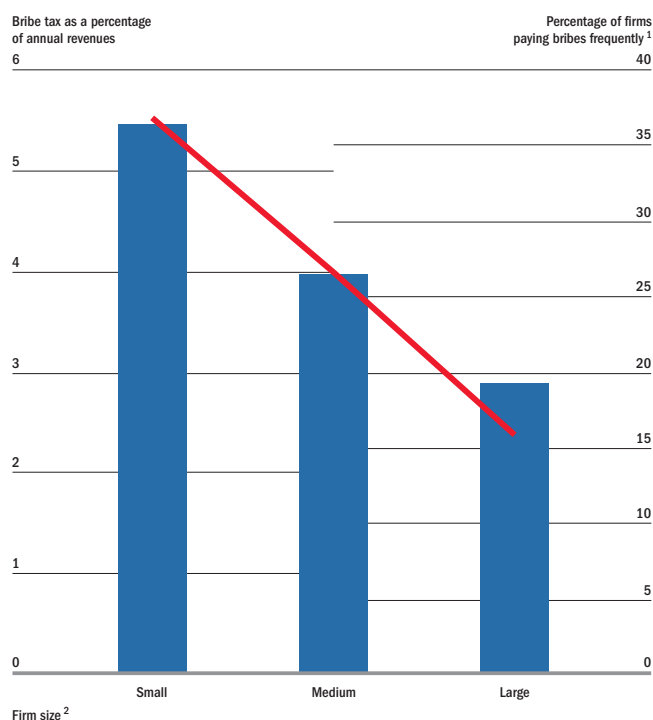
² Firms were asked what percentage of annual revenues "firms like yours" make in irregular 'unofficial payments' to public officials. The actual bribe tax as a share of annual revenue was computed on the basis of the midpoint (or the lower end in an open-ended category) of six possible categories listed in the survey: up to 1%; 1-1.99%; 2-9.99%; 10-12%; 13-25%; more than 25%. The standard error of the reported average bribe tax is 0.006 (averaged across countries). Thus the statistical margin of error (with 95% confidence) is 1.2%.

The fact that privatised firms pay a level of bribe tax similar to that paid by state firms is surprising. Privatisation does not appear to have a significant influence on the propensity for private firms to pay bribes, despite the allegations of corruption in the privatisation process, especially in the CIS.

In their direct dealings with state officials, firms can give – or be compelled to give – their time, a portion of their control over company decisions (in the form of state intervention), and a portion of their cash flows (in the form of bribes). Undoubtedly, the shift from central planning to a market economy has led to significant reductions in all of these costs, with the prominent exception of bribes.¹⁹ This raises the question: why has corruption increased with the onset of transition? One simple answer would suggest that bribes are substitutes for more intrusive state intervention. In other words, firms might be paying bribes to state officials to prevent the state from intervening in company decisions and from wasting management time. This explanation corresponds with recent theo-

Chart 6.10

Bribe tax by firm size



■ Bribe tax as a percentage of annual revenues
 — Percentage of firms paying bribes frequently

Source: Business Environment and Enterprise Performance Survey.

¹ For a definition of the frequency and extent of the bribe tax, see Table 6.3.

² Firm size is defined in terms of full-time employees. Small = 0-49, Medium = 50-499 and Large = 500+.

retical studies of corruption that view bribes as one element of an implicit bargain between the state and firms to negotiate the boundaries of their dealings with each other.²⁰ Evidence from the transition economies points to a more complex view.

An examination of the correlations between the bribe tax, time spent with officials and state intervention provides a rough indication of the extent to which these different costs to the firms can be considered as substitutes. There is a strong link between the level of bribes paid by the firm and the time spent with officials – that is, the more a firm pays in bribes, the more time it spends dealing with officials.²¹ Bribery does not enable firms to spend less management time dealing with government. This link is strongest for new entrants, which bear the heaviest burden of this double tax. There is also no evidence that bribery reduces the amount of state intervention. The correlation between the level of bribes and the extent of state intervention is positive, though not statistically significant.²² In summary, comparing across enterprises within any given country, bribery, state intervention and time spent with officials tend to go hand-in-hand. The next section will examine whether bribery brings firms any direct

¹⁹ This is not to suggest that bribery was non-existent under central planning, although anecdotal evidence would suggest that it was considerably less than current levels.

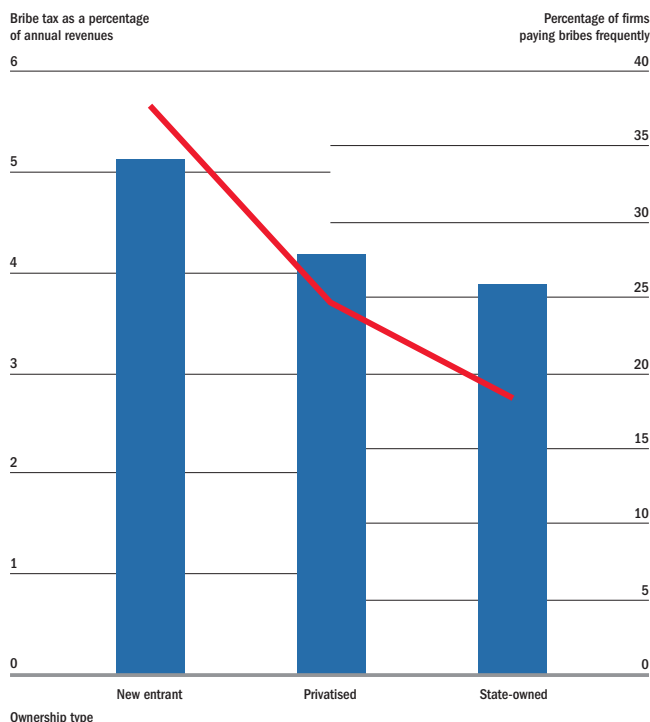
²⁰ From a theoretical perspective, firms could grant the state limited claims on their cash flow rights in exchange for more secure control rights. See Shleifer and Vishny (1993).

²¹ The correlation coefficient is 0.30.

²² The correlation coefficient is only 0.06.

Chart 6.11

Bribe tax by ownership



■ Bribe tax as a percentage of annual revenues
 — Percentage of firms paying bribes frequently
 Source: Business Environment and Enterprise Performance Survey.
 Note:
 For a definition of the frequency and extent of the bribe tax, see Table 6.3.

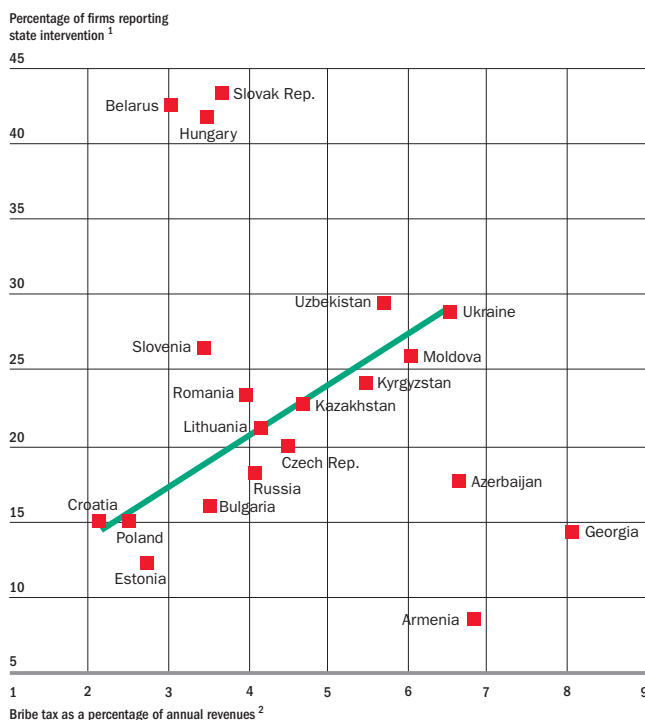
financial gains, but the evidence here suggests that it does not lower the direct costs to the firm from its dealings with the state.

This positive relationship between bribes and state intervention is also observed at the cross-country level. Chart 6.12 plots the country average of bribes paid by firms with the degree of state intervention reported by firms. For most countries, the relationship is clear: the greater the level of state intervention, the higher the bribes. However, there are two groups of countries that do not conform to this pattern. Three countries on the lower right-hand corner of the chart – Armenia, Azerbaijan and Georgia – have bribe levels that are among the highest within the entire region, but at the same time have very low levels of state intervention. All three countries have experienced prolonged military conflicts or civil unrest, which may have profoundly weakened the capacity of the state. Such weak states are likely to be less able to intervene at the firm level and to place controls on public officials to constrain corruption.

In contrast, the countries in the upper left-hand portion of the chart – Belarus, Hungary and the Slovak Republic – have high levels of state intervention without the corresponding high levels of bribes. In these countries, the state appears to have chosen to play a more substantial role in the activities of firms, but has sufficient strength to prevent any accompanying increase in corruption. In Belarus, the strong state reflects the very slow pace of reforms,

Chart 6.12

State intervention and the bribe tax



Source: Business Environment and Enterprise Performance Survey.

¹ See state intervention index, Table 6.2.

² For a definition of the bribe tax, see Table 6.3.

which has resulted in little change from the Soviet-style relationship between the state and the firm. The more advanced countries within this group – Hungary and the Slovak Republic – have chosen to establish a strong state role at the enterprise level in the context of the developing market economy, while developing sufficient constraints on public officials to limit corruption.

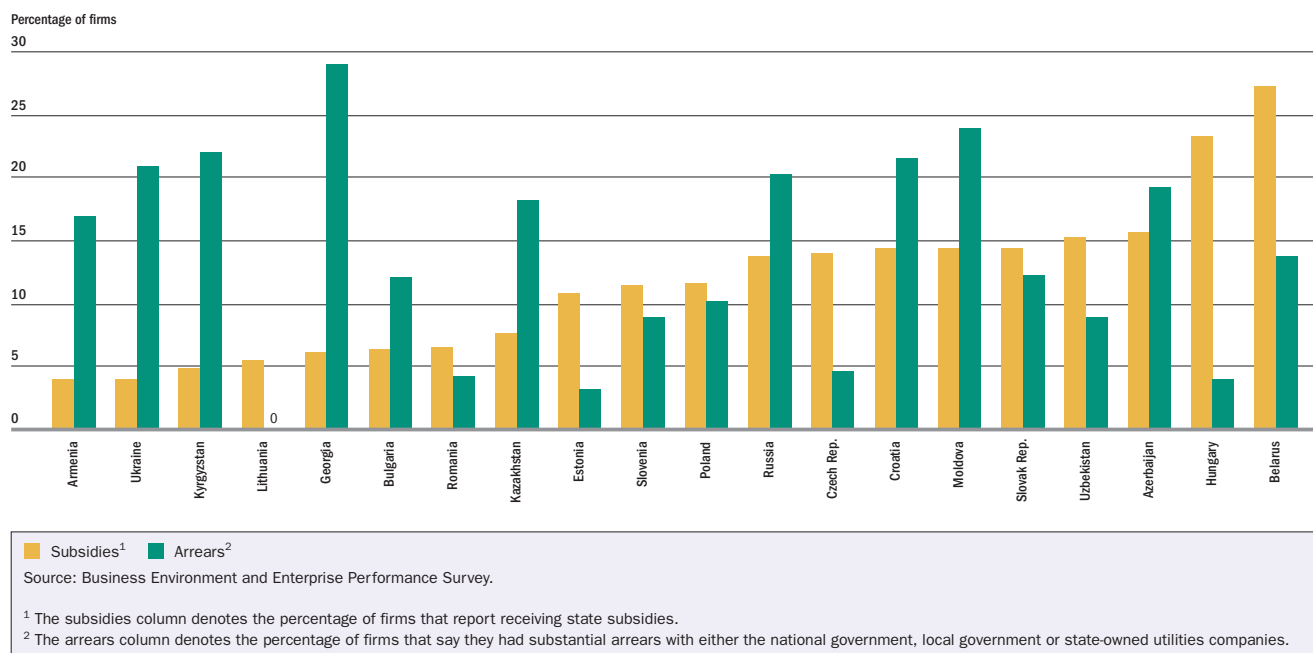
6.5 Benefits to the firm

Do firms receive any specific benefits – that is, beyond the provision of standard public goods – in return for these various types of dealings with the state? Such benefits could take a number of forms, including direct subsidies, implicit subsidies (for example, tolerance of tax arrears and arrears to state-owned utilities), special exemptions from state regulations, and preferences in awarding state contracts. As many of these benefits are non-transparent by nature, they cannot be easily measured and compared across countries and firms. However, the survey provides an opportunity to examine two types of benefits, namely direct subsidies and implicit subsidies from the state in the form of arrears.

Chart 6.13 shows the patterns of subsidies and arrears across the transition economies. Subsidies, of course, are the most direct form of state support. There is substantial variation in these benefits both across countries and across firms within a country. The tolerance of arrears, both tax arrears to the state and payment arrears to state-owned utilities, has also become an important

Chart 6.13

Subsidies and arrears



implicit form of state subsidies to firms in transition economies. The chart shows the proportion of firms in each country that report receiving state subsidies or maintaining substantial arrears either to the state or utility companies.

The proportion of firms receiving subsidies is quite low in most countries of the region, although this gives no indication of the volume of subsidies. In the large majority of transition economies, fewer than 15 per cent of firms report receiving state subsidies. Belarus and Hungary – which have achieved very different levels of reform – have the highest proportion of subsidised firms. In contrast, a large fraction of firms report a substantial level of arrears in a number of countries. The relationship between the proportion of subsidised firms and the number of firms with high arrears is particularly interesting. In Armenia, Bulgaria, Georgia, Kazakhstan, Kyrgyzstan and Ukraine, firms are primarily supported by means of implicit, rather than direct, subsidies. In Belarus, the Czech Republic, Hungary and Uzbekistan firms are primarily supported through direct subsidies, while the level of arrears has been contained. Again, differences in the capacity of the state may be behind the decision of governments to use direct versus implicit subsidies in channelling benefits to firms. In particular, where the state supports enterprises, there is a greater reliance on direct subsidies in more advanced transition countries and, at the other extreme, in countries that have maintained large elements of the previous command system.

The pattern of state benefits to the firm also varies according to the characteristics of the firm. Chart 6.14 shows the proportion of firms receiving subsidies and maintaining substantial arrears according to the type of ownership of the enterprise. As expected, the state is more likely to subsidise directly state-owned firms than private firms, although just over 15 per cent of privatised firms

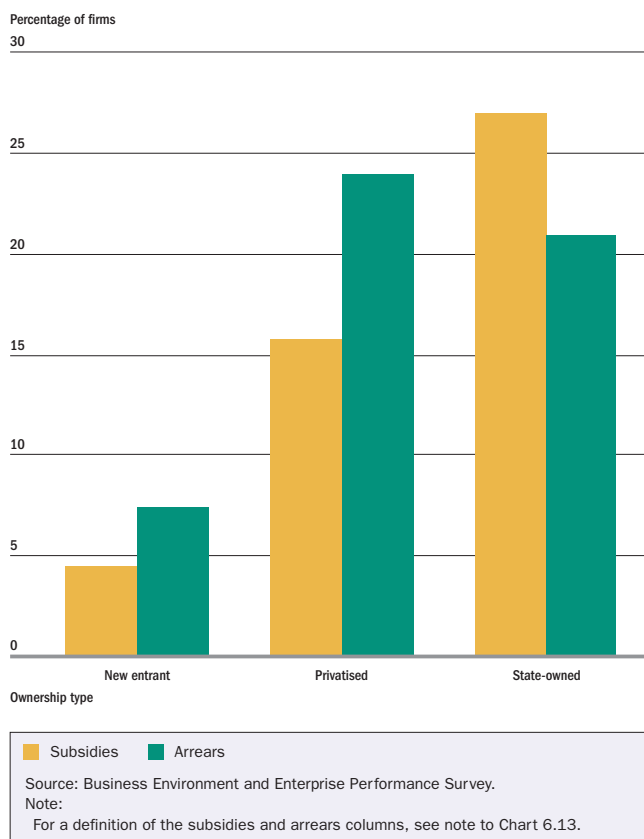
still receive some state subsidies. Yet the reduced flow of explicit subsidies to privatised firms is partly compensated by higher implicit subsidies in the form of arrears. Nearly a quarter of all privatised firms report a substantial level of arrears either to the state tax authorities or to state-owned utilities. New entrants are least likely to get any state subsidies, but when they are given they are more likely to be in the form of implicit subsidies.

While Chapter 7 will explore further the factors that influence the likelihood of firms to receive subsidies, the main concern in this chapter is whether these financial benefits from the state are directly related to the bribes, time and control which firms provide to the state. Simple correlations among these factors reveal an interesting pattern. State intervention is accompanied by higher than average levels of direct subsidies, but at the same time lower levels of implicit subsidies. However, the more a firm pays in bribes the less likely it is to receive direct subsidies. In addition, bribes do not have any significant impact on the level of implicit subsidies. When combined with the evidence in the previous section, it is clear that bribes neither prevent state officials from intervening in the firm nor “buy” state subsidies for the firm.

Firms differ in the pattern of costs and benefits deriving from their dealings with the state. Table 6.4 summarises the costs and benefits experienced by different types of firms, as discussed in the earlier sections in this chapter. State-owned firms continue to allow the state substantial control over company decisions and pay moderate levels of bribes to state officials, while receiving benefits from the state mainly in the form of direct subsidies. In privatised firms, state intervention has been substantially reduced, but the level of bribes remains at least as high as – if not higher than – the level in state-owned firms. The flow of benefits from the state to privatised firms has not ceased, but has changed forms,

Chart 6.14

Subsidies and arrears by ownership



with a greater reliance on implicit, as opposed to direct, subsidies. The survey does not identify differences in this pattern of costs and benefits for firms prior to and after privatisation, but the comparison between state-owned and privatised firms suggests that privatisation has “depoliticised” the firm in terms of removing the state’s control over company decisions. However, it has not broken the financial ties – in terms of subsidies and bribes – that bind the state and privatised firms.

New entrants have a very different relationship with the state. They face very low levels of state intervention, but they pay high levels of bribes. And yet they continue to spend nearly as much management time dealing with state officials as their counterparts in state-owned and privatised firms. New entrants get very few direct benefits from the state, as both direct and implicit subsidies are low. The high costs imposed by the state on new entrants, with few associated benefits, has been an important factor impeding the development of this sector in many transition countries, as discussed further in Chapter 8.

There are also important differences in the pattern of costs and benefits across the transition economies. These differences do not appear to be related in any simple way to the progress of market reforms. Among the advanced countries, the relationship between the state and firms takes different forms. Some countries within this group, such as Estonia and Poland, have severely cut back state intervention in all firms (even in state-owned firms) as well as the

Table 6.4

The private costs and benefits of the state-firm relationship

Ownership type	Costs to the firm			Benefits to the firm	
	Intervention	Time spent	Bribes	Direct subsidies	Indirect subsidies
State-owned	High	Medium	Medium	High	Medium
Privatised	Low	Medium	Medium	Medium	High
New entrant	Low	Medium	High	Low	Low

flow of direct and implicit state subsidies to firms. Yet other advanced countries, including Hungary and the Slovak Republic, have maintained substantially higher levels of state intervention in enterprises, while also providing direct subsidies to a wider range of firms. While this combination of intervention and subsidies has been associated with high levels of bribery, arrears and a high tax on management time in other parts of the region – especially in the CIS – the advanced countries have managed to avoid that trap. Indeed, most of the advanced countries have managed to contain these problems at levels below those reported in the rest of the region.

Among the less advanced transition countries, the variations in the costs and benefits of the relationship between state and firm are less systematic, but two groups of countries can be identified. In countries such as Armenia and Georgia, where war has taken a severe toll on the capacity of the state to play a substantial role in the economy, the state is unable to intervene in or to subsidise firms directly, while bribery and the provision of implicit subsidies through arrears remain very high. In other countries, such as Belarus and Uzbekistan, the state maintains practices similar to those from the previous command system. State intervention in a very broad range of company decisions remains high and a large number of firms receive direct subsidies and state investment. Yet the pattern of bribes in these countries is mixed. Between the two groups lie most of the remaining countries of the CIS and south-eastern Europe, in which state intervention, bribes and subsidies (primarily implicit) all reach moderately high levels.

6.6 Conclusions

A decade of transition has transformed the interaction between the state and enterprises in the countries of central and eastern Europe and the CIS. The state no longer uses plans and commands to direct firms, but the links between the state and firms remain close. The survey data show that firms both incur costs and receive benefits from this relationship. On the cost side, government officials intervene in a variety of company decisions, extract bribes from firms, and impose significant demands on the time of senior managers. At the same time, firms remain dependent on the state for a range of benefits including direct investment, tax and utility arrears, and influence over regulation and policy-making.

The nature of this relationship between the state and enterprises depends both on the characteristics of firms, such as size and ownership, and on characteristics of the economy, such as the degree of state capture, the level of privatisation and the capacity

of the state. There is no simple relationship between the extent of market-oriented reforms and the nature of the interaction between the state and enterprises. But the process of “depoliticising” enterprises remains very incomplete in all transition economies. The reform process has been associated with a change in the form of state intervention, but not necessarily with a reduction in the overall level of intervention or in the informal tax imposed on firms in the form of bribes and time spent dealing with government officials. Moreover, these costs affect enterprises in different ways and thus distort the competitive playing field. In particular, the bribe tax is sharply regressive, falling more heavily on small, new entrants than on state-owned or privatised firms.

There is also no simple relationship between economic reform and the quality of governance. Firms in the most advanced and least advanced transition economies have more favourable assessments of governance than those in countries that have adopted partial reforms. This reflects the dismantling of the old command system in those economies without the development of functional, market-oriented institutions. The evidence suggests that the degree of state capture by private interests is an important determinant of the quality of governance, in addition to market reforms such as privatisation and liberalisation. The impact of these reforms on the quality of governance depends strongly on the extent of state capture. The challenge of effective depoliticisation of the economy requires both market reforms and measures to constrain state capture by private interests.

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Part III

Enterprise response to reforms

Chapter 7

Competition, enterprise performance and the investment climate

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Competition, enterprise performance and the investment climate

At the centre of transition is the challenge of reallocating resources and restructuring existing enterprises. This redeployment of resources can arise in two ways. The first is through the reallocation of labour and capital from lower to higher productivity firms and industries. Those firms with a supply capacity in excess of the likely market demand for their products tend to shed resources by laying off employees and by closing down plants. At the same time, those firms – including newly established ones – with market demands in excess of their supply capacity will seek to attract resources by recruiting new employees and by investing in new or second-hand plant and equipment. In fact, large shifts in output and employment across sectors have taken place since the start of transition.¹ However, the available evidence does not indicate that labour is systematically flowing within countries from sectors with relatively low productivity and wages to those with higher productivity and wages as strongly as basic economic considerations might suggest.²

The second way in which resources are redeployed is for existing firms to adapt to market demands and to restructure their activities. This restructuring can take many forms. Firms can adjust their activities by developing new products and by upgrading or discontinuing existing ones. Existing plant and equipment can be modified and their employees retrained to meet new production requirements. Firms can attempt to attract new customers and switch suppliers. They can change their organisational structure.

Restructuring activities can be combined with shedding resources that cannot be adapted to new uses and with attracting new employees and investing in new plant and equipment. The two ways of redeploying resources therefore potentially complement each other. However, since available evidence suggests that the sectoral redistribution of labour makes a limited contribution to productivity gains in transition economies, enterprise restructuring is particularly important.

This chapter examines how reforms affecting competition, soft budget constraints, ownership and the “investment climate” have affected the restructuring and growth of enterprises. It uses the results of the Business Environment and Enterprise Performance Survey undertaken by the EBRD in collaboration with the World Bank (see Annex 2.1 to Chapter 2 for a brief description). The chapter first examines the external factors that can influence the activities of the firms in the survey, such as the competition they

face in product markets, the softness of budget constraints, their ownership structure and corporate governance, and their perceptions of the investment climate in the country. Second, it characterises the restructuring actions taken by firms, such as recruiting or shedding employees and developing new product lines or upgrading existing ones. Third, it reports on the overall performance of firms, as measured by growth in sales and in labour productivity. In addition to the survey findings, the chapter also draws on a comprehensive review of existing studies of enterprise performance in transition economies to check the robustness of the findings and to examine issues on which the survey does not yield clear results.

Striking among our findings are the importance of competition, hard budget constraints and the investment climate to the restructuring and growth of enterprises in the survey. Importantly, competition has a strong but “non-linear” relationship to performance. Firms reporting the presence of one to three competitors have developed new products with greater frequency and have much higher sales growth than either firms with a monopoly or those that face strong competition. These findings support the “Schumpeterian” view that strong economic performance is associated with some market power gained through innovation.³ Firms operating in countries that impose hard budget constraints and that have more favourable investment climates also perform more strongly.

7.1 Growth and restructuring of enterprises in transition

As discussed in Chapter 3, there has been considerable variation in the macroeconomic performance of the transition economies over recent years. Twenty transition countries are covered by the survey.⁴ With the exception of recent weakness in the Czech Republic, the countries of central Europe and the Baltic states have registered moderately strong growth (at an average annual rate of 4.5 per cent from 1996 to 1998). In south-eastern Europe (Bulgaria, Moldova and Romania) GDP has contracted sharply. In the central CIS, GDP has continued to contract in Russia and Ukraine but has grown significantly in Belarus. Strong growth has been recorded throughout the Caucasus (Armenia, Azerbaijan and Georgia) and in Kyrgyzstan. Elsewhere in Central Asia, Uzbekistan has recorded growth at just over 2 per cent per year and GDP has remained constant in Kazakhstan.

¹ See Chapter 4 of this Report as well as Chapter 4 of *Transition Report 1997*.

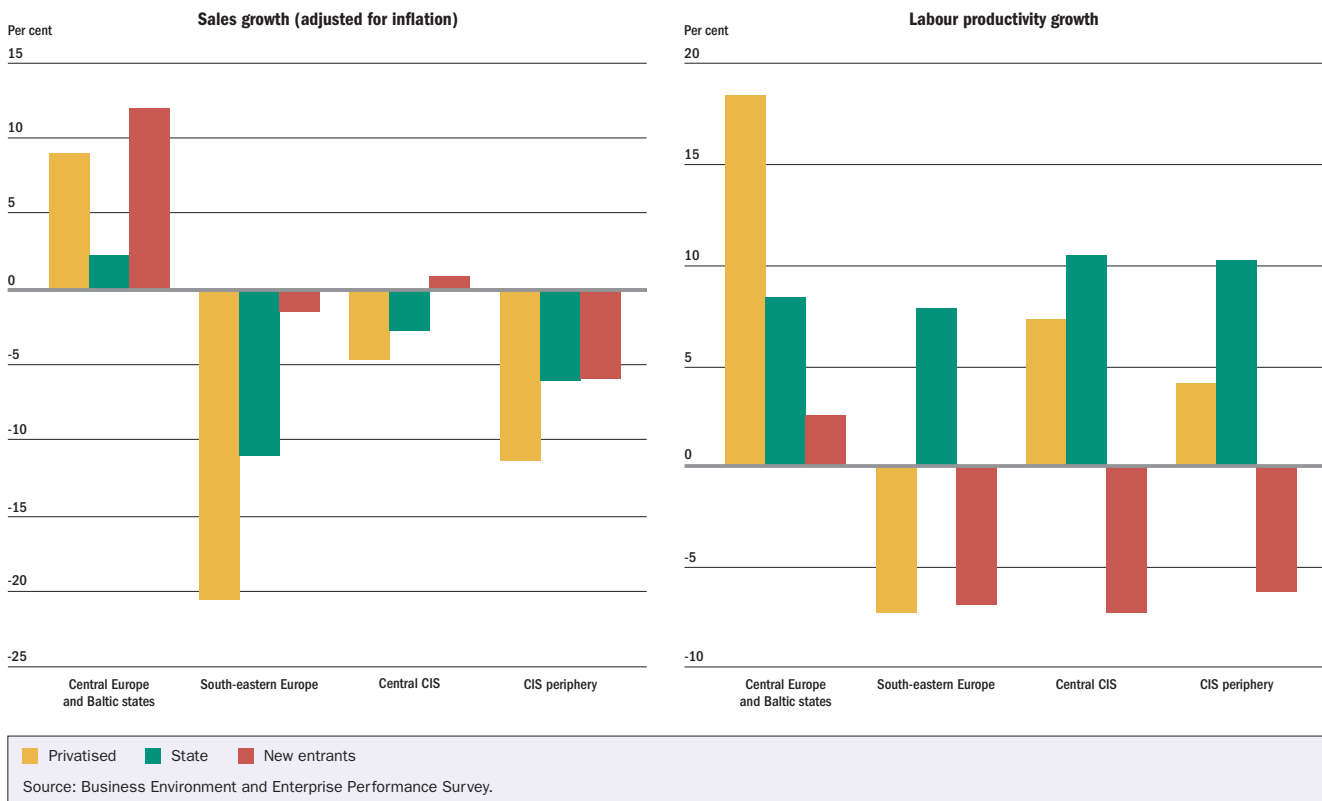
² See Carlin, Fries, Schaffer and Seabright (1999).

³ See Chapter 3 of *Transition Report 1997* for a “Schumpeterian” perspective on the role of competition and innovation in transition economies. For a comprehensive analysis of competition and innovation and their contribution to growth and development, see Aghion and Howitt (1998).

⁴ The countries included in the survey are Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, the Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Lithuania, Moldova, Poland, Romania, Russia, the Slovak Republic, Slovenia, Ukraine and Uzbekistan. For analytical purposes, the countries are grouped into five geographical regions: central Europe and the Baltic states (Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Poland, the Slovak Republic and Slovenia); south-eastern Europe (Bulgaria, Moldova and Romania); central CIS (Belarus, Russia and Ukraine); and the CIS periphery, comprising the Caucasus (Armenia, Azerbaijan and Georgia) and Central Asia (Kazakhstan, Kyrgyzstan and Uzbekistan).

Chart 7.1

Growth in sales and labour productivity over the past three years by region and ownership



Recent macroeconomic developments provide the context for the survey of enterprises in the 20 countries. For many countries, a similar pattern of output and productivity growth emerges from the survey. Chart 7.1 shows that the average rate of sales growth (adjusted for inflation) for countries in central Europe and the Baltic states was 9 per cent over the past three years, compared with substantial declines in each of the south-east European countries. Growth in Slovenia and Estonia is considerably higher in the survey than in GDP data for these countries and in Lithuania it is much lower. For Russia and Uzbekistan, growth performance looks much more impressive in the survey than in the aggregate data for these countries. The opposite is the case for the rest of the CIS. These discrepancies between the survey and the aggregate data are broadly the same for productivity growth and need to be borne in mind when interpreting the survey results.

The survey also reveals how firms in the region have been restructuring their operations. Table 7.1 summarises the frequency with which firms undertake particular types of restructuring activities. As would be expected, the proportion of new firms reporting substantial cuts in employment is lower than for “old” firms, whether state-owned or privatised, while there is a higher proportion of new firms reporting substantial increases in employment. To some extent this may reflect a “survivor bias” in the survey, since it covers only those new entrants that have survived. While plant closure rates are similar for state-owned and privatised firms, a new plant is more likely to be opened by new firms and privatised ones than by a state-owned enterprise.

In the central CIS new firms dominate employment creation to a greater extent than elsewhere and, for the CIS as a whole, there is little difference between state and privatised firms in job creation. Outside the CIS, privatised firms are more likely than state firms to create jobs.

Perhaps the most fundamental types of restructuring are the launch of new or improved products. State firms have lagged behind others with respect to launching new products, except in the central CIS where the performance of state firms is somewhat better. The possibility that some product proliferation may be associated with an increased role of barter in the economy is examined in Section 7.7 and Box 7.1. There is relatively little variation across types of firms and regions with respect to the upgrading of existing products. However, in common with the development of new products, there is less activity in the CIS periphery than elsewhere.

The table also reveals a striking degree of organisational change among firms throughout the region. Over half of privatised firms and state firms have had at least some degree of internal reorganisation in the last three years. Firms in regions with falling output (south-eastern Europe and the central CIS) have changed their organisational structure with the greatest frequency. Not surprisingly, new entrants have been less likely than other types of firms to change their structures. Taking an overview of restructuring, it is striking that even if state firms have shown less tendency to restructure than private firms, in several respects they have not stood still.

Table 7.1

Enterprise restructuring activities by region and ownership

(Proportion of the total of each type of firm, in per cent)

	Privatised	State	New entrants	Total
Employment decreases				
Central Europe and the Baltic states	45	52	20	32
South-eastern Europe	54	55	18	34
Central CIS	46	45	22	33
CIS periphery	55	52	19	37
Total	52	49	20	35
Employment increases				
Central Europe and the Baltic states	23	14	36	29
South-eastern Europe	21	12	34	27
Central CIS	21	16	41	32
CIS periphery	13	11	22	17
Total	20	13	34	26
New product development				
Central Europe and the Baltic states	36	25	28	30
South-eastern Europe	32	30	33	32
Central CIS	30	36	36	34
CIS periphery	24	21	22	22
Total	31	26	29	29
Upgrading of existing products				
Central Europe and the Baltic states	48	42	42	44
South-eastern Europe	43	48	47	46
Central CIS	40	41	37	38
CIS periphery	31	34	26	29
Total	41	40	38	39
Change of suppliers				
Central Europe and the Baltic states	17	12	17	16
South-eastern Europe	22	20	26	24
Central CIS	31	25	32	31
CIS periphery	19	17	16	17
Total	22	17	22	21
Change in organisational structure				
Central Europe and the Baltic states	59	55	33	46
South-eastern Europe	58	69	38	50
Central CIS	62	49	47	57
CIS periphery	48	39	30	38
Total	57	53	37	48

Source: Business Environment and Enterprise Performance Survey.

Identifying whether certain kinds of restructuring contribute to improved performance and the factors that enhance performance directly and indirectly via their influence on restructuring can be instrumental in promoting a successful transition. With wide variation in the performance of firms in the transition, it should in principle be possible to isolate at least some of the factors that contribute to these differences among firms both across and within countries. The survey on the business environment and enterprise performance was undertaken to identify such factors.

7.2 External factors, restructuring and growth

While managers are the primary decision-makers within firms and their workers and capital are the main source of productive inputs, the performance of firms is influenced by factors that are external to the managers and the resources they control. The external factors that motivate firm managers are varied, but perhaps most

fundamental is the survival of the firm itself. To survive in a market economy, firms must attract customers and control costs. This is the basic market test of firms. However, to relieve this pressure, managers can also lobby the state for financial support. Any softening of the budget constraints of firms would make survival easier and lessen the need for managers to respond to market pressures.

The job security of managers, however, may depend not only on survival of the firm, but also on satisfying the firm's shareholders. They and their representatives, typically a board of directors, have the authority to hire or to dismiss the senior management of a firm. However, the interests of different types of shareholders can vary. For example, where the state is the controlling owner of a firm, it may be willing to sacrifice profitability for political or social objectives, such as the maintenance of employment and social

protection or the provision of essential services. Where the state has privatised firms, the design of privatisation schemes often reflects similar political or social considerations. Privatisation of state firms to strategic investors or to dispersed outside shareholders has been the exception rather than the rule throughout the region.⁵ In cases where outside shareholders own firms, they are likely to place profitability above other possible objectives. By contrast, insider shareholders (managers and employees) may place a higher weight on their continued employment in the firm as workers or managers than on profitability.

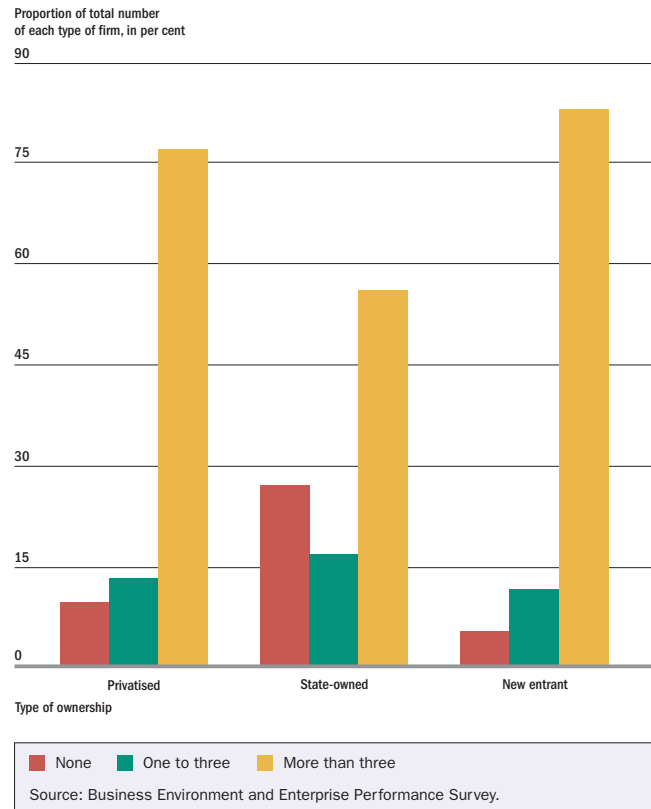
While product markets and shareholders exert economic pressures on firm managers, many other factors shape these pressures and the response of managers to them. These factors include the macroeconomic environment, the nature of taxation and business regulation, the provision of public goods (the judiciary, public infrastructure, and law and order) and private provision of essential business services (infrastructure services, finance, accounting and auditing). These factors are referred to collectively as the “investment climate”.

The survey has gathered a great deal of information about the characteristics of firms, their performance and their operating environment. Some of the factors influencing performance vary from firm to firm. Examples include competition in the market for the firm’s products, ownership and the firm’s origin – that is, whether it is an “old” firm or a new company. Other external factors are features of the general operating environment of the country and are broadly common to all firms in the country. To evaluate the impact on firms of aspects of the investment climate and of the softness of budget constraints, the survey asked managers in different countries the same questions about their judgement of the impact of external conditions in their country on their business. From these answers it is possible to construct a country-wide measure for each factor.⁶ These country-wide measures are essentially estimates of various aspects of the economic environment in which firms in different countries operate.

There are questions, however, to which the survey cannot provide clear answers. In particular, an important question is the impact of privatisation and of the type and structure of private ownership on restructuring and performance. To answer this question, it is necessary to have detailed information on the characteristics of state-owned enterprises before privatisation began. Unless it is known whether better or worse firms were privatised, it is not possible to assess whether the practices and performance of the firm after privatisation are due to the change in ownership or due to features of the firm that were already present before privatisation, such as the quality of its managers, workers and assets. Section 7.8 presents the information that is available about the effects of privatisation and ownership type on performance from

Chart 7.2

Number of competitors that firms face by their ownership



the existing studies that have attempted to take into account the pre-privatisation characteristics of firms.

7.3 Product market competition

Competitive pressure is one of the main factors in the efficient allocation and use of resources by firms. Rivalry between firms also provides a strong impetus for innovation. By introducing new products or improving production methods, a firm can gain a competitive edge over its rivals and can earn extraordinary profits. These profits are the return on innovation. They also create an incentive for rivals to imitate or surpass the improved product or process, making the initial innovation obsolete but creating a ladder of quality improvements. Competitive processes are therefore central not only to the efficient use of resources but also to the development of innovation, which is characteristic of a market economy.

The survey asked enterprise managers in transition economies for their perceptions of the competitive pressures they faced, including the number of their competitors in the domestic market for their main product. Chart 7.2 shows that the competitive environment in which state firms operate looks quite different from

⁵ For a review of privatisation methods in transition economies and their implication for post-privatisation ownership and corporate governance, see Chapter 5 of *Transition Report 1997* and Carlin (1999).

⁶ In analysing the determinants of firm performance, it may seem reasonable to assume that the direction of influence runs only from the external factors faced by firms through the business decisions they take to performance outcomes. While this sequence may often occur, the direction of influence can also run the other way. For example, the strong performance of a firm may make the firm less likely to need a bailout and thus less likely to exhibit signs of a soft budget constraint. Similarly, strong firm performance, or the observed willingness of its managers to take difficult restructuring decisions, may make the firm a more attractive prospect for privatisation, particularly to a strategic investor. In seeking to identify the influence of external factors on firm performance, it is therefore necessary to control for the fact that the direction of influence can run in both directions. The use of country-wide external factors is one way to control for this “reverse causality”.

Table 7.2

Importance of pressure from domestic and foreign competitors

(Proportion of each type of firm that perceives domestic or foreign competition as very important, in per cent)

	Privatised	State	New entrants	Total
Domestic competition				
Central Europe and the Baltic states	29	20	32	30
South-eastern Europe	32	17	33	29
Central CIS	13	9	16	15
CIS periphery	17	6	17	15
Total	22	14	25	22
Foreign competition				
Central Europe and the Baltic states	31	24	16	22
South-eastern Europe	32	20	20	23
Central CIS	9	2	8	9
CIS periphery	11	6	8	9
Total	21	13	13	16

Source: Business Environment and Enterprise Performance Survey.

that reported by privatised firms and new entrants. Nearly 30 per cent of state-owned firms faced no competitors in this market compared with between 5 and 9 per cent for private firms. Whereas just over half of state-owned enterprises reported that they faced more than three competitors in their main product market, this is true of some 80 per cent of privatised and new private firms. There is therefore a strong association between firm ownership and market structure in transition economies, with many state firms operating as a monopoly in the market for their main product. The pattern is least evident in the central CIS, where state firms appear to perceive themselves as monopolies less frequently and as facing more than three competitors more frequently than elsewhere.

This pattern is confirmed by the responses of firm managers to a question about how their customers would respond to a 10 per cent increase in the price of their main product line, assuming that their competitors did not raise their prices. State firms were about twice as likely as privatised and new firms to answer that their customers would continue to buy about the same quantity as before. Consistent with the findings for the number of competitors, the differences across ownership type were less marked in the central CIS than elsewhere.

The impact of competitive pressure can depend not only on the number of competitors but also on their characteristics, in particular whether they are a domestic rival or a foreign competitor. To gauge the extent to which firms faced domestic or foreign competition, the survey asked about pressure from domestic or foreign competitors in determining their decisions to develop new products and markets. Firms in central Europe and the Baltic states and in south-eastern Europe were more than twice as likely as those in the CIS to identify pressure from domestic competitors as very important. There was a tendency in all regions for domestic competition to be viewed as important more frequently by private firms (both privatised and new ones) than by state firms. Foreign competition was identified as an important spur to new products

considerably more frequently outside the CIS. The results are shown in Table 7.2.

The consequences of market power for restructuring and performance, however, are in principle ambiguous. Strong competitive pressures leave little scope for inefficiencies in the allocation and use of resources in production. At the same time, these pressures can squeeze profits and retained earnings, diminishing the incentive to invest and the amount of retained earnings available to finance investment. A balancing of efficiency considerations against the need to encourage and to reward innovation suggests that the desirable market structure is not necessarily a perfectly competitive one. Rather, at any point in time, there should be at least some markets with only a limited number of rivals and with some market power in order to encourage innovation. However, over time, dominance in any one market may be only transitory as rivals imitate success and as other innovations are introduced.

In transition economies, market power can arise either from previous entrepreneurial initiative (for example, through the introduction of new products into the market) or from other sources, such as protected market positions inherited from the previous regime. A statistical analysis of the price-cost mark-ups reported by firms reveals that only in the case of new entrants is there a clear association between the current profit margin and previous decisions to develop new products or to upgrade existing ones. Compared with an average reported mark-up of 17 per cent, a previous decision to develop a new product was associated for new entrants with an increased mark-up of 2.9 percentage points, and a decision to upgrade an existing product with an increased mark-up of 1.9 percentage points.⁷ These results suggest that new private entrants are able to create at least transitory profits from their innovative activities, while this is less evident in state-owned and privatised enterprises. To the extent that these firms possess market power, it may arise from other sources, such as legacies from the past.

⁷ In a regression analysis of a firm's price-cost mark-up, the former is significant at the 5% level and the latter at 10%.

Table 7.3

Sources of enterprise financing for fixed investment by region and ownership

(Proportion of total fixed investment for each type of firm, in per cent)

	Privatised	State	New entrants	Total
Internal funds				
Central Europe and the Baltic states	49	44	49	49
South-eastern Europe	68	55	65	63
Central CIS	69	66	69	69
CIS periphery	68	47	71	66
Total	62	50	61	60
State funds				
Central Europe and the Baltic states	1	19	0	3
South-eastern Europe	2	20	0	5
Central CIS	4	22	1	4
CIS periphery	2	39	0	8
Total	3	26	1	5
Bank loans				
Central Europe and the Baltic states	18	8	10	12
South-eastern Europe	10	10	7	8
Central CIS	7	5	6	6
CIS periphery	4	2	4	3
Total	11	6	7	8
Sales of stock				
Central Europe and the Baltic states	11	7	12	11
South-eastern Europe	3	2	1	1
Central CIS	2	2	1	1
CIS periphery	5	1	1	2
Total	6	3	5	5

Source: Business Environment and Enterprise Performance Survey.

The level of retained earnings is also an important factor influencing investment and innovation. Table 7.3 shows the proportion of fixed investment over the previous year financed from various sources. The data reveal that retained earnings financed 60 per cent of all investment and that they are more important for privatised firms than for state firms. State firms continue to receive a significant proportion of investment finance from the state, 26 per cent on average and 39 per cent in the CIS periphery.

The table shows that only privatised firms in central Europe and the Baltic states and in south-eastern Europe have significant access to bank loans, which account for about one-fifth of the finance for total fixed investment. New entrants appear to be less likely than privatised firms to have access to bank loans to finance investment and rely much more than other firms on family sources, even in central Europe and the Baltic states. The issue of new equity is a significant source of finance only in central Europe and the Baltic states, primarily for privatised firms and new entrants. New equity and bank loans appear to account for nearly the same proportion of investment finance in that region. In the survey, firm managers cite the lack of access to finance as the single most important obstacle to the operation and growth of their business.

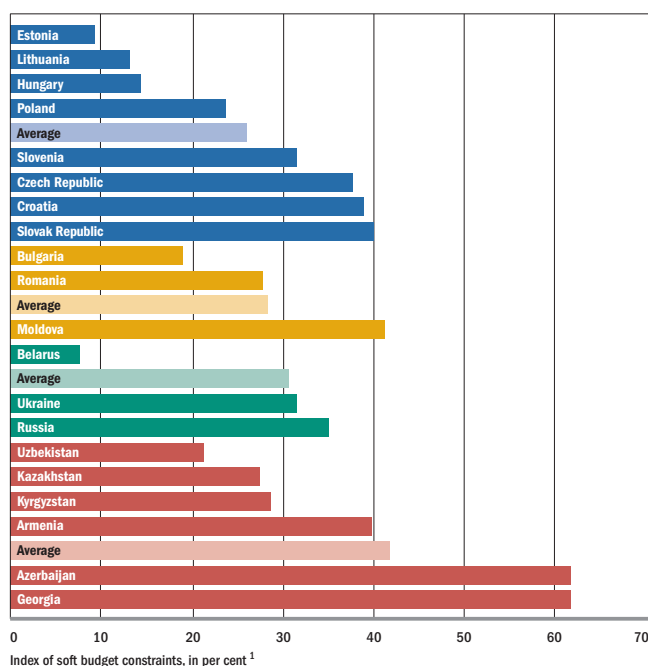
7.4 Budget constraints: subsidies, soft loans and arrears

While competition can encourage efficiency gains and innovation, this potential can be realised only if firms have to attract customers to survive and prosper. If instead, enterprises can lobby the state for support, the potential benefits of competition can readily dissipate, not only for the enterprises that receive the support but also for any firms against which they may compete in product markets or in the factor markets (labour and capital). Rather than develop products and production methods that are profitable once customer demand and input costs are taken into account, enterprises with soft budget constraints can persist in the inefficient use of resources, including excessive employment, and can sell products at prices below cost.

There are a wide variety of ways in which the budget constraints of enterprises are eased in transition economies. Perhaps the most direct way that governments support enterprises is through budgetary subsidies to producers and through soft government loans. While these production subsidies have been substantially reduced in most countries, they still amounted in 1998 to between 0.5 per cent of GDP (Armenia) and 6.5 per cent (Russia) for the 20 countries covered by the survey. Moreover, as discussed in the preceding section, state firms in transition economies tend to have favoured access to government credit, particularly those in CIS countries. These non-commercial credits typically contain a large subsidy element.

Chart 7.3

Soft budget constraints in countries grouped by region



■ Central Europe and Baltic states ■ Central CIS
 ■ South-eastern Europe ■ CIS periphery

Source: Business Environment and Enterprise Performance Survey.

¹ The index of soft budget constraints is the proportion of firms in a country that failed to pay all of their taxes. A higher index value therefore means a softer budget constraint.

A less direct, but potentially more significant, means of support for enterprises in transition economies is the tolerance of tax arrears and the non-payment of utility bills. The non-payment of such bills, particularly those of state-owned energy producers, is tolerated in many transition economies. This practice largely reflects a perpetuation of the old system, which used the region's generous endowment of energy resources to support heavy industry through the low administered pricing of this input.⁸

The survey asked firms if they were in arrears on their taxes or utility bills. The proportion of firms in each country indicating they had failed to pay all of their taxes or utility bills provides a measure of the softness of budget constraints for the economy as a whole. Chart 7.3 shows the tax arrears measure of soft budget constraints by country and by region. Those countries in central Europe and the Baltic states tend on average to have the lowest incidence of tax arrears, with the exceptions of Croatia and the Czech and Slovak Republics. The central CIS countries and those in the Caucasus (as well as Moldova) have the highest incidence, with the notable exception of Belarus, where tax arrears are lower than in any other country in the sample. However, it must be recognised that soft loans and other means of enterprise support remain pervasive in Belarus.

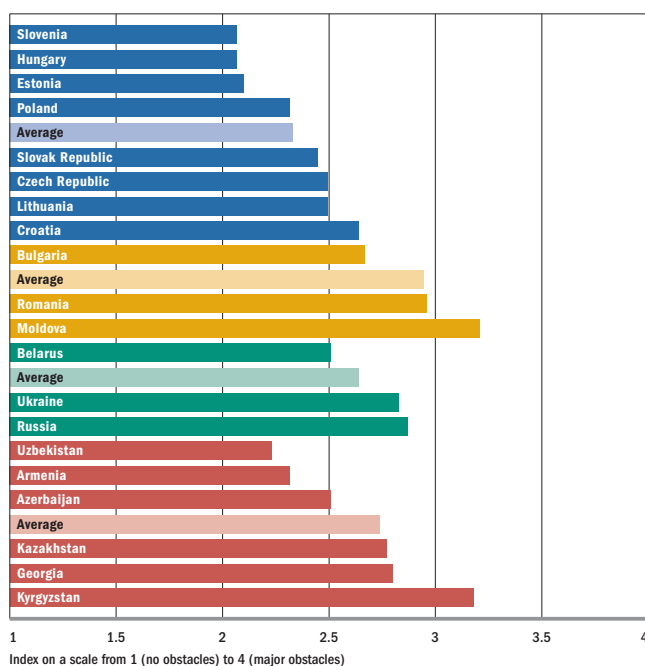
For the purpose of statistical analysis, however, it is important to recognise that the incidence of arrears varies with the size, sector,

⁸ See Gaddy and Ickes (1998).

⁹ The survey did not attempt to ask firm managers about the extent and nature of their compensation.

Chart 7.4

Average investment climate score by region



■ Central Europe and Baltic states ■ Central CIS
 ■ South-eastern Europe ■ CIS periphery

Source: Business Environment and Enterprise Performance Survey.

ownership and sales growth of firms. In particular, larger firms and those that are state-owned or have been privatised tend to have a greater incidence of tax arrears compared with small firms and new entrants. Also, firms that are growing more rapidly tend to be less likely to have tax arrears. Therefore, to develop a standardised measure of how effectively taxes are administered and utility bills are recovered in each country, it was necessary to take account of these specific factors.

7.5 Ownership, corporate governance and managerial selection

The ownership and corporate governance of a firm influence its operating decisions and performance largely by appointing managers and by specifying their objectives, compensation and incentives. The authority to hire or to dismiss the senior management of a company rests largely with the shareholders of a company and the board of directors. However, different types of owners – managers and workers, the state, outside strategic investors and portfolio investors – can have different objectives for a firm and different means of effecting change within the company. Firms with different types of ownership structures may therefore discipline their managers in different ways, even if the firms are exposed to relatively similar economic pressures.

The survey asked firms about the turnover of their managers and the extent to which new managers came from outside the firm.⁹ This issue is particularly important because state-owned enterprises entered the reform period with managers in place who had

Table 7.4

Managerial turnover by region and ownership

	Privatised	State	New entrants	Total
Changed general manager in past three years				
(Proportion of each type of firm, in per cent)				
Central Europe and the Baltic states	34	43	10	22
South-eastern Europe	28	36	3	16
Central CIS	26	18	12	18
CIS periphery	23	34	7	18
Total	29	33	10	20
New general manager from outside the firm				
(Proportion of firms of each type that have changed their general manager, in per cent)				
Central Europe and the Baltic states	47	44	33	43
South-eastern Europe	45	29	21	35
Central CIS	30	20	30	29
CIS periphery	47	24	23	33
Total	42	34	30	37

Source: Business Environment and Enterprise Performance Survey.

been originally appointed under very different circumstances. Table 7.4 shows the proportion of firms with a new general manager in the preceding three years, by ownership and region. Although the differences in managerial turnover rates between state-owned and privatised firms are relatively small in the sample as a whole, there are quite pronounced regional differences. In central Europe and the Baltic states, privatised firms are less likely than state firms to have changed their managers. Where the manager has changed, it is only outsider-owned firms that are more likely than state-owned ones to have brought in a new manager from outside the firm. In the central CIS region, privatised firms have seen more managerial turnover than state firms in recent years. Not surprisingly, new entrants have much lower rates of turnover, since most of these firms are owner-managed.

While the ownership structure of a firm may have some influence on managerial turnover and on the selection of new managers, the pressure to change ultimately arises from the market environment in which the firm operates. A statistical analysis of the likelihood of a firm changing its general manager reveals that the chances of a manager having been replaced increase significantly if the firm faces one to three competitors in the market for its main product and if it is operating in an environment of relatively hard budget constraints (measured by the incidence of tax arrears in the country). Higher rates of managerial turnover are also associated with firms in countries with a better investment climate. The analysis also confirms that new entrants and insider-owned firms have lower rates of managerial turnover than do other firms and that both of these types of firm are also less likely to have a new manager chosen from outside the firm. A harder budget constraint is associated with outside recruitment but even after taking account of all of these factors, outside recruitment is less likely away from central Europe and the Baltic states, suggesting the slower development of the managerial labour market elsewhere.

In one existing study of managerial selection and its impact on firm performance in transition economies, there is evidence for a sample of Czech firms listed on the Prague Stock Exchange that the presence of a new manager in the firm was positively associated with productivity and a measure of profitability (Tobin's q-ratio).¹⁰ The analysis was refined to distinguish between the appointment of a new manager from within the firm and a new manager from outside the firm appointed by a private owner or by the government. The study found that best performance was associated with a new outside manager appointed by a private owner. Next in terms of performance was a new manager from outside appointed by government. New managers from within the firm registered the worst performance. Whether managers owned equity in the firm had no measurable effect on performance.

The evidence of this study points to the potential importance of managerial selection and the managerial labour market for firm performance. The results from the survey suggest that the competitive environment, hardness of the budget constraint and ownership type are significant factors for managerial turnover. Privatised firms owned by insiders are less likely than privatised firms owned by outsiders or state firms to use the managerial labour market to select new managers.

7.6 Investment climate

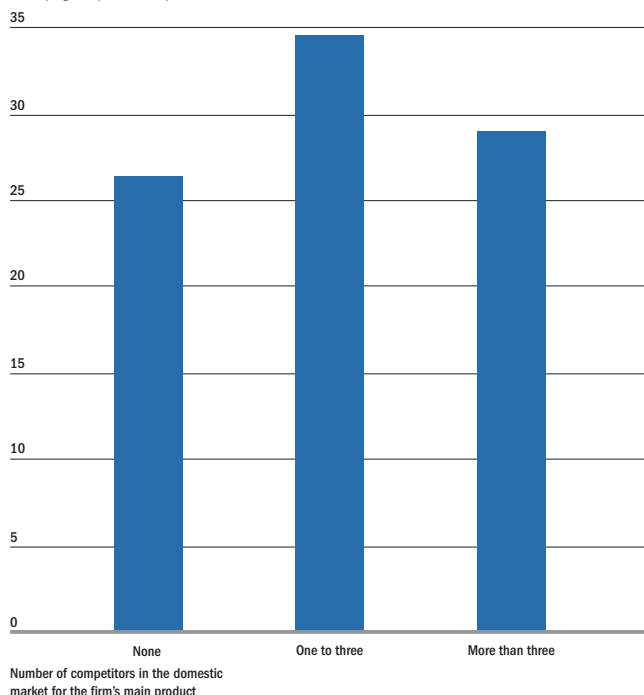
In addition to competitive conditions, the hardness of the budget constraint and corporate governance pressures, the broader investment climate in which firms operate can potentially influence their restructuring decisions and performance. The survey asked managers to rank the extent to which aspects of the macro-economy, taxation, policy stability, business regulation, the judiciary, law and order, infrastructure and finance imposed an obstacle to the operation and growth of their business.

¹⁰ See Claessens and Djankov (1999).

Chart 7.5

New product development and domestic competition

Proportion of each type of firm developing new products, in per cent



Source: Business Environment and Enterprise Performance Survey.

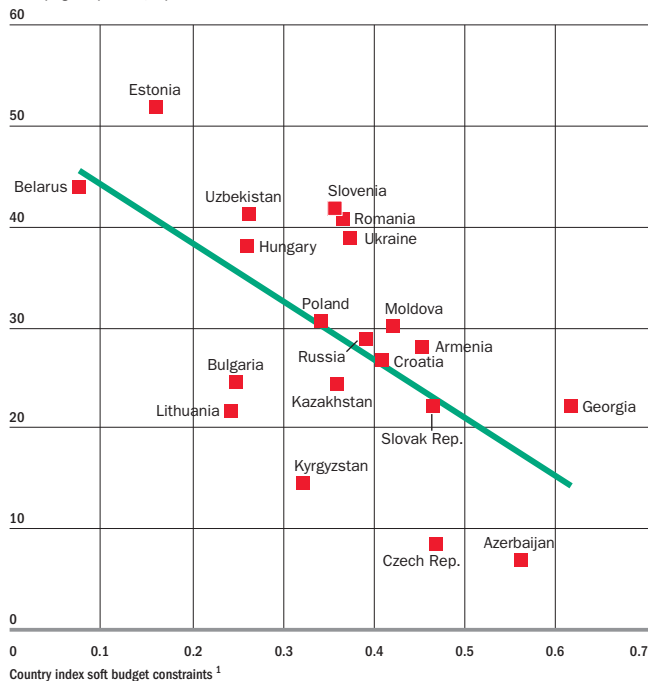
Chart 7.4 provides a detailed view of the investment climate based on the responses of firm managers to the survey. A value of 1 corresponds to no obstacle and 4 indicates a major obstacle: a lower score means a more favourable investment climate as perceived by managers. A summary score is obtained for each country by calculating the unweighted average for all firms and all measured dimensions of the investment climate. This average is then corrected for the effects of size, sector, ownership and sales growth of firms so as to identify the underlying investment climate in each country. This correction is necessary because the composition of firms in the sample differs across countries and because larger firms and those that are state-owned are more likely than privatised firms and new entrants to have favourable perceptions of the investment climate. Also, investment climates are perceived as favourable by some sectors more than others.

Chart 7.4 shows the summary scores for each of the 20 countries covered by the survey. In common with the average of the EBRD's transition indicators, the more favourable investment climates tend to be recorded in countries in central Europe and the Baltic states than in those countries further to the south and east.¹¹ However, the survey produces some surprising results within this overall pattern. Enterprise managers in the Czech Republic and Croatia take a more critical view of their investment climate than do their neighbours, whereas those in Armenia, Azerbaijan and Uzbekistan perceive more favourable investment climates compared with the views of neighbouring countries. Part of the

Chart 7.6

New product development and budget constraints

Proportion of firms in a country developing new products, in per cent



Source: Business Environment and Enterprise Performance Survey.

¹ The index of soft budget constraints is the proportion of firms in a country that failed to pay all of their taxes. A higher index value therefore means a softer budget constraint.

variation across countries may reflect differing norms as to what precise conditions constitute a major or minor obstacle to enterprises. In particular, the components of the business environment included in the investment climate measure are relevant to a market economy. In a country that has achieved little progress in transition, economic activity may be mainly guided by mechanisms only weakly related to those of a market economy, with the consequence that measures of obstacles to doing business according to market rules will be of little relevance.

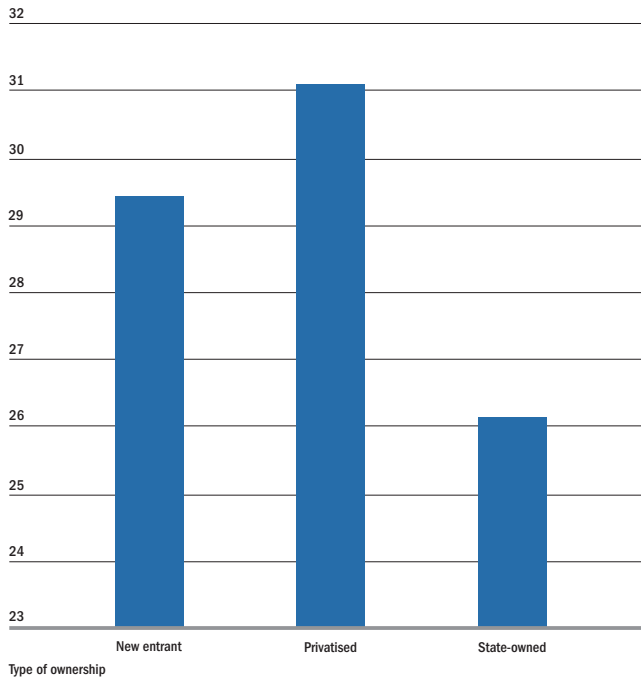
Much of the cross-country variation in perceptions of the investment climate is concentrated along particular dimensions. For example, not only does macroeconomic and policy instability pose one of the major business obstacles, this dimension also has the highest variance in scores across countries. The countries with more stable and predictable government policies are in central Europe and the Baltic region and those with less certain policies are in south-eastern Europe and the central CIS. While finance and taxation are also major obstacles, these aspects of the investment climate are more similar across the countries. The other dimension of the investment climate with considerable cross-country variation is the judiciary, corruption and law and order. Again, these issues are perceived as less problematic in central Europe and the Baltic states than in south-eastern Europe and the CIS. The exceptions to this stylisation are Croatia and Lithuania

¹¹ See Annex 2.1 to Chapter 2 for a more detailed analysis of the EBRD survey measures of the investment climate and the EBRD's transition indicators.

Chart 7.7

New product development and type of ownership

Proportion of each type of firm developing new products, in per cent



Type of ownership

Source: Business Environment and Enterprise Performance Survey.

(where they are more problematic than in neighbouring countries) and Armenia, Belarus and Uzbekistan (where they are less).

7.7 Factors influencing enterprise restructuring

The next two sections of the chapter seek to link the external factors that can potentially influence the performance of enterprises – competition, hard budget constraints, ownership and the investment climate – with restructuring actions and with sales and productivity growth of firms sampled by the survey. The focus of this section is on restructuring activities, in particular the strategic restructuring decisions that are fundamental to the growth of firms. Such activities may include the development of new products, the upgrading of existing ones and the structural reorganisation of the firm. They typically involve substantial sunk investment costs and will be undertaken only if the balance between return and risk is favourable.

A statistical analysis was undertaken to examine the likelihood of firms in the survey having carried out certain types of restructuring over the past three years and to identify the key factors influencing different types of restructuring.¹² This analysis reveals that new product development is undertaken if a firm has some but not too many competitors in the market for its main product and faces hard budget constraints (see Charts 7.5 and 7.6). New entrants are somewhat more likely than other types of firms to

develop new products or upgrade existing ones (see Chart 7.7). In addition, market power, as measured by the 10 per cent price rise test, increases significantly if a firm has introduced a new product. This finding suggests that innovations are associated with market power. Broadly similar results are found regarding the decision to upgrade an existing product.

Similarly, the likelihood of restructuring the organisation of a firm increases significantly if there are hard budget constraints, if the firm has some but not too many competitors in the market for its main product and in response to pressures from foreign competitors, creditors and the government. Both state-owned and insider-owned firms are significantly less likely than outsider-owned privatised firms or new entrants to change their organisational structure. A foreign ownership stake also makes organisational change more likely.

The results of the survey analysis highlight the factors that influence restructuring by firms. In particular, firms that are operating in an environment of hard budget constraints and that have some market power are more likely to develop new products. Ownership differences do not appear to be particularly important. By contrast, when looking at the likelihood of organisational change, pressure from creditors and the government or government agencies appears to be important and ownership differences become more significant.

Several previous studies have examined whether firms with different types of owners undertake different types of restructuring. A study examining a number of CIS countries found that the disposal of assets by firms and the undertaking of minor renovations were more likely in foreign-owned firms and where managers had a stake in the company.¹³ An analysis of firms in Moldova and Georgia revealed that the type of insider-privatisation was significant for restructuring decisions.¹⁴ Firms privatised through management and employee buy-outs (MEBOs) showed greater dynamism, whereas voucher-privatised firms were indistinguishable from state-owned ones. It is striking that in all of these cases, the same types of firms that undertook restructuring were also the ones with better productivity performance.

A study of restructuring in Russian enterprises found that changes in the boundaries of the firm through the break-up of the firm or mergers were greater in privatised than in state-owned firms. There was also a greater tendency for privatised firms to change the channels through which they sold their output.¹⁵ With respect to both kinds of restructuring, a more active approach was shown by manager-owned firms than by outsider-owned companies. When looking for ownership effects regarding job creation in Bulgaria, Hungary and Romania, there was no difference between state and privatised firms and only in Bulgaria and Romania did new firms create more jobs.¹⁶

¹² The statistical analysis involved the estimation of a logit regression of whether a firm undertook a particular restructuring action over the past three years against measures of the competition that a firm faced in product markets, its ownership, the hardness of budget constraints and quality of the investment climate in the country where the firm operated.

¹³ See Djankov (1999b).

¹⁴ See Djankov (1999a).

¹⁵ See Earle and Estrin (1997).

¹⁶ See Bilsen and Konings (1997).

Box 7.1

Barter: its causes and consequences

Transactions in barter, offsets or bills of exchange (money surrogates) make up more than 10 per cent of transactions for just under a third of firms in the survey, and over 25 per cent of transactions for nearly a fifth of firms. In Russia and Ukraine just over half of the firms reported that they conducted more than 10 per cent of transactions in this way, and just over a third that they conducted more than 25 per cent of their business this way. Although there are some doubts as to whether the question is interpreted the same way in all countries (very high barter rates are reported in Croatia and Slovenia, for example), the phenomenon has been independently documented in the central CIS (see Commander and Mummsen, 1999). Our survey sheds valuable light on its causes and consequences.

- The extent of barter increases as the quality of the investment climate declines. In particular, firms that regard finance and taxes as major obstacles to the operation and growth of their firms are more likely to engage in barter. Even allowing for variation in the investment climate, barter is much more frequent in the central CIS countries than elsewhere in the region. Within Russia and Ukraine, the extent of barter is significantly associated with tax offsets and frozen bank accounts. (Barter is used to reduce tax arrears and as a substitute for bank credits.)
- However, allowing for other factors, firms in countries with soft budget constraints are less likely to engage in barter. This suggests that barter is strongly associated with financial constraints: firms reporting strong pressure from creditors use barter much more than others. (Barter is used to keep cash flows away from creditors.)
- The extent of barter increases in line with the size of firms (there are economies of scale in barter transactions). Within the central CIS, the use of barter is more common in firms with no competitors than in those facing some degree of competition. This suggests that barter may be used by firms with market power as a means of discriminating between customers with different capacities to pay (see Guriev and Ickes, 1999).

- State-owned firms and new entrants are less likely than privatised firms to engage in barter.

Does barter have an adverse impact on the restructuring and performance of firms?

- In the central CIS, barter is linked with poor performance, although the nature of the relationship varies across countries. In some it is a case of barter leading to poor performance whereas in other countries poor performance leads to barter. Across the sample as a whole, however, there is no systematic relation between barter and performance.
- Barter is not associated with unwillingness by firms to change. On the contrary, barter is closely linked with changes in the structure of firms. However, as we have seen, these may have varying effects on the firm's performance. This corroborates evidence from micro-economic studies (see Ledeneva and Seabright, 1998) that barter transactions frequently involve significant managerial effort and the construction of ingenious chains of transactions.
- In the central CIS, however, barter is linked with a tendency to resist the upgrading of existing products. This is natural if barter allows otherwise unsaleable goods to be traded. There is no observed negative impact on the decision to launch new products. However, this might be due to some barter transactions requiring firms to produce new products purely to satisfy the demands of a barter chain (a possibility documented also in microeconomic studies).

Overall, the evidence suggests that barter is often a highly inventive and resourceful response of firms to difficult business conditions. It is the conditions rather than the responses that are the problem: in a better investment climate firms could direct their efforts to more productive ends.

While most studies of restructuring seek to examine how firms respond to pressures from the product markets and from shareholders, firms can also adapt to dysfunctional investment climates. Barter is an example of how firms adapt in some transition economies, particularly in the central CIS. Box 7.1 takes a closer look at the causes and consequences of barter in these countries.

7.8 Factors influencing enterprise performance

This section investigates how the external factors considered throughout this chapter influence growth in sales and productivity. These aspects of enterprise performance are fundamental to the overall performance of the economy. Other issues, such as profitability, are also important, but they are difficult to measure accurately, particularly through a survey.

A statistical analysis of the growth in sales and productivity of firms in the survey over the past three years yields a number of very interesting results.¹⁷ Firms reporting the presence of one to three competitors have much higher sales growth than firms

with either a monopoly or strong competition (see Chart 7.8). Firms reporting that they could raise prices without suffering a significant loss in sales also have higher sales growth. The source of competitive pressure for sales growth is also significant. Sales growth is higher in those firms that report significant pressure from customers or from foreign competitors to develop new products and markets, but is no higher in firms reporting pressure from domestic competitors. This suggests that domestic competition may be only a weak substitute for foreign competition in transition economies.¹⁸ Moreover, firms that operate in countries with relatively soft budget constraints also expand more slowly (see Chart 7.9). There is a positive link between investment climate and sales growth, but it is not especially strong.

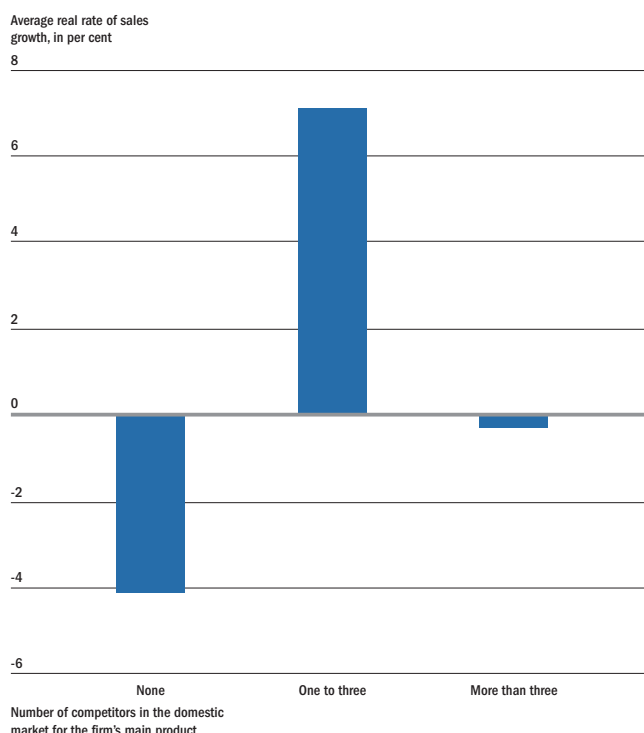
While the survey cannot indicate whether privatisation or a specific type of owner has brought about better performance because the relative quality of the firms prior to privatisation and ownership change is not known, several other studies have been able to investigate this question. It is striking that in all of the

¹⁷ The statistical analysis involved the estimation of a multivariate regression of firm growth against measures of the competition that a firm faces in product markets, its ownership and the hardness of budget constraints and quality of the investment climate in the country where the firm operates.

¹⁸ There are few systematic studies of the impact of competitive conditions on enterprise performance. In a study of Bulgaria, Jones et al. (1998) find a positive effect of larger market share on performance. Using a measure of competition at industry level, Konings (1998) finds in a study of Bulgaria and Estonia that more competitive pressure in the industry enhances firm performance in Bulgaria but not in Estonia. For Russia, Earle and Estrin (1998) find that greater competition in the market complements the effect of privatisation in enhancing performance. A study of Georgian firms (Djankov and Kreacic, 1998) found that competition from foreign producers tends to be associated with employment cuts and changes in suppliers (but tends to reduce the likelihood of the disposal of assets, renovations and computerisation). By contrast, firms with a larger market share are more likely to engage in computerisation, renovations, the establishment of a new marketing department and the disposal of assets.

Chart 7.8

Sales growth by number of domestic competitors



Source: Business Environment and Enterprise Performance Survey.

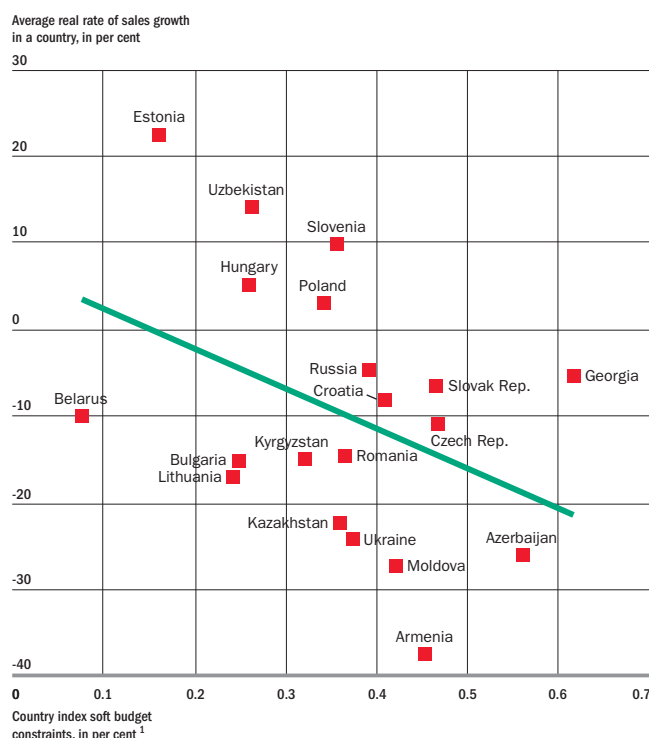
available studies that make adjustments for the effects of selection, privatisation has been found to have a positive impact.¹⁹ These studies also provide assessments of the impact of different types of owners. For example, firms with foreign ownership tend to perform better than state-owned firms. It is not the case that insider-ownership is uniformly associated with poor performance.²⁰

With the survey, however, it is possible to check if ownership is related to performance. State firms and private companies with different types of owners, including those with a foreign ownership stake, have similar sales growth – once the other influences on growth have been taken into account. New firms have significantly higher sales growth, although this may reflect in part the fact that the only new entrants sampled are those that have survived in the market place. Sales growth is closely linked (positively) with the size of firms, but geographical location as measured by region is not often significant once other factors have been taken into account. Rather, as discussed in Section 7.2, the external factors that explain some of the variation in the performance of firms tend to vary across regions.

The results of a statistical analysis of the factors influencing labour productivity growth are largely consistent with those for sales growth. Competition again has a non-linear relationship with

Chart 7.9

Sales growth and soft budget constraints



Source: Business Environment and Enterprise Performance Survey.

¹ The index of soft budget constraints is the proportion of firms in a country that failed to pay all of their taxes. A higher index value therefore means a softer budget constraint.

performance. Firms reporting the presence of one to three competitors have much higher productivity growth than firms with either a monopoly or strong competition. Firms reporting that they could raise prices without suffering a significant loss in sales also have higher productivity growth. Pressure from foreign competitors and customers is also a significant source of productivity growth. In contrast to the sales growth results, there is a tendency for new entrants to have weaker productivity growth and for the size of firm to be insignificant.

It is useful to identify whether strategic restructuring, such as new product development and product upgrading, has a positive influence on performance and to assess whether the external factors that are important for restructuring have an influence on performance over and above their influence on restructuring. For example, a hard budget constraint may prompt firms not only to develop new products but also to cut costs and improve their price competitiveness. If this were so, the hard budget constraint would have an indirect effect on performance via new product development as well as a direct influence.

To pursue these questions, a final analysis considered the influence on sales growth of competition, ownership, soft budget

¹⁹ See Claessens and Djankov (1997), Grosfeld and Nivet (1997), Smith et al. (1997) and Frydman et al. (1998).

²⁰ A study of firms in the Czech Republic, Hungary and Poland (Frydman et al., 1998) finds that both manager- and employee-ownership are not associated with performance that is better than that of state-owned firms, whereas studies of Russia (Earle and Estrin, 1997), of Estonia (Jones and Mygind, 1999) and of Slovenia (Smith et al., 1997) find results to the contrary for manager-owned, worker-owned or both. A study of six CIS countries finds that where managers have a stake of more than 30% or less than 10%, the effect is positive (Djankov, 1999b).

constraints, investment climate and restructuring, taking into account the fact that restructuring decisions are the result of these external factors. This analysis reveals that both the launch of new products and the upgrading of existing ones are closely linked with sales growth but the switching of suppliers and reorganisation of the firm are not. The latter, however, may affect other measures of performance, such as costs and profits.

Most significant is the finding that the number of competitors does not have a significant influence on sales growth once account is taken of its influence on restructuring decisions. This result suggests that competition contributes to the growth of firms primarily through its impact on the development of new products and the upgrading of existing ones. The link between competition and innovation is therefore strong, not only in principle, but also in practice.

7.9 Conclusions

Analysis of the Business Environment and Enterprise Performance Survey and the results of related studies provide a number of important findings with respect to the influence of competition, hard budget constraints, ownership and the investment climate. Most notable are the following:

- The intensity of competition faced by state firms is significantly lower than that faced by other firms. Moreover, competition has a strong but non-linear relationship to both restructuring and performance: too little competition appears to lead to stagnation, but too much is also associated with lower performance. It is an intermediate degree of competition that is associated with deep restructuring and high growth rates. This finding may be partly because a degree of market power is the reward for prior innovation and willingness to restructure and a strong process of market selection (see Chapter 8).
- State firms and privatised firms have shown a similar rate of management turnover. Insider-owned firms make less use of the managerial labour market than either state or outsider-owned firms. Evidence from elsewhere suggests that “new blood” is good for performance.
- In related studies that have taken account of the characteristics of firms prior to their privatisation, it has been found that privatisation has a positive impact on performance. Firms with foreign ownership tend to perform better than state-owned firms. However, insider ownership is not uniformly associated with poorer performance.
- Not all forms of restructuring are equally effective in improving performance. The launching of new products and the upgrading of existing ones are significantly associated with improved performance, but mere internal reorganisation of the firm is not. The latter, however, may affect other measures of performance, such as profitability, since it is strongly associated with pressure from shareholders and creditors.
- The investment climate has a weakly positive relationship to sales performance, but not through its effect on new product development or upgrading. However, the investment climate may affect the entry into the market of new firms and their success or failure (see Chapters 8 and 9). Moreover, while these external influences on the performance of firms vary across the transition countries, geographical location as measured by region is not an important factor on its own in explaining performance.

Taken together, these findings have a number of important implications regarding the promotion of strong productivity and output growth. Perhaps foremost among them is the importance of competition as the spur for innovation and growth. The results of this chapter show clearly that it is the link between competition and innovation, in the form of deep restructuring and new product development, which underpins growth. Rapid growth is achieved by firms that face neither too little nor too much competition and that have (temporary) market power as a result of product innovations. The hardness of budget constraints and, to a lesser extent, the quality of the investment climate also have an impact on the growth in output and the productivity of firms. Policies to promote competition, in particular the process of market entry and exit, are the focus of Chapters 8 and 9. Chapter 8 examines small and medium-sized enterprises and the expansion of the new private sector, while the final chapter of the Report examines how to encourage the restructuring of large industrial enterprises.

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Market selection and the role of SMEs

The previous chapter highlighted the importance of competition in spurring restructuring, innovation and growth at the enterprise level. Achieving these dynamic benefits from competition is fundamental to a successful transition, but in many countries they have not yet been realised. Competition not only encourages existing firms to innovate and adapt to changing market conditions, it also brings about appropriate selection of producers in the market, weeding out inefficient firms and rewarding efficient firms that innovate and take risks. But how well has this process of market selection worked in practice across transition economies? In particular, what have been the important factors influencing the closure or downsizing of existing firms and the establishment and expansion of new ones? This chapter seeks to answer these fundamental questions.

For new enterprises to enter the market and expand, the business environment should not impose barriers that prevent enterprises from responding to changing consumer demands and the introduction of new technology. A significant obstacle to entry, particularly in transition economies, can be the continued presence of non-viable firms in the market, often made possible by the persistence of soft budget constraints and other discriminatory policies. Uneven advantages for some favoured existing firms can significantly distort the functioning of markets and dilute the potential benefits of competition. It is therefore as important to facilitate the closure or contraction of inefficient firms as it is to allow expansion by the new private sector, particularly new business start-ups. Moreover, the business environment should encourage the right types of firms to enter and expand.

This chapter assesses the process of market selection that has developed across the transition economies, the factors that have facilitated or hindered this process and some policy options to improve it. The focus is on non-financial enterprises and the factors influencing their contraction and expansion. The analysis is based largely on the Business Environment and Enterprise Performance Survey undertaken by the EBRD in cooperation with the World Bank for this Report (see Annex 2.1 to Chapter 2 for a brief introduction to the survey). To supplement this evidence, existing studies of job creation and job destruction in transition economies are reviewed.

The chapter consists of five sections. Section 8.1 reports on the general process of market selection and how it varies across countries. Section 8.2 examines exit from the market (including closure as well as downsizing) by state-owned enterprises (SOEs) and

looks at the connection between contraction and exit barriers. Section 8.3 examines the entry of new firms into the market, focusing on the private sector. It identifies the most important entry barriers, and examines how they affect expansion. Section 8.4 assesses the key policy priorities for competition and support for small and medium-sized enterprises (SMEs). Section 8.5 concludes the chapter.

The main findings from this analysis of market selection are that start-ups act as the main spur for employment expansion and growth, while severe impediments to efficient exit in transition economies act as a major barrier to the entry and expansion of newcomers. The analysis also highlights the significance of corruption and anti-competitive practices as the most difficult obstacles to the operation and growth of start-ups. The key priorities are to introduce policies aimed at improving the business environment and creating an even playing field for SMEs. These policies should also aim to improve competition among providers of business inputs, focusing on access to essential business services, especially infrastructure services such as telecommunications and transport.

8.1 Market selection

Because of the distorted structure of output at the start of transition, growth in the new private sector was expected to be concentrated in sectors that were under-represented in the centrally planned economy, particularly distributive trade and services.¹ Growth was also expected in SMEs, which had not been developed under the previous regime. However, recent empirical studies from central Europe and the Baltic states suggest that the dominant factors for job creation have been ownership and age of firms rather than the sector in which they operate. In particular, the empirical results reveal that it is new, privately owned start-ups that fuel the job creation process. In Poland, the remarkable recovery since 1993 is closely linked with the entry and expansion of start-ups.² In contrast, new private firms in Russia and Ukraine do not outperform firms of other ownership types (state-owned and privatised enterprises) in terms of net job creation, but are still an important source of job growth.³ One plausible reason for this is the relatively slow restructuring and job destruction in the state-owned enterprise sector in these economies, which in turn limits the emergence and growth of start-up activities. An alternative view is that it is the absence of sufficient productive market entry and expansion alternatives that explains the hoarding of labour by unproductive enterprises.

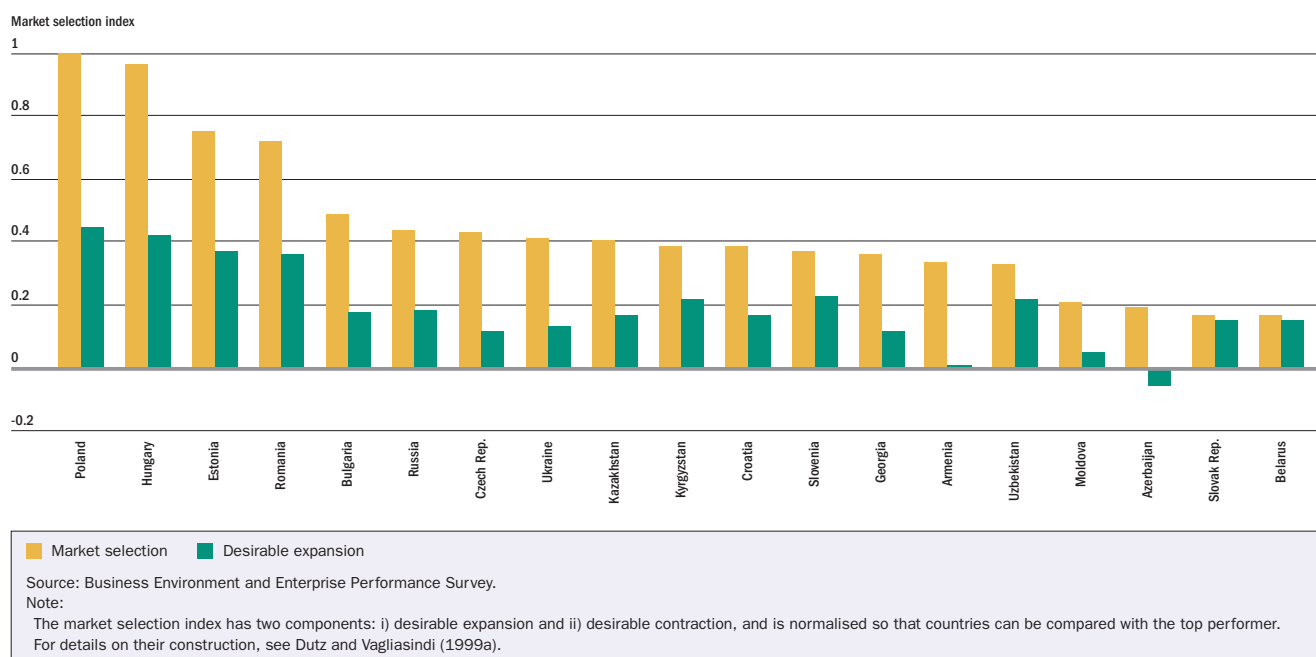
¹ See Chapter 4 for an analysis of structural change in transition economies.

² See Konings, Lehmann and Shaffer (1996) for Poland, Faggio and Konings (1998) and Bilsen and Konings (1998) for Bulgaria, Estonia and Romania, and Bojnec and Konings (1998) for Slovenia.

³ Acquisti and Lehmann (1999) for Russia and Konings and Walsh (1999) for Russia and Ukraine come to almost identical conclusions.

Chart 8.1

Market selection and desirable expansion



The existing studies generally explore the ease of market entry, expansion, contraction and exit by measuring the gross flows of jobs, job creation and destruction rates. However, the following analysis focuses on the expansion of start-ups and the new firms, particularly those in the private sector, compared with the contraction of the state-owned enterprise sector. It assesses how specific countries in the region have diverged from the underlying pattern of job creation in the new private sector and job termination in the state-owned enterprise sector.

The experience of firms in the survey reveals that over the past three years the expansion in employment has been concentrated in new private firms and the shedding of employment in SOEs. Given the nature of the transition and the underlying process of resource reallocation at its core, a summary indicator of market selection should consider both the expansion and contraction of enterprises. The indicator should also characterise countries according to the most desirable types of start-up expansion and SOE contraction. For this purpose, a measure relating to enterprise performance – changes in labour productivity – is used to reflect the desirability of a firm expanding or contracting. The indicator of market selection for each country used in this chapter thus examines both the net proportion of expanding firms that are raising their productivity and the proportion of contracting firms that are state-owned and are experiencing declines in their labour productivity.⁴

Chart 8.1 ranks countries according to this indicator of market selection, namely a composite of desirable expansion (mainly driven by the productivity-weighted expansion of both start-ups and privatised firms) and desirable contraction (driven by the productivity-weighted contraction of SOEs). The first bar for each country reports the overall value of this indicator. The second bar

reflects the contribution attributable to desirable types of expansion. The difference between the two bars reflects the proportion of contracting firms that are state-owned and did not raise their productivity.

Poland and Hungary, followed by Estonia, are the countries that exhibit the most desirable characteristics. These three countries display the highest proportion of private sector enterprises that are increasing productivity and expanding employment, as well as the highest proportion of SOEs decreasing productivity and releasing resources for new and expanding enterprises. Azerbaijan, Belarus and the Slovak Republic exhibit the worst overall findings. Belarus and the Slovak Republic are the countries with the least desirable pattern of market exit, not only because they have a relatively low share of contracting state-owned firms but more importantly because almost none were of the desirable type. Azerbaijan differs by featuring a relatively large number of expanding SOEs that are decreasing productivity, which therefore produces a negative effect on overall expansion.

The indicator reveals that favourable market selection is most commonly found in central and eastern Europe, albeit with substantial variation at the country level. The analysis also suggests that focusing only on stimulating the expansion of start-ups is not a sufficient policy, particularly for economies with the worst expansion patterns. A key priority must be to exert pressure on SOEs to deter the expansion of productivity-decreasing firms that are still in the state sector.

The following sections will explore key barriers and policy initiatives that may have led to desirable types of contraction and expansion. The intention is to try to shed some more light on why

⁴ See Dutz and Vagliasindi (1999a) for a detailed analysis of the methodology used to construct such indicators and of underlying patterns of expansion and contraction dynamics.

Table 8.1

Legal bankruptcy rules and enforcement experience

Annual number of petitions filed	1996	1997	1998
High (+1,000)	Czech Republic (91)* Hungary (92)* Kazakhstan (92) Poland (35)*	Czech Republic Estonia* Hungary Kazakhstan (97) Poland Russia Ukraine	Hungary Poland (98) Russia (98) Ukraine*
Medium (51–1,000)	Bulgaria (94) Croatia (94) Estonia (92) Kyrgyzstan (94) Latvia (92/96)* Lithuania (92)* FYR Macedonia (89) Russia (92) Slovak Republic (91)* Slovenia (93) Ukraine (92)* Uzbekistan (96)	Bulgaria Croatia (97) Georgia (97) Kyrgyzstan (97) Latvia Lithuania FYR Macedonia (97) Slovak Republic Slovenia*	Bulgaria Croatia Czech Republic* Estonia Kazakhstan* Kyrgyzstan Latvia* Lithuania FYR Macedonia (98) Romania Slovak Republic* Slovenia Uzbekistan*
Low (0–50)	Albania (92/95)* Armenia (95) Azerbaijan (94) Belarus (91) Bosnia and Herzegovina (94) Moldova (92/96) Romania (95) Tajikistan (92) Turkmenistan (93)	Albania Armenia* Azerbaijan (97) Belarus Bosnia and Herzegovina Moldova Romania Tajikistan Turkmenistan Uzbekistan*	Albania Armenia Azerbaijan Belarus Bosnia and Herzegovina Moldova Tajikistan (98) Turkmenistan

Source: Legal indicator surveys for 1997-99, Office of the General Counsel, EBRD.

Note:

A new date indicates a new law. **Bold** type indicates countries changing between categories. Starred entries indicate at least one amendment during the intervening period.

certain countries have had more desirable developments than others, and what can be done to encourage more desirable types of market entry and expansion.

8.2 Exit from the market and contraction

Exit includes both company closure – for instance, liquidation under bankruptcy-type laws or more informal forms of complete shut-down – as well as less-than-complete asset sales, including reorganisation under bankruptcy-type laws, workouts under general contract law, and downsizing.⁵ Exit is normal in a well-functioning market economy and is essential in transition economies given the legacy of production according to non-market criteria.

Formal exit mechanisms

It is helpful to distinguish between the use of formal exit mechanisms – relying on bankruptcy laws to bind all creditors – and other methods under general civil or commercial codes, such as workouts under contract law or owner-led downsizing. Such a

distinction is useful because the existence of well-designed formal exit processes and the credible threat of their use by creditors should, in principle, provide strong incentives for appropriate closure and downsizing through other mechanisms as well. Even though a predominance of informal exit was to be expected early in the transition given the lack of appropriate laws and institutions, the development of effective bankruptcy procedures is likely to exert a strong influence on the nature and extent of alternative forms of asset sales and downsizing.

Table 8.1 shows the extent of legal bankruptcy rules and enforcement experience across all transition economies (see also Annex 8.1). By 1997, all transition countries had adopted a bankruptcy law. Belarus, the Czech and Slovak Republics, FYR Macedonia and Poland had established laws by the end of 1991.⁶ Albania, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Russia, Tajikistan and Ukraine first adopted laws in 1992, while Uzbekistan and Georgia were relatively late in adopting a bank-

⁵ We exclude from the latter category sales of parts or the whole firm as a going concern as well as spin-offs of parts of viable firms to new owners, even when they resulted in significant downsizing. See Chapter 7 on the effect of changes in ownership and control over assets and forms of restructuring.

⁶ Poland amended a much earlier 1935 law.

ruptcy law (1996 and 1997 respectively). An early start may have given some of these countries an advantage to the extent that experience with bankruptcy law can help to develop legal and administrative capacity.

A second indicator that is reflected in Table 8.1 is the extent to which original laws have been amended or fully replaced by new laws. In this respect, the only countries that have had no amendments since inception are Belarus, Bosnia and Herzegovina, Bulgaria and Georgia. The process of drafting and implementing legal changes can be expected to have at least two positive effects on the extent and effectiveness of legal enforcement. First, it can be supposed that changes in rules over time generally are in the direction of improvements, especially in terms of adapting and fine-tuning the rules to the idiosyncrasies of national legal and business environments. Second, the various forms of discussions within legal, business and political circles associated with the process of legal reform help to build better understanding, and are often associated with enhanced resources for upgrading legal and administrative capacity. From these perspectives, those countries that have spent more time reviewing and amending the law may be expected to have more active enforcement.

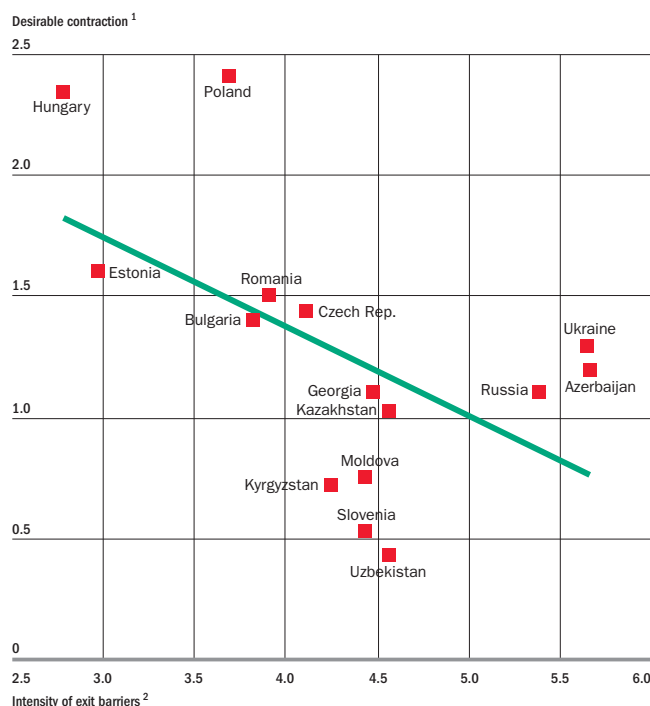
Table 8.1 also classifies countries according to how many petitions for liquidations or reorganisation have been filed in a calendar year, by three categories: low (0-50 petitions), medium (51-1,000) and high (over 1,000).⁷ Although the number of filings is only a rough measure of frequency of use, and although the available categories are crude, the classification is nevertheless informative.⁸ Perhaps most striking is the relatively large number of countries that have no, or virtually no, filings at all over three years (Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Moldova, Tajikistan and Turkmenistan). Even though Russia and Ukraine have had higher reported levels of filings over the past two years compared with previous years, the only two countries to have had consistently high levels of bankruptcy filings over the past three years are Hungary and Poland.⁹ The conclusion is that formal exit mechanisms remain relatively ineffective in most transition economies.

Impact of exit barriers on contraction

Barriers to appropriate market exit, which in turn often become barriers to entry, can be broken down into legal/regulatory barriers and the continuation of soft budget constraints. The evidence to date across most transition countries strongly supports the importance of both well-designed institutional mechanisms and financial discipline for market exit.¹⁰ One important finding is that the only two countries that have had consistently high levels of bankruptcy filings over the past three years, Hungary and Poland,

Chart 8.2

Exit barriers and desirable contraction



Source: Business Environment and Enterprise Performance Survey.

¹ Desirable contraction is an index reflecting the proportion of contracting state-owned firms that experience declines in their labour productivity.

² Intensity of exit barriers is a soft budget index composed of subsidy and barter components (higher values reflect higher barriers). For details on their construction, see Dutz and Vagliasindi (1999a).

are also the two countries characterised by the highest number of desirable market exits of SOEs with declining productivity.

Chart 8.2 illustrates a strong negative relationship between soft budget-related exit barriers and desirable contraction. The horizontal axis is a soft budget index that reflects a composite of separate subsidy and barter indices.¹¹ A low score reflects relatively hard budget constraints, which should be associated with “efficient” contraction. The vertical axis, on the other hand, shows the extent of desirable contraction across countries, as captured by the contraction part of the market selection indicator (see Section 8.1).

As highlighted in Chart 8.2, Estonia, Hungary and Poland, the countries with the lowest soft-budget barriers to market exit are also the top countries in terms of the appropriate disposal of resources from the state-owned enterprise sector. Azerbaijan, Russia and Ukraine, followed by Kazakhstan and Uzbekistan, on

⁷ This classification is based on data collected in 1997-99 from annual questionnaires prepared by the EBRD's Office of the General Counsel and sent to selected law practitioners and others familiar with legal practice.

⁸ See Hashi et al. (1998) on the pitfalls inherent in such numbers.

⁹ See Chapter 5 of the *Transition Report 1997* for a more detailed description of the functioning and shortcomings of bankruptcy proceedings in the Czech Republic, Hungary and Poland.

¹⁰ This finding across the 20 transition countries from the Business Environment and Enterprise Performance Survey supports the main conclusion of Balcerowicz, Gray and Hashi (1998), which was based exclusively on the Czech Republic, Hungary and Poland.

¹¹ Both indices reflect subjective responses by enterprises on a scale of 1-4 from the Business Environment and Enterprise Performance Survey, and are country means for SOEs. The subsidy index is low to the extent that SOEs report that their competitors do not receive any subsidies from the national or local government, including the tolerance of tax arrears. A low barter index reflects a low or non-existent share of barter or money surrogates in the firm's sales.

the other hand, are characterised by the highest soft-budget barriers and also relatively less desirable contraction. This confirms that the phenomenon of soft budget constraints remains both widespread and harmful, particularly in the central CIS and Central Asia regions.¹²

8.3 Entry into the market and expansion

The issues relating to expansion of the private sector are examined in this section, with particular emphasis on the role of new enterprises. The most relevant barriers to the operation and growth of enterprises are analysed, again largely from the perspective of start-ups.

Importance of start-ups

The entry and expansion of start-ups is central to a successful transition for several reasons, including their contribution to employment and output growth and to the reallocation of resources across sectors. Start-ups are a dynamic component of employment and overall economic growth within most sectors of a market economy. By introducing and expanding new goods and services, start-ups are also a way of changing the balance between sectors. Finally, they play a critical role in encouraging innovations within existing firms and in forcing the contraction or exit of inefficient incumbents. They therefore provide an additional pressure on market selection.

Start-ups are overwhelmingly small and medium-sized firms and they account for the largest share of expanding enterprises. By definition, start-ups in transition economies are young enterprises, having begun their activities after 1989. According to size, 95 per cent of start-ups are SMEs (defined as less than 200 full-time employees), of which 54 per cent are micro-enterprises (with up to nine employees) and 27 per cent are small (between 10 and 49 employees). Conversely, 89 per cent of micro-enterprises and 82 per cent of small firms are start-ups, with the rest mainly privatised spin-offs from larger former SOEs.

Employment expansion has been more vigorous in start-ups than in SOEs, in terms both of the frequency of expansion across firms and of the average increase. Across all enterprises and countries, 37 per cent of start-ups have increased employment over the past three years, whereas only 17 per cent of privatised and 18 per cent of SOEs have expanded. Not surprisingly, a similar pattern emerges in terms of size, with expansion being recorded in 30 per cent of smaller, 27 per cent of medium-sized and 21 per cent of large enterprises. In terms of average growth in employment across all expanding firms, the highest average has been registered by start-ups (63 per cent), followed by privatised firms (37 per cent) and SOEs (34 per cent). A similar pattern emerges across different sizes of enterprises, with the mean growth in employment of expanding enterprises being largest for smaller firms (61 per cent), and less for medium-sized and large enterprises (48 per cent for each category).

Start-ups have also been the spur for changing the balance between sectors, facilitated by the downsizing and exit of SOEs. Across all enterprises and countries, there has been a significant reallocation of resources towards previously underdeveloped sectors, particularly services. By comparing the sector of operation for enterprises established before 1989 (predominantly SOEs) with those established after the beginning of transition (predominantly start-ups but also privatised firms), a dramatic shift is evident. Of the firms in the survey established before 1989, 7 per cent were in distributive trade, whereas 30 per cent of firms established after 1989 were in this sector. This pattern of start-ups has helped to attract resources to the distributive trade sector.

Market entry barriers

The Business Environment and Enterprise Performance Survey provides the opportunity to undertake a detailed assessment of the most binding constraints for the entry and expansion of start-up enterprises. The number of obstacles for start-ups compared with SOEs is explored in more detail below, to ascertain the most binding and troublesome types of barriers for newcomers, and to assess the extent to which the business environment is biased against start-ups. Lastly, a separate section draws a link between expansion across countries and the main pattern of barriers.

Main barriers for start-ups

In addition to exit policies and soft budget constraints, six main impediments to entry and expansion are classified according to four major categories: (i) macro-stabilisation, (ii) legal-institutional norms, (iii) micro-level financial constraints that distort market-driven incentives, and (iv) micro-level non-financial constraints that distort incentives. A widely held view regarding the most important factors for start-up entry and expansion is that countries primarily need to stabilise their economies by bringing inflation under control, and to liberalise prices, trade and foreign exchange controls.¹³ These macro-economic obstacles are revealed through the survey responses by the extent to which inflation is regarded as problematic for the operation and growth of businesses. Another view claims that prevailing legal-institutional norms and ultimately capricious action by government officials constrain private sector development.¹⁴ Particularly in transition economies, it has been argued that vested interests have hindered the expansion of the new private sector to maintain control over both incumbent firms and the extraction of rents (see also Chapters 5 and 6). This type of obstacle is captured by enterprise perceptions of the relative importance of corruption.

Financing is isolated as a separate category of micro-level constraint in light of the commonly held view, especially prevalent among enterprise managers seeking loans at preferential rates, that the main obstacle to entry and expansion is access to finance. Lastly, other non-financial barriers affecting enterprise incentives are frequently claimed to be all-important in stifling entry and expansion. This relatively broad category covers taxes and regula-

¹² See also Chapter 7.

¹³ See World Bank (1996).

¹⁴ See Johnson, Kaufmann and Shleifer (1997).

Table 8.2

Main barriers to entry and expansion

	Start-ups		SOEs
	Early transition	Recent entrants	
1. Taxes and regulations	3.28	3.25	3.05
South-eastern Europe	3.37	3.45	3.12
Central CIS	3.50	3.32	3.42
CIS periphery	3.23	3.21	3.08
Central Europe and the Baltic states	3.21	3.15	2.83
2. Inflation	3.04	3.21	2.93
Central CIS	3.51	3.36	3.42
South-eastern Europe	3.46	3.58	3.19
CIS periphery	3.11	3.30	3.14
Central Europe and the Baltic states	2.72	2.81	2.38
3. Financing	2.97	3.11	3.15
South-eastern Europe	3.25	3.53	3.39
Central CIS	3.09	3.23	3.36
CIS periphery	2.90	3.01	3.14
Central Europe and the Baltic states	2.87	2.90	2.96
4. Corruption	2.53	2.58	2.24
South-eastern Europe	2.87	2.74	2.60
CIS periphery	2.70	2.72	2.56
Central CIS	2.49	2.09	2.25
Central Europe and the Baltic states	2.31	2.52	1.83
5. Anti-competitive practices	2.44	2.50	2.17
Central CIS	2.73	2.27	2.39
CIS periphery	2.52	2.42	2.27
South-eastern Europe	2.48	2.79	2.48
Central Europe and the Baltic states	2.31	2.53	1.88
6. Infrastructure	2.01	2.23	1.96
South-eastern Europe	2.46	2.58	2.16
CIS periphery	2.00	2.45	1.98
Central CIS	1.97	1.96	2.06
Central Europe and the Baltic states	1.85	1.87	1.81

Source: Business Environment and Enterprise Performance Survey.

Note:

Average value of perceived barriers on a 1-4 scale, with 4 representing a major obstacle. Start-ups are broken down into early transition (founded 1989-96) and recent entrants (founded over past three years).

tions (both in terms of levels of perceived charges and complexity of the system), lack of access to infrastructure, and market failures due to anti-competitive practices.

Table 8.2 shows the average values of these barriers as perceived by start-ups (on a 1 to 4 scale, with 4 representing a major obstacle), broken down by region, with SOEs as a comparison group.¹⁵ Responses by start-ups have been further broken down into two age categories: early-transition (enterprises founded

between 1989 and 1996) versus recent start-ups (founded over the past three years) to explore the different types of barriers felt by the most recent entrants.

The results show that micro-level non-financial constraints in the form of taxes and regulations are perceived as the most relevant barrier to expansion by start-ups. Inflation comes next, followed by lack of access to finance, corruption, anti-competitive practices and lastly lack of access to infrastructure services. In terms of regional variation, a higher average intensity of barriers is consistently reported by start-ups located in the CIS and in south-eastern Europe than in central Europe and the Baltic states. Across all major categories, barriers to start-ups become greater the further east the enterprises are based.

Another key finding is that all barriers except taxes/regulations are felt more intensely by recent entrants than by older start-ups, highlighting that newcomers are particularly affected by all such obstacles. The largest difference in responses by newcomers and older start-ups concerns infrastructure in the CIS periphery, suggesting that access to required infrastructure services is a particularly severe constraint for new entrants in this area. In the case of taxes/regulations, these obstacles may become greater as firms grow and pass certain “formality” thresholds, as shown by the slightly higher response from older start-ups. It is also interesting to note that the financing constraint is actually significantly greater for SOEs than for start-ups, reflecting the trend that subsidies and other forms of soft credit are now less available than before.

Difficulties for start-ups: the uneven playing field

To compare rankings for start-ups across regions, it is necessary to take into account the differences in the level of responses across countries. These may have been caused by a number of factors (for instance, respondents in a country with a cyclical upturn may systematically rank barriers as less intense when times are good). A simple way to do this is to examine the responses of start-ups relative to SOEs. In this way, it is possible to assess for each region how troublesome specific obstacles are for private newcomers compared with more established enterprises. The extent of divergence between responses by start-ups and SOEs indicates the extent to which the business environment poses varying challenges for different types of enterprises, creating an uneven playing field. More specifically, it shows the degree to which the business environment makes entry and expansion more difficult for start-ups.¹⁶

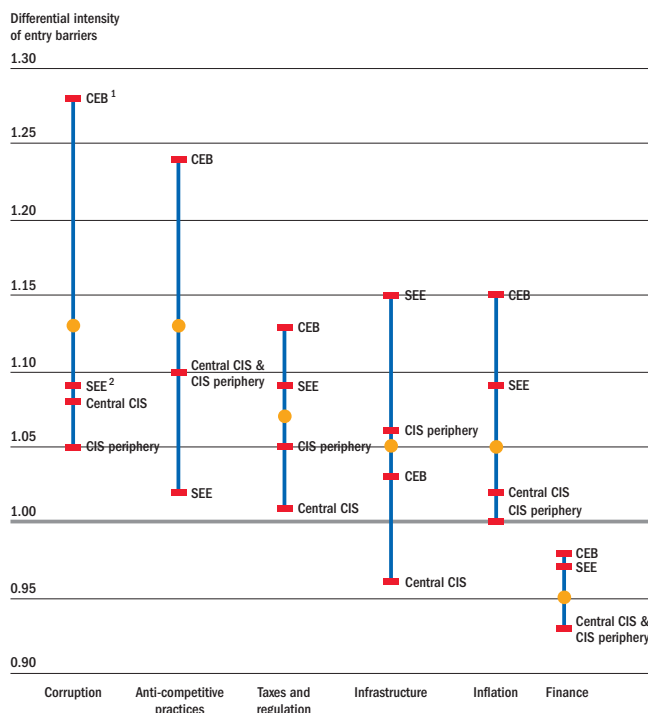
Across all regions, corruption and anti-competitive practices are perceived by start-ups as the most difficult obstacles, with both barriers being ranked on average as 13 per cent greater by start-ups than by SOEs (see Chart 8.3a). The emphasis on corruption and anti-competitive practices reflects the fact that: (i) existing firms that have benefited from rents may increase bribes to seek to maintain income when threatened by innovative newcomers (see Chapter 6); and (ii) start-ups may often be the main victims of

¹⁵ See Chapter 7, footnote 4, for a description of the regional classification.

¹⁶ For each barrier category, a value different from unity indicates an uneven playing field, discriminating against start-ups whenever greater than 1.00.

Chart 8.3a

Uneven obstacles for start-ups: main barriers



● Average values across all regions

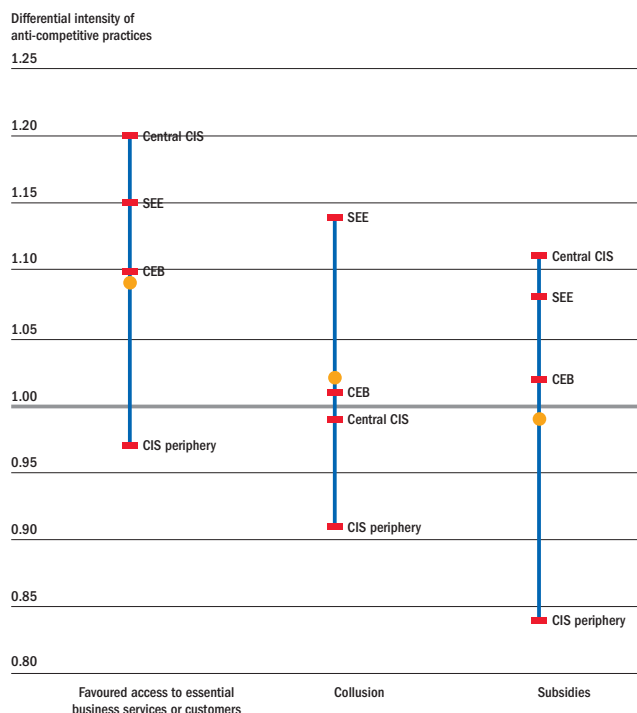
Source: Business Environment and Enterprise Performance Survey.

¹ Central Europe and Baltic states.

² South-eastern Europe.

Chart 8.3b

Uneven obstacles for start-ups: anti-competitive practices



Note:

For each barrier category, a value different from 1.00 indicates an uneven playing field, discriminating against start-ups whenever greater than 1.00. For details on their construction, see Dutz and Vagliasindi (1999a).

abuse of market power and other anti-competitive practices by larger and dominant firms (including SOEs).

Taxes and regulations rank next, no longer seen by start-ups as the most important obstacle but still having a discriminating effect against start-ups across all regions. Access to infrastructure and macro-stabilisation factors are seen as somewhat less critical barriers, although on average they still have a much more significant effect on start-ups than on SOEs. Lastly, financing is not only the least troublesome barrier but notably it is also the only constraint where both the average across all regions and the individual averages across enterprises within each region are below unity. The fact that finance is perceived as a more troublesome barrier for SOEs than for start-ups no doubt reflects the fact that cost and access to finance have become more difficult for SOEs in recent times. The lesser importance of finance as a critical barrier for start-ups is a robust finding.¹⁷

While the main result highlighted by Chart 8.3a is the significance of corruption and anti-competitive practices as obstacles to start-ups across all regions, it is also interesting to note that start-ups in central Europe and the Baltic states appear to have been affected to a great degree by most constraints. This result should not be surprising, since for this region the high relative scores reflect not

only the fact that barriers facing start-ups are low (compared with other regions) but that barriers facing SOEs are even lower. Access to infrastructure services is a particularly troublesome obstacle for new entrants, not only in the Caucasus and Central Asian economies of the CIS periphery but even more so in south-eastern Europe (see also the high scores for infrastructure obstacles for these regions by recent entrants in Table 8.2).

Anti-competitive practices

Chart 8.3b reports in more detail on some key components of anti-competitive practices, one of the top-ranked barriers. Enterprises were asked to estimate how the specific practices of their competitors created barriers that could result in an uneven playing field. These included receiving favoured access to essential business services (credit and infrastructure services) or customers, receiving subsidies from national and/or local government (including the tolerance of tax arrears), and collusion (to limit access to credit, supplies, land, equipment or customers).

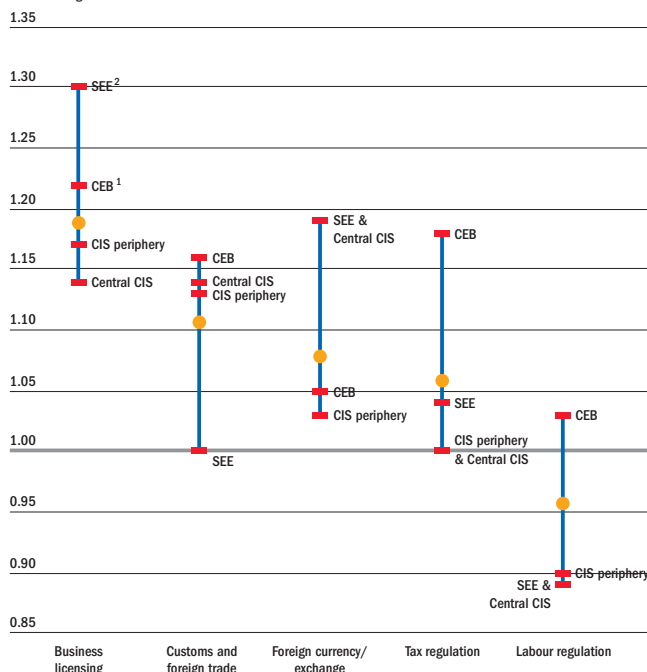
Across all regions, favoured access to essential business services is perceived as the most difficult obstacle, on average viewed as roughly 10 per cent more troublesome for start-ups than for SOEs. Collusion and discriminatory soft budgets were ranked on average as somewhat less important, with both types of practices affecting

¹⁷ Johnson, McMillan and Woodruff (1998) explicitly compare the impact of macro-stabilisation, finance and legal-institutional norms (in particular, differences in the protection of property rights) on private enterprise job creation. They also find that finance is not a top constraint for SMEs.

Chart 8.3c

Uneven obstacles for start-ups: taxes and regulations

Differential intensity of taxes and regulations



● Average values across all regions

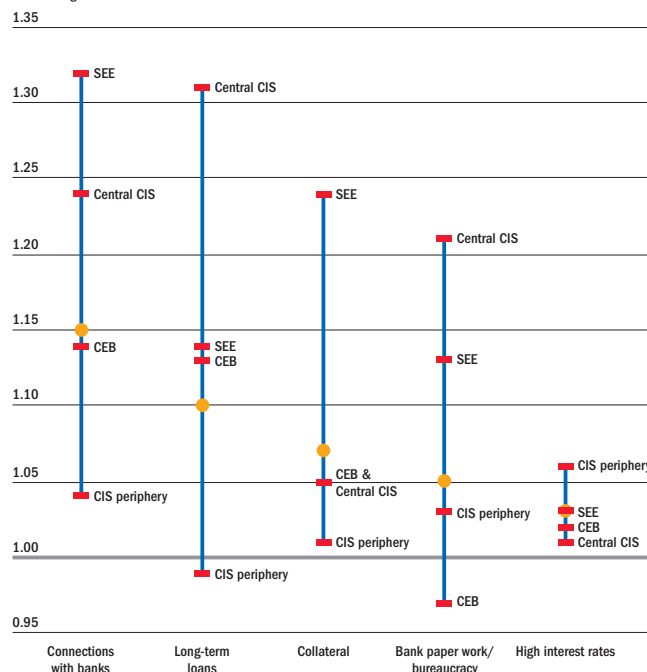
Source: Business Environment and Enterprise Performance Survey.

¹ Central Europe and Baltic states.² South-eastern Europe.

Chart 8.3d

Uneven obstacles for start-ups: financing

Differential intensity of financing



Note:

For each barrier category, a value different from 1.00 indicates an uneven playing field, discriminating against start-ups whenever greater than 1.00. For details on their construction, see Dutz and Vagliasindi (1999a).

start-ups and SOEs with approximately the same intensity. In terms of regional variation, it is interesting to note that both for the countries of the central CIS and south-eastern Europe, start-ups face higher constraints compared with other regions. In contrast, in the Caucasus and Central Asian economies of the CIS periphery, these anti-competitive practices are more troublesome for SOEs than for start-ups.

Taxes and regulations

Across all regions, business licensing is perceived as the most serious obstacle to operation and expansion among a broad range of tax and regulatory constraints, on average almost 20 per cent more troublesome for start-ups than for SOEs (see Chart 8.3c). In every region this obstacle is ranked as more severe by start-ups than by SOEs. The high ranking across all regions by start-ups confirms that in most instances the initial and regular renewal of licences (and the opportunities for arbitrary bureaucratic interference) is a major element of the uneven conditions facing start-ups. It also suggests that SOEs generally enjoy preferential treatment by other government officials in the enforcement of such administrative rules.

Customs and foreign trade, foreign currency and exchange, and tax regulations pose greater obstacles to start-ups than to SOEs on average across all regions. On the other hand, labour regulations do not put start-ups at a disadvantage except in central Europe and the Baltic states. For all other regions, the bias against SOEs

is because labour regulations in those regions are less stringently enforced, and because start-ups can avoid such regulation to the extent that they belong to the informal sector. In addition, start-ups are subject to more flexible regulation because of their smaller size. For the countries of central Europe and the Baltic states, on the other hand, labour regulations are more likely to be stringently enforced, as seen in the bias against start-ups (and the fact that this region has the greatest obstacle concerning labour regulations for both start-ups and SOEs).

Financing

A key finding of this chapter is that financing is of less importance as a critical barrier for start-ups when compared with non-financial constraints (especially anti-competitive practices and taxes/regulations), legal-institutional norms (corruption) and macro-stabilisation obstacles (inflation). However, individual financing issues are nevertheless still perceived as being significantly more troublesome for start-ups, specifically ease of access to finance. In particular, the need for special connections with banks and other financial institutions in order to have sufficient access to finance is perceived as the barrier that most discriminates against start-ups (see Chart 8.3d).

Importantly, lack of access to long-term bank loans, collateral requirements imposed by financial institutions, and the additional costs of access imposed on enterprises by bank paperwork and bureaucracy all discriminate more significantly against start-ups

than the more transparent cost of finance dimension (interest rates). This result is reflected not only in the higher cross-regional averages of all access-related obstacles, but also in the particularly strong discrepancy in responses for access-related dimensions versus cost of finance by start-ups in the central CIS and south-eastern Europe regions. These access-related barriers offer the greatest scope for discretion and arbitrary judgements and constitute the financing areas where start-ups are at their greatest disadvantage.

Impact of main entry barriers on expansion

Chart 8.4 shows a strong negative relationship between the level of entry barriers and desirable expansion. The horizontal axis is an entry barriers index, the average of the main six barriers to expansion. The smaller the value of the index, the lower the level of obstacles as perceived by start-ups. The vertical axis indicates the extent of desirable expansion across countries, as captured by the expansion part of the market selection indicator (see Section 8.1). For Estonia, Hungary and Poland, the countries with the most desirable expansion, the barriers index is below the average value for the sample. On the other hand, entry barriers are most intense for Kyrgyzstan, where desirable expansion is substantially below that of the first three countries. For Azerbaijan, Georgia, Moldova and Ukraine, countries with some of the least desirable expansion dynamics, the barriers index is above the average sample value.

The analysis supports the importance of removing, or at least lessening, the main obstacles to entry and expansion for all countries. Corruption and anti-competitive barriers are critical for start-ups, with anti-competitive barriers even more important in stifling expansion in the slowest-growing countries. For economies that have poor conditions for expansion, it is important not only to stimulate expansion by start-ups but also to introduce policies promoting the restructuring or exit of inefficient SOEs and the improved governance of privatised enterprises.

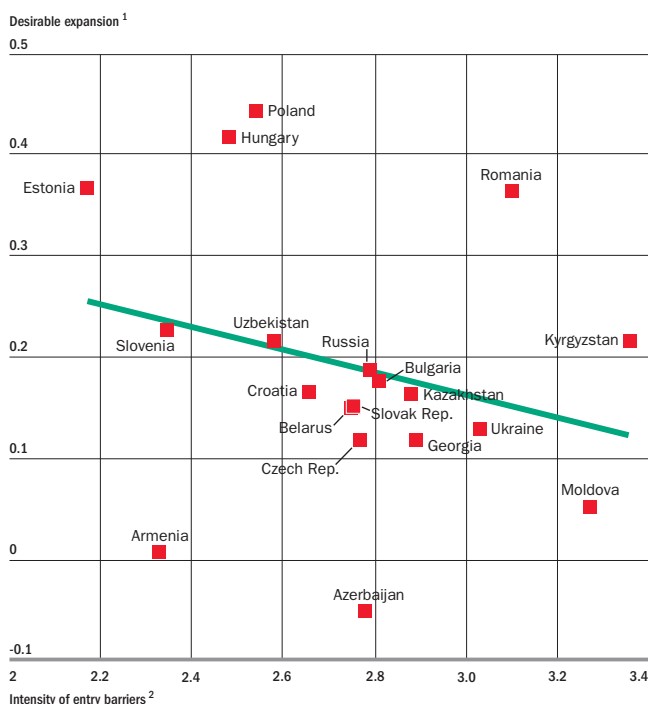
8.4 Policy priorities

Any successful policy strategy to help expand the new private sector must ensure that all enterprises can compete on an equal basis, so that lower-cost and innovative enterprises can enter and expand and less efficient enterprises are forced to restructure or exit. A basic principle of successful SME development is to create an even playing field. In light of the significance of corruption and anti-competitive practices as critical barriers for start-ups, fundamental business environment rules are needed that reward successful innovation by entrepreneurs showing initiative and taking risk. Steps also need to be taken to ensure that start-ups are able to enter the market. These two policies – ensuring adequate rewards for productive innovation and fostering opportunities for start-ups¹⁸ – can be promoted through a proactive competition policy and through better targeted SME support policies.

Since comprehensive legal reforms generally require a substantial amount of time and are likely to encounter strong opposition, simplification of regulatory rules to allow the early introduction of

Chart 8.4

Main entry barriers and desirable expansion



Source: Business Environment and Enterprise Performance survey.

¹ Desirable expansion is an index reflecting the net proportion of expanding firms that are raising their productivity.

² Intensity of entry barriers is a composite of the six main barriers to entry and expansion as perceived by start-ups (higher values reflect higher barriers). For details, see Dutz and Vagliasindi (1999a).

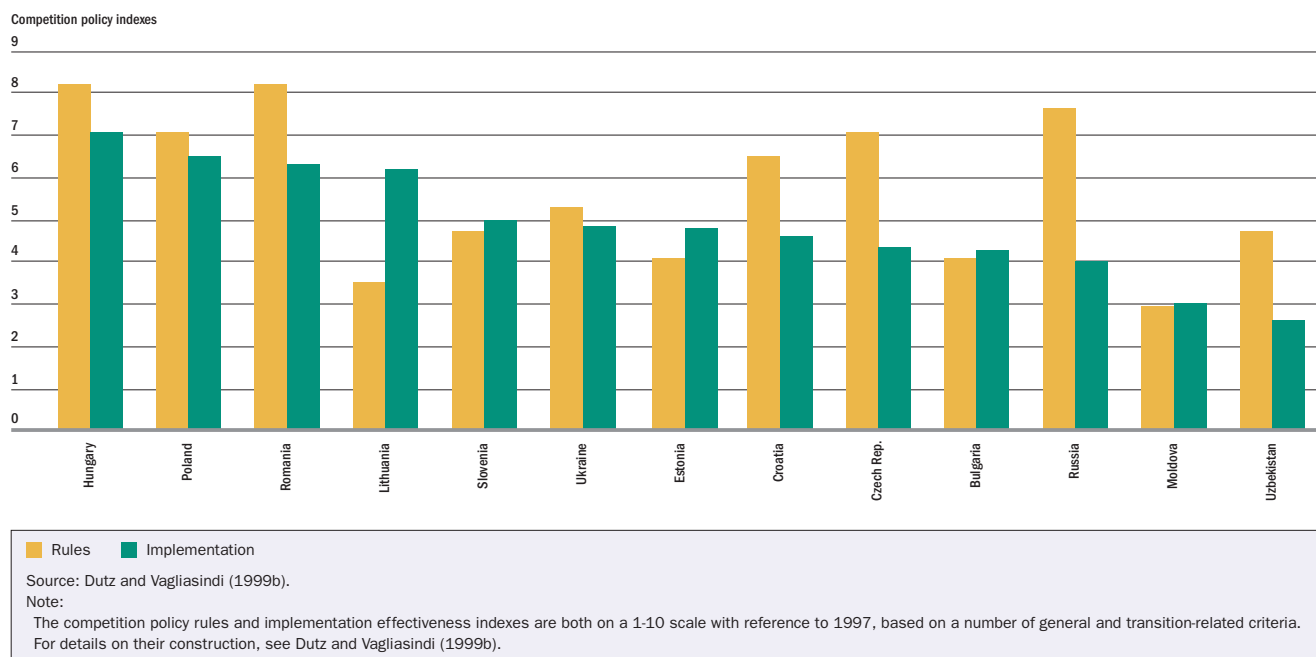
competition should not be delayed.¹⁹ The benefits from increased competition in infrastructure sectors – particularly those areas that affect the economy as a whole, such as telecommunications and transport – are likely to be greater than in most other sectors. Not only do telecommunications services offer strong opportunities for substantial cost reductions and improvements in service quality, they also increase access to information and reduce transaction costs. By reducing economy-wide transaction costs, such infrastructure services have the potential to affect the interactions of enterprises in a range of sectors. As a practical illustration, the introduction of electronic commerce has changed the way of doing business by lowering transaction costs (for example, reducing the number of intermediaries), reducing barriers to market entry and improving access to information for consumers.

Competition policy is entwined with a broad range of other economic policies affecting foreign and domestic competition, including international trade and foreign direct investment, regulation of infrastructure sectors (particularly where elements of natural monopoly are still widespread), privatisation and SME policies. The effectiveness of these policies is closely related to the effectiveness of competition policy.

¹⁸ For a more detailed discussion of these two complementary sets of policies to further development through entrepreneurial activity, see Dutz, Ordovery and Willig (1999).

¹⁹ See Vagliasindi and Waterson (1998) for a specific application within the context of telecommunications.

Chart 8.5

Competition policy rules versus implementation**Competition policy**

Competition policy is a critical area since it is intended to improve market selection and promote stronger rivalry in markets. Its principal instruments include law enforcement and competition advocacy. Both are critical in a transition environment.

Law enforcement includes legislative action against the abuse of market power, bans on cartels (agreements between competitors, such as price fixing to prevent rivalry) and other agreements that are exclusionary, and screening of mergers and other combinations that are likely to harm competition. While the traditional emphasis of law enforcement has been on enterprises, most transition economies have also targeted anti-competitive acts by other government bodies, especially at regional and local levels.

Of equal or greater importance is competition advocacy, which traditionally covers recommendations to prevent the granting of market power privileges through the legal and regulatory decisions of government. Competition advocacy can encompass not only objections to draft laws and regulations but also orders to modify existing regulations. It can also cover the promotion of start-ups by focusing on the removal of access barriers to essential inputs. To form a culture of competition among enterprises and the general public, the competition authorities need to make a proactive effort, especially in terms of informing and helping to mobilise key constituencies of support. Ultimately, support for competition policies will depend on how existing enterprises and actual/potential entrants participate in the policy formulation process.

Chart 8.5 classifies countries according to two effectiveness indicators regarding competition policy: the first based on rules, the

second based on implementation (with both indicators on a 1-10 scale and measured with reference to 1997). The rules-based index classifies the prevailing competition laws according to a number of distinct criteria. The criteria are both general and transition-related, including whether private cartel agreements and anti-competitive activities by state entities are prohibited, whether competition advocacy includes the right to make recommendations or order changes in rules, and whether all decisions and annual reports must be publicly available. The implementation index is based on feedback from competition agencies and legal practitioners in the country to assess the level of enforcement.²⁰

Chart 8.5 shows that competition policy rules have not been fully implemented. Countries with poor relative enforcement include Croatia, the Czech Republic, Russia and Uzbekistan.²¹ The poorest overall implementation ratings across all countries are in the areas of prosecution of cartel agreements, imposition of exemplary/punitive fines, and transparency/education. None of the countries appeared to devote enough attention to ensuring that all enterprises (and start-ups in particular) have unimpeded access to all essential business services, nor to discovering the most important strategic bottlenecks to competition. It is crucial for transition economies to develop a more active role for competition policy and to foster sector-specific regulatory reforms to improve access to essential business services.

Policies in support of new enterprises in the private sector and SMEs

Policies in support of SMEs should focus on the key aspects of the overall business environment and the development of more targeted business support and financial services. In all these

²⁰ See Dutz and Vagliasindi (1999b) for a more detailed description of both the methodology used in constructing such indicators and the impact of progress in competition policy rules and implementation on the intensity of competition.

²¹ Lithuania is the reverse, its stronger enforcement foreshadowing preparatory work towards a subsequent state-of-the-art new competition law, which was adopted in 1999.

areas, transition economies stand to benefit from a more market-oriented approach to SME development that emphasises how governments should encourage the development of markets for non-financial and financial services suited to SMEs rather than the direct provision of services and benefits.²² In terms of the overall business environment, this approach helps to improve access to markets and reduces bias against small firms, above all ensuring the protection of private property rights and contracts against all forms of expropriation. In terms of business support and financial services, the emphasis should be on increasing the quality and cost-recovery of public programmes and on promoting innovation in products and delivery mechanisms.

Business environment

As a complement to economy-wide competition policies that seek to encourage rivalry, public policy has a critical role to play in ensuring that legal and regulatory frameworks are conducive to productive investments of the types that lead to sustainable economic development. In particular, policy must ensure that innovative and productive entrepreneurial activities are more rewarding than unproductive activities related to lobbying for government favouritism or organised crime. Where insufficient attention is paid to stable, transparent, unbiased and predictable legal and regulatory frameworks and the required institutional capacity to enforce such rules, it can be expected that entrepreneurial activities will be channelled into non-productive activities.

To ensure the availability of capital to fund productive entrepreneurship and the appropriability of returns to success, the key rules include the protection of private property rights and contracts, in particular the protection against all – especially arbitrary – forms of expropriation. In addition to fundamental private property and contract rules to preserve rewards from initiative and risk, there are certain additional elements of the business environment that can place a disproportionate burden on SMEs and start-ups, discouraging their entry into the formal sector and their expansion. In particular, tax, registration, licensing and other regulatory requirements create opportunities for arbitrary bureaucratic interference and should be scrutinised from a cost-benefit perspective, including how the burden is distributed across different types of firms. To favour market entry and expansion of start-ups, possibilities for administrative interference should be reduced by simplifying laws and regulations wherever feasible.

As an example, Table 8.3 shows the number of major taxes and the average rates that national tax authorities levy on a typical business. The number of taxes (see Column 1) is a rough indicator of the complexity of the tax system. It is clear that the countries that have performed best – such as Poland and Hungary – have had the least complex national tax systems, whereas the poorest performers, such as Uzbekistan, tend to be at the other end of the spectrum. A further source of discrimination against smaller enter-

prises is the structure of the tax system and differential tax rates across corporate and personal taxation. In almost all countries, businesses registered as sole proprietors are subject to personal income tax rather than corporate profit tax. Since in many cases the top marginal rate of personal income tax is higher than the top rate of corporate profit tax, sole proprietors face a heavier tax burden than comparable incorporated firms.

More than half of the countries listed in Table 8.3 have introduced some kind of measures to alleviate tax-related problems for SMEs and new start-ups. These measures range from the use of lump-sum tax payments or presumptive taxation – where the tax base is inferred from simple indicators – to tax relief for small firms and tax exemptions for new enterprises. Moreover, at least nine of the countries listed in Table 8.3 exempt the smallest businesses from payment of VAT. Of all these measures, the most promising is presumptive taxation, since it simplifies compliance procedures and therefore reduces the scope for arbitrary interference. The introduction of tax relief and tax exemptions to encourage the creation of start-ups, on the other hand, is problematic since these measures often assist firms that would have been created without these incentives.²³

Business support services

One form of business support that exists in all transition countries is the presence of a chamber of commerce. Systems with mandatory membership typically cover an entire country through a national network in all areas, whereas voluntary membership systems rely on self-selective coverage of businesses.²⁴ However, from the perspective of delivering business services that are most responsive to the actual needs of user SMEs in transition economies, voluntary systems are likely to out-perform mandatory ones. Mandatory chambers have frequently inherited the institutional structures of their communist-era predecessors, with larger firms better represented than small and new enterprises. As a result, the interests of members are not always adequately reflected. The advantage of voluntary chambers lies in the fact that they are closer to the market and therefore to the needs of businesses.

A potentially important area for government is to help address information and coordination problems among SMEs. For example, training and information activities that have been effective include the gathering of systematic information on SME opportunities, exchange visits of successful SME plants in non-competing geographical areas, and otherwise disseminating the experiences of successful entrepreneurs as examples to motivate and guide others.²⁵ In addition to such initiatives, business support networks can play a vital role in helping to mobilise a stronger and more vocal political constituency among entrepreneurs and SMEs for improved public policy towards these groups.

²² This section draws on the lessons learned from policy-makers in transition economies as summarised in OECD/UNIDO (1998). Hallberg (1999) provides a related analysis of SME development programmes in developing countries.

²³ See OECD/UNIDO (1998).

²⁴ An overview of the relative merits of mandatory or voluntary systems based on the British and German chamber systems can be found in Bennett et al. (1993).

²⁵ For interesting case studies of business development services demanded by small enterprises, see Tanburn (1999) as cited in Hallberg (1999). For instance, SMEs were willing to pay the full cost of enterprise exchange visits to towns outside their market area to tour other SMEs in their industry.

Table 8.3

SME taxation

Country	Number of principal national taxes	Maximum rate profit (income) tax (in per cent)	Standard rate VAT (in per cent)	VAT exemption (turnover threshold) in US dollars	Special tax regime for small businesses	Tax breaks: for new investments* for new firms †
Albania	4	30	20	na	lump-sum	none
Armenia	4	30 (30)	20	none	na	2 years exemption†
Azerbaijan	3	32	20	none	na	profits reinvested in fixed assets*
Belarus	6	30 (40)	20	none	50% discount on profit tax	na
Bosnia & Herzegovina (Federation/Republika Srpska)	na	30/20 regressive (25)	18/20	–	na	na
Bulgaria	4	27	20	45,000	na	na
Croatia	4	35 (35)	22	7,800	na	na
Czech Republic	5	35 (40)	22	23,000	none	5 years exemption for investments over US\$ 10 million*
Estonia	4	26 flat	18	18,000	no	none
FYR Macedonia	4	15 (35)	25	na	lump-sum tax for sole traders	profits reinvested in fixed assets*
Georgia	6	20 (20)	20	na	na	na
Hungary	3	18 (42)	25	none	none	tax reductions for investments over US\$ 5 million*
Kazakhstan	5	30	20	none	planned	planned
Kyrgyzstan	6	35 (40)	20	none	na	na
Latvia	5	25 flat	18	17,000	20% relief on profit tax	na
Lithuania	7	29 flat (24 flat)	18	25,000	na	profits reinvested in fixed assets*
Moldova	5	32 flat (50)	20	none	none	none
Poland	3	34 (40)	22	65,000	imputed, based on revenues	na
Romania	6	38 (45)	22	6,000	na	tax reductions for investments over US\$ 50 million; profits reinvested in fixed assets*
Russia	6	13 (12-35)	20	none	simplified profit tax and VAT filing procedures; exemption from advance tax payments	2 years profit tax exemption plus 2 years reduced profit tax†
Slovak Republic	4	40 (42)	23	23,000	na	profit tax reduced by 50% in the first year (35% in 2nd, 25% in 3rd)†
Slovenia	4	25 (50)	20	na	–	40% of investments in fixed assets are tax deductible*
Tajikistan	3	50 (40)	23	na	50% discount on profit tax	profits reinvested in fixed assets*
Turkmenistan	6	25	20	na	30% profit tax	na
Ukraine	9	30 (40)	20	na	advance tax payments	–
Uzbekistan	10	40	20	none	–	profit tax reduced by 75% in the first year (and 50% in 2nd year)†

Sources: IMF reports, KPMG's *Country Tax Facts* and IBFD *Central and East European Tax Directory 1999*.

Note:

Principal taxes are those taxes that a typical business in either manufacturing, construction or trade has to pay as a result of its normal, continuous business activity. If different from profit tax, income tax is listed as one of the principal business taxes, since in most cases businesses registered as sole proprietors

are subject to personal income tax, rather than profit tax. In addition, principal taxes include profit, VAT, payroll and social security (plus property, land, ecology, road, public health fund, vehicle and other taxes).

While self-help organisations such as these can help SMEs to overcome deficits in information and expertise, public-private initiatives such as technology parks and business incubators can also play a critical role. In practice, however, they have rarely been successful in transition economies, often due to the absence of effective coordination between governments, private sector interests and other institutions.²⁶ The challenge is for governments to help develop cost-effective means to assist in the provision of business services that are responsive to the needs of local SMEs.

Current best practice suggests that the actual providers of services should be business-like and demand-led, viewing SMEs as clients rather than beneficiaries.²⁷ Indicators of performance of business service providers – including evaluation based on budgetary allocations and steady increases in cost recovery – can provide a solid basis for improvements to future services. In general, those business development services provided or subsidised by governments can achieve lower cost and higher quality when they involve the private sector in the delivery of services – through chambers of commerce, larger firms linked to SMEs through buyer or supplier relationships, and other SMEs.

Financial services

While the Business Environment and Enterprise Performance Survey finds that financing is not the most important constraint facing start-ups, access to finance is likely to become more important as the private sector becomes further established. In the more advanced transition countries, such as Hungary and Poland, it is still difficult to obtain funding for long-term investments, whereas in the less advanced countries even access to working capital can be difficult for smaller enterprises.²⁸ This can be attributed to a variety of factors. For example, limited financial sector competition relieves banks of the pressure to develop lending services for smaller enterprises, and there are high risks and transaction costs associated with commercial SME lending. In addition, problems of information and contract enforcement are related to legal and regulatory frameworks that are still evolving and to inadequate institutional capacities.

As in the area of non-financial business services, a market-oriented strategy for improving access to finance for start-ups and SMEs is needed. This should emphasise policies to increase competitive pressure on financial service providers, to upgrade the capacity of banks and related finance providers in meeting the needs of smaller clients, and to address some of the underlying causes of higher risk-related costs. The key is to demonstrate to local banks that lending to start-ups and SMEs can be profitable. In many cases this means that SME finance programmes require significant technical assistance to introduce appropriate credit technologies, such as more cost-effective credit-scoring techniques to evaluate the creditworthiness of smaller clients. For example, EBRD-supported small business finance programmes typically ensure that donor-funded experts work closely with local bank management to improve their organisational procedures,

analysis of loan applications and monitoring of loans. In this way, sound banking practices are transferred to local institutions.

Legal and regulatory frameworks for finance should not restrict the development of innovative financial institutions and instruments that facilitate small client financing, such as venture capital, small equity investments, leasing and more appropriate forms of local currency finance. At the same time, the risks associated with lending to smaller clients can be reduced by improving not only the laws but also the enforcement capabilities of institutions responsible for the enforcement of contracts, and the forfeiture and collection of collateral. The experience of the EBRD's micro- and small-lending programmes suggests that successful SME lending operations are hindered by restrictions on the type of collateral and the absence of appropriate collateral registration procedures, especially on the use of movable assets as collateral.

A crucial aspect of SME finance programmes of the EBRD and most other international financial institutions is that lending should be on commercial terms. Experience has shown that grant schemes are often difficult to monitor and are very slow to disburse. Generous grant schemes may also undermine the repayment culture of small enterprises and therefore hinder the development of commercially viable SME lending by the local financial sector. Similarly, guarantee schemes might reduce the due diligence efforts of local banks that benefit from these schemes. Guarantee schemes may be justified in some cases, however, if they serve to overcome the initial reluctance of banks to lending to SMEs.

8.5 Conclusions

The effectiveness of market selection has varied with the barriers to exit from and entry into the market across transition countries. While new private enterprises have been the spur for employment expansion and growth, they have performed best in those countries characterised by desirable processes of both contraction and expansion. The main conclusion here is that it is not enough to focus exclusively on stimulating the expansion of start-ups but that the business environment must both ensure sufficient pressure on productivity-decreasing enterprises to release resources as well as provide an even playing field for market entrants to expand.

On the exit side, the evidence suggests a continuing strong link between well-designed bankruptcy laws, financial discipline and desirable contraction. On the entry and expansion side, a key finding is that corruption and anti-competitive practices are the most significant barriers from the perspective of start-ups, and that most obstacles to enterprise expansion are skewed against start-ups. Based on a more detailed breakdown of anti-competitive practices, regulations and finance-related obstacles, it is favoured access to essential business services, access to business licences, and access to rather than cost of finance that are the greatest problems for start-ups. Significant entry barriers, in turn, are strongly linked with less desirable expansion.

²⁶ One example is the lack of formal or informal relations between science parks or incubators and relevant academic institutions (Muent 1999). See also Smallbone and Welter (1998).

²⁷ See Hallberg (1999).

²⁸ See Pissarides (1998).

In light of these findings, the most important policy priorities for the promotion of increased entrepreneurship are to ensure adequate rewards for productive innovation and to foster opportunities for start-ups. In order for the business environment to be as attractive as possible to new productive investments, an over-riding priority remains the adequate enforcement of legal and regulatory frameworks that protect property rights and contracts. Wherever feasible, laws, taxation and regulations should be simplified to ensure an even playing field and reduce opportunities for inappropriate administrative interference.

A priority for competition policy is to focus on the removal of barriers preventing start-ups from having equal access to essential inputs, including essential business services such as telecommunications, transport and finance. In terms of business support and financial services for SMEs, governments should wherever possible encourage the development of markets for service provision rather than directly provide them. Such efforts can be assisted through the encouragement of voluntary associations of entrepreneurs, which should in turn also play a stronger and more vocal role in each country's policy formulation process.

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Annex 8.1: Insolvency law and practice in transition countries¹

An efficient and effective legal structure for companies' exit procedures, such as liquidation and reorganisation, are of paramount importance for the further development of a market economy in transition economies. As the design of effective insolvency procedures involves not only specific expertise but also extensive implementation efforts, it often received little attention in the initial phases of transition. Insolvency legislation should enhance the protection of all parties' rights in a transparent and equal way. Insolvency procedures maximise and protect the value of the insolvent entity for the benefit of all parties involved and the economy in general. The key question to be answered is how to distribute the costs/risks between market participants.

An insolvency system will inevitably reflect a country's policy choices, its social and cultural background and its legal and institutional history, but a list of internationally accepted guidelines would help each country to develop or refine its insolvency system in line with best practice. Such guidelines could provide a standard against which to assess existing insolvency systems and could identify key policy decisions that all systems will need to consider. Currently, there are no such internationally accepted guidelines,² although the World Bank has recently established – as a result of a G22 initiative³ – an Advisory Panel and an associated group of experts, who are responsible for drafting international guidelines for an effective insolvency system.

Choice between debtor-oriented and creditor-oriented system

The US insolvency system is a key example of a debtor-oriented system. Chapter 11 (the reorganisation option) of the US Bankruptcy Code allows a debtor to retain control of the insolvent entity and provides the debtor with the exclusive right for a limited period to propose a reorganisation plan. The allocation of control rights to the debtor is a policy choice that favours keeping troubled enterprises as a going concern rather than breaking up the enterprise through liquidation. The disadvantage of this policy choice, however, is the possibility that these debtor rights can be abused.

The UK insolvency system, on the other hand, focuses on creditor rights. The use of an administrative receivership places control over troubled enterprises in the hands of a third party, who effectively operates on behalf of secured creditors. The clear disadvantage of this system is the fact that it encourages liquidation since the secured creditor is primarily interested in selling the assets of the enterprise in difficulty instead of trying to save it.

Most insolvency systems in the industrialised world, however, provide a mixture of incentives both to debtors and creditors. Regarding control of a troubled company, a mixed system provides for the appointment of a trustee in charge of the enterprise in difficulty, who should be neutral both to the debtor and creditors.

Commencement and duration of an insolvency procedure

Commencement of insolvency procedure

A clear definition of insolvency is essential given the importance of any trigger mechanism that puts a legal entity into insolvency. If the trigger is pulled too early, that action may have detrimental effects for the debtor who is trying to save its business; if the trigger is pulled too late, creditor rights may be impaired because the debtor's assets may be depleted. For example, in its 1992 Bankruptcy Act, Hungary chose an automatic trigger. This meant that any enterprise with debts that were more than 90 days overdue was required to file for bankruptcy. This provision created a flood of debtor bankruptcy filings in 1992, and, taking into account the lack of an efficient reorganisation procedure, resulted in the removal of this automatic trigger in the 1993 amendment to the Bankruptcy Act.⁴

Most western European insolvency systems have a trigger that relies on either a combination of “cash” criteria and “accounting” criteria or one of the two criteria. Under the cash criteria, an enterprise is insolvent if it is unable to pay its debts in a timely fashion (for most market economies this means within 90 days). Under the accounting criteria, an enterprise is insolvent if its liabilities exceed its assets. Given the relatively low standard of accounting practices in many transition economies, a combination of the two tests may often be the best approach.

The choice of party or combination of parties – the debtor, the creditor or the court – that can file an insolvency petition also results in a different use of insolvency procedures. In situations where insolvency law provides for the possibility of both a reorganisation and liquidation, both debtor and creditor should be allowed to file a petition. In cases where only a debtor can file a petition, insolvency law should provide incentives for the debtor to avoid delaying the filing of a petition. In cases where the court can initiate an insolvency procedure, it needs to be clear that the court is administratively capable of implementing this task.

¹ In this annex we use the term “insolvency” to represent both liquidation and reorganisation proceedings. This annex will focus only on insolvency issues for enterprises and not for financial institutions.

² The only internationally accepted standard in a related field has been reached through a four-year coordinated effort between the International Federation of Insolvency Practitioners (INSOL) and the United Nations Commission on International Trade Law (UNCITRAL) on cross-border insolvency situations. The General Assembly of the United Nations adopted the UNCITRAL Model Law on Cross-Border Insolvency on 11 November 1997.

³ Following the financial crises in East Asia, Russia and Brazil, the G22 established a Working Group on International Financial Crises. This group issued a report on “Key Principles and Core Principles of Insolvency Regimes”, which is used as a basis for discussions on drafting internationally acceptable standards for insolvency regimes. The International Monetary Fund has published a report on “Orderly and Effective Insolvency Procedures: Key Issues”. Other initiatives have been led by the American Bankruptcy Institute, the Insolvency Committee of the European Union, INSOL, and the European Federation of Insolvency Practitioners.

⁴ In contrast, the Czech Republic's 1998 amendment to its bankruptcy law does not provide a clear definition of insolvency or a clear indication when a debtor is required to file a petition and has given rise to an inadequate use of the law.

It is important for transition economies to remove all impediments to the filing of an insolvency petition by all parties. For example, the 1992 Bankruptcy Law of Ukraine contained extensive and time-consuming impediments to filing a petition both for the debtor and creditors.

Duration

A speedy insolvency procedure will avoid delays that would harm both the debtor and creditors and overburden the court system. The legitimate interests of creditors can be assured only if the insolvency proceedings take place sufficiently quickly to preserve the value of the debtor's assets. A timely insolvency procedure can also, depending on the type of insolvency system, provide the debtor with a "clean" balance sheet and a "fresh start", which can, in turn, help to promote private sector development. Therefore, strict time limits should be included in the insolvency law for the filing of petitions, the drafting and voting on reorganisation plans, and the valuation and sale of assets.

The problems with slow insolvency proceedings can be seen in the Slovak Republic, where it is usual to wait one year for a hearing after a petition is filed. In addition, each debtor is required to go through a "reorganisation" phase irrespective of the state of its financial conditions. Consequently, an insolvency case in the Slovak Republic can take anywhere between three and five years to resolve.

Alternatives to liquidation

Every workable insolvency law should have an alternative to liquidation – that is, a form of reorganisation. The insolvency law should cover, among other things, the following reorganisation issues: commencement of a reorganisation procedure; parties that can commence a reorganisation procedure; extent of the "stay" during the negotiation of a reorganisation plan; management's role during negotiations; how to transfer to liquidation at any time; time limits in general; voting on a reorganisation plan; and implementation of a reorganisation plan.

Special attention should be given to the level of creditor support needed to approve a reorganisation plan. Reorganisation in industrialised economies' insolvency systems normally requires two-thirds or a majority of creditors to approve a reorganisation plan. Romania required a 100 per cent approval in its earlier insolvency law but changed this requirement in its June 1995 Bankruptcy Law. That law allows creditors representing two-thirds of outstanding claims to approve the reorganisation plan. The new law also requires a simple majority of creditors in each class to approve the plan. The bankruptcy laws that came into effect in 1996 in the Czech Republic and Latvia both require only a simple majority of creditors to approve a reorganisation plan. The requirement of qualified majority approval of a plan, such as in Romania, provides additional protection for creditors.

It is important that the reorganisation procedure includes a stay on the ability of creditors to enforce legal remedies against the assets

of the debtor once the negotiations regarding the reorganisation plan have started. Some transition economies in early versions of their bankruptcy laws allowed secured creditors to continue filing legal actions against the debtor, even if reorganisation negotiations had started. This can quickly defeat the purpose of such negotiations by depleting the debtor's assets.

Management and activity of enterprises during an insolvency procedure

Company management during insolvency

The management of a troubled enterprise can stay in place, be removed, or can be rendered powerless. In a majority of insolvency systems of industrialised economies the current management is removed and the court appoints a trustee or administrator. The trustee administers the enterprise, and the debtor is required to reveal all assets and liabilities.

Restricting company activity during insolvency

Most industrialised economies' insolvency systems introduce a "stay" on all financial transactions once the insolvency procedure has started. This can cover a wide variety of activities but in most cases it includes a prohibition on the issuance of new debt, the payment of outstanding claims and the sale of assets.⁵ The stay should be applicable to the debtor and all types of creditors – that is, both secured and unsecured. The secured creditors should be included in this since their incentive will be to sell their collateral as soon as possible, even though this may not be beneficial for the insolvency procedure. However, the trustee should make sure that the collateral of the secured creditor is protected. A number of insolvency systems in transition economies exclude the payment of taxes and salaries from the operation of the stay. However, these exceptions should be kept to a minimum, and exceptions should be made only for those assets that are irrelevant to the sale of an enterprise as a going concern.

Power of the trustee

A trustee is an independent person whose role is to supervise or manage the insolvency proceedings. Given the extent and importance of the role of a trustee, it is advisable to establish sufficient training and professional standards, possibly through a licensing regime. Romania had to decide, when drafting its insolvency law, whether to give the bulk of the insolvency work to trustees or judges. It was reluctant to give the work to trustees because this was a new profession that had yet to develop the necessary financial qualifications and integrity. It is preferable for the court to appoint the trustee and for the insolvency law to provide for conditions under which the trustee can be dismissed. The method chosen by the insolvency law on how to determine the remuneration of the trustee should be transparent.

Priority among creditors

To promote investment finance and to implement an efficient and effective liquidation, priority among creditors should be respected. Secured creditors should be compensated according to the value of their secured claim. The 1994 Bankruptcy Law of Bulgaria

⁵ The Croatian Bankruptcy Law enacted in 1994 provides for the court to issue a resolution commencing the bankruptcy which results in the trustee taking over all managerial powers, employees being given 30 days notice of dismissal, a stay being issued on proceedings and execution, and all claims against the debtor maturing.

provides this clear priority for secured creditors. Poland's insolvency legislation, on the other hand, does not provide secured creditors with the highest priority. Administrative costs, such as payment of liquidation specialists, must be paid before the secured creditors are compensated. Super-priority claims, such as taxes or payments to employees, should be kept at the lowest level possible, as such a priority can undermine lenders' confidence in security.

If reorganisation is the outcome of the insolvency system, the priority among creditors and the relationship towards the shareholders depends completely on the outcome of the reorganisation plan. Special attention should be given to the role and rights of minority shareholders. Often they are not heard or cannot take part in the voting on a reorganisation plan – a frequent complaint in Russia, for example. A possible solution could be to appoint one representative for all minority shareholders, who can participate in the reorganisation procedures.

Obstacles to implementation

Building court capacity

A common misconception is that court involvement is by definition slow and cumbersome. It is often true that liquidation via the court is slow as it can take time to identify and verify competing claims and because competing claimants often commence litigation to challenge the actions of the liquidators. However, reorganisation via the court is not necessarily slow.⁶ The most important factor is the court's capacity to handle the often-complex commercial issues involved in insolvency cases.

The key issue in many transition economies is selecting the court that has jurisdiction over insolvency cases. Some countries in transition have chosen to establish a separate bankruptcy court, which has often replaced the arbitrage court inherited from the previous regime. Other transition economies have chosen to make the bankruptcy court an independent court within the commercial court system or part of the commercial court system. For example, Lithuania has converted the old arbitrage court system into courts dealing with bankruptcy and other commercial law issues. On balance, it may be advantageous to have bankruptcy cases heard in the commercial courts because the judges will (presumably) be familiar with the more complex commercial issues, and the cost of creating a separate bankruptcy court system is likely to be beyond the resources of most transition countries.

Training of judges and court personnel

Special attention should be given to training all court personnel, not only the judges but also clerks and other court administrators. The insolvency law should provide for the discretion of the court and of the judges in particular in order to establish a workable insolvency court system.

Training of insolvency-related professions

Implementing an insolvency system depends not only on the court but also on the professionals involved in the insolvency process. Professional standards, licensing and training should be developed and further refined for liquidators, trustees, accountants, valuation specialists and lawyers specialising in insolvency cases. For example, Estonia has established a certification examination for potential trustees after they have attended a two-week training course. Croatia has recently proposed bankruptcy amendments that will require trustees to have at least ten years of experience in finance and pass a professional examination.

Public awareness of insolvency possibilities and procedures

Public awareness is essential. The insolvency system should be transparent and accessible. Creditors should find it easy to know how to file, where to file and what time limits exist. The same is true for the debtor and for any party involved directly or indirectly in the insolvency procedure.

Has insolvency reform created effective exit mechanisms?

Since 1997, the EBRD's Office of the General Counsel has conducted a survey concerning the extensiveness and effectiveness of commercial laws in its countries of operations, including a series of questions on insolvency law. The insolvency survey attempts to quantify to what extent a country's insolvency laws are comprehensive, according to lawyers and insolvency experts, and whether these laws work in practice. In other words, the survey attempts to measure whether insolvency legislation operates as an efficient means of exit for enterprises. The survey also attempts to gauge whether such laws, when implemented, have been effective in achieving this objective.

More than half of the countries surveyed have enacted new insolvency legislation or substantially amended existing laws within the past two years. This is partly a response to the growing number of insolvent enterprises in many countries and the need for legal procedures for their liquidation. In addition, accession to the European Union has prompted central European countries to review legislation enacted during the early 1990s. Moreover, organisations such as the World Bank and the EBRD have launched major technical assistance projects in many countries to assist in the development of effective insolvency mechanisms.

Analysis of results

Very few major changes have occurred between 1998 and 1999 in the bankruptcy scores that countries have received. In a few instances, there were small shifts either upward or downward – as perceptions of the effectiveness of the insolvency regime either rose or fell.⁷

⁶ In Hungary over 5,000 reorganisation cases were filed in 1992 and 1993; 90% of these cases were completed by the end of 1993. Of the completed cases, reorganisation agreement was reached in 27% of the cases, no agreement was reached and hence straight liquidation resulted in 30% of the cases, and 43% of the cases were completed administratively i.e. they were rejected on technical grounds or rendered irrelevant as the debtor paid its debts.

⁷ One surprise in the survey was Latvia's lower score in a year when it had amended its legislation to strengthen the power of trustees. At the time of the survey respondents may not have yet fully understood the changes made in the law at the end of 1998. Failure to publicise the changes fully or provide sufficient trustee training could explain this lack of comprehension.

Bulgaria, Croatia, Estonia, FYR Macedonia, Hungary and Kyrgyzstan have all received high marks for their insolvency laws and the implementation of those laws. Some may be surprised to see FYR Macedonia in this grouping. Nonetheless, it enacted new insolvency legislation in 1998. Similarly, Kyrgyzstan's high showing in 1999 may reflect optimism about its legislation, which came into force at the end of 1997. Kyrgyzstan also had one of the earliest bank insolvency laws, which came into force in 1994.

The majority of countries included in the survey received a 3 rating. Their laws are perceived by survey respondents as substantively adequate but in need of revision in at least one of the major areas discussed above. These scores are generally consistent with the general trend for most countries to revise and update their insolvency practices. Most countries have either revised laws that were enacted in the early 1990s or have adopted new legislation that is meant to achieve many of the objectives discussed above. At the same time, respondents do not perceive these laws as effectively enforced. Delays, lack of properly trained personnel or inactive liquidators are some of the reasons for this perception. The Czech Republic, for example, has received a steady 3 rating despite having amended its insolvency legislation in 1998. The new amendments, as discussed above, do not clarify when a debtor is legally insolvent and required to file a petition. Therefore, respondents may not have perceived the recent changes to Czech law as having any tangible impact on the effectiveness of the process.

Poland's score increased from a 2 to a 3+ in 1999. Poland's lower rating, relative to other pre-accession countries such as Hungary and Slovenia, may reflect the uncertainty over whether secured creditors receive the highest priority in a liquidation proceeding. As a result, respondents (many of whom represent lenders) may perceive this as a significant impediment to an effective insolvency regime in Poland. Moldova's score also rose significantly between 1998 and 1999, possibly in response to proposed modifications to its existing insolvency law.

Countries with a score of 2 have been consistently perceived as having ineffectual insolvency processes and outmoded legislation. For example, Ukraine's system involves requirements that make it difficult for creditors to commence insolvency proceedings, although the law is expected to be amended substantially in 2000. The new amendments will include more comprehensive procedures for reorganisation and will also introduce the concept of a liquidator.

Other countries in this category include Uzbekistan and Belarus, whose score actually increased in 1999. In 1998, Belarus amended its original 1991 insolvency legislation. Although the law has been applied only a few times (many insolvent companies continue to operate), these amendments probably explain the higher score.⁸ Survey respondents might also have reacted to a new insolvency law that the Belarus Government introduced in late November 1998, even though this law is not scheduled to enter into force until early 2000.

Georgia and Armenia also fall into this category following a decline in their scores. These declines are due to significant decreases in the perception of the effectiveness rather than the substance of their insolvency laws. For example, Georgia's insolvency law became effective in January 1997 and cases have been brought under this law, but none of these cases has yet been concluded. Time delays such as these, perhaps caused by the judiciary's lack of understanding of their powers under the law, are a key factor in lowering Georgia's score.

Conclusions

Insolvency need not have a negative connotation. Insolvency procedures can facilitate negotiations between debtors and creditors, and can help to avoid premature closures of companies facing financial difficulties. They can also encourage debtors to service their debts more consistently and can lead to appropriate downsizing and sale of assets. While there is no ideal insolvency model, a list of internationally accepted principles for effective and efficient insolvency systems would be an important tool for transition countries seeking to develop or refine their insolvency system. These principles are in the process of being established. The EBRD's legal indicator survey identifies a gap between the adoption or amendment of insolvency legislation and its effective implementation. This result suggests that transition economies should focus on implementing the existing insolvency laws and revise them once they have been put into practice.

⁸ In addition, the new Civil Code, effective 1 July 1999, clarified the order of priority for creditors.

Table 8.1.1

EBRD legal indicators: extensiveness and effectiveness of bankruptcy law

Country	1999 overall score	1998 overall score
Albania	1	2
Armenia	2-	3
Azerbaijan	3+	3
Belarus	2	1
Bosnia and Herzegovina	1	2
Bulgaria	4-	4
Croatia	4-	4
Czech Republic	3+	3+
Estonia	4-	4
FYR Macedonia	4	4
Georgia	2-	3
Hungary	4-	3
Kazakhstan	3	3
Kyrgyzstan	4-	3
Latvia	3+	4
Lithuania	3	2
Moldova	3	1
Poland	3+	2
Romania	3	3
Russia	3-	3
Slovak Republic	3	3
Slovenia	4	3+
Tajikistan	na	1
Turkmenistan	na	1
Ukraine	2	2+
Uzbekistan	2	2

Categories**4+ Insolvency law perceived as comprehensive and highly effective**

as exit mechanism. Countries have insolvency legislation that is perceived as comprehensive and clear with respect to issues such as legal definition of insolvency, the role of the courts and trustees during the liquidation, the priorities of creditors and reorganisation proceedings. Insolvency law is also perceived as being effectively implemented in almost all instances.

4 Insolvency law perceived as adequate and reasonably effective as exit mechanism.

Countries are perceived as having adequate or satisfactory laws dealing with liquidation with respect to issues such as the legal definition of insolvency, the role of the courts and trustee during liquidation, and the priorities of creditors. Insolvency law is also perceived as effective in the majority of cases. For example, respondents perceive that liquidation proceedings are often concluded in a timely fashion, and that legal personnel (judges and liquidators) fulfil their duties effectively. Reorganisation proceedings are also perceived as effective in helping creditors and debtors reach a settlement at least some of the time.

3 Insolvency law perceived as barely adequate and with only basic effectiveness.

Countries are perceived as having barely adequate insolvency legislation. The law may be perceived as unclear on an essential component, such as the priorities of creditors or the legal definition of insolvency or the powers of the trustee or liquidator. In addition, the legislation is perceived as ineffective when implemented. Proceedings are perceived as lengthy, and court involvement may adversely affect the duration of proceedings. Reorganisation proceedings may not be utilised frequently or are perceived as ineffective in promoting settlement between creditors and debtors.

2 Insolvency law perceived as inadequate and ineffective as an exit mechanism.

Countries are perceived as having inadequate insolvency legislation. Legislation enacted in the early 1990s may be in need of significant amendment or revision. The existing legislation is perceived as lacking in several areas, including the definition of insolvency, the role of the trustee and the courts in liquidation, the priorities of creditors and also the nature of reorganisation proceedings. The laws in these countries are also seen as ineffective due to lengthy delays in completing insolvency proceedings, lack of skilled judicial personnel or trustees and uncertainty about how courts and trustees will fulfil their duties.

1 Insolvency law perceived as wholly ineffective and may discourage use of insolvency as exit mechanisms by creditors.

Countries are perceived as having rudimentary insolvency legislation or laws that are rendered ineffective by virtue of lack of enforcement or implementation. Respondents may perceive the law as creating disincentives for creditors to file petitions and to use liquidation as an exit mechanism even when they have large outstanding debts with a particular company.

Restructuring large industrial enterprises

When the transition process began, it was well understood that enterprise restructuring would require two important types of reform: liberalisation and privatisation. Freeing trade and prices would introduce competition and market prices, while private ownership would introduce profit-oriented incentives within the firm. Ten years on, progress in liberalisation and privatisation has been remarkable, but enterprise restructuring – especially in the industrial sector – has not. This chapter attempts to explain what went wrong and how it can be fixed.

Central planning has left behind many large industrial enterprises – most of them by now privatised – in severe financial difficulty. Section 9.1 describes how drastic changes in demand structures at the onset of transition led to rapid industrial downsizing. Most industrial enterprises responded by engaging in “reactive” restructuring, reducing output, employment and capacities. Industrial production has now stabilised in most countries, but only the advanced reformers are showing renewed output growth. In most other countries, firms have been slow to introduce the “deep” restructuring measures, such as the development of new products and processes, that are ultimately the basis for renewed growth and the creation of jobs. Annex 9.1 explores trends in international trade to gauge which sectors are likely to have long-term prospects for such growth and which are likely to shrink further.

Section 9.2 examines the policies and obstacles that have affected industrial restructuring. The reduction of direct state subsidies, price controls and trade protection resulted in reactive restructuring and downsizing of the industrial sector. However, deep restructuring through investments in new products and processes has remained constrained by distorted incentives at the enterprise level. Although most large industrial firms have been privatised, they lack effective new owners and their corporate governance is undermined by vested interests. Furthermore, a wide variety of “soft budget constraints”, such as payments arrears and ineffective bankruptcy, have implicitly subsidised unprofitable behaviour. A poor investment climate has inhibited the growth of the new private sector in many countries, reducing competition and removing other employment opportunities for workers in the old industries. In addition, some countries, especially in the CIS, have failed to address the social challenge of large-scale structural change.

The way forward is fraught with obstacles and risks. Section 9.3 lays out some guidelines for policy, while Section 9.4 examines specific mechanisms for the restructuring of large industrial enterprises. Necessary reforms include improvements in the investment climate to allow the entry and growth of new private enterprises,

reforms of the social safety net to facilitate labour mobility and to reduce resistance to restructuring, and gradual institutional strengthening that reduces soft financial support for enterprises. Ownership and management change at the enterprise level is also often needed to help break vested interests of insiders and initiate deep restructuring. Strategic investors can be instrumental in promoting large enterprise restructuring. Section 9.4 discusses a variety of methods to bring in strategic investors – for example, by “ring-fencing” their investment from old obligations and state interference.

9.1 Industrial decline and progress in enterprise restructuring

Transition brought about massive structural change, moving economic activity away from large-scale industry and towards the service sector (see Chapter 4). Price liberalisation raised input costs, while subjecting the final products to the laws of supply and demand. Demand for manufactured products fell sharply as international trade and consumer choice were freed, while the state scaled back its demand for industrial and agricultural products. Financial sector reforms reduced the allocation of soft credits to industry in many countries. The disintegration of the Council for Mutual Economic Assistance (CMEA) trading area and the break-up of the Soviet Union erased many of the old system’s gains from specialisation. Large vertically integrated industrial complexes lost their captive markets as trade with the rest of the world was freed. A capital stock originally aimed at large-scale production of heavy machinery and transport equipment became largely obsolete.

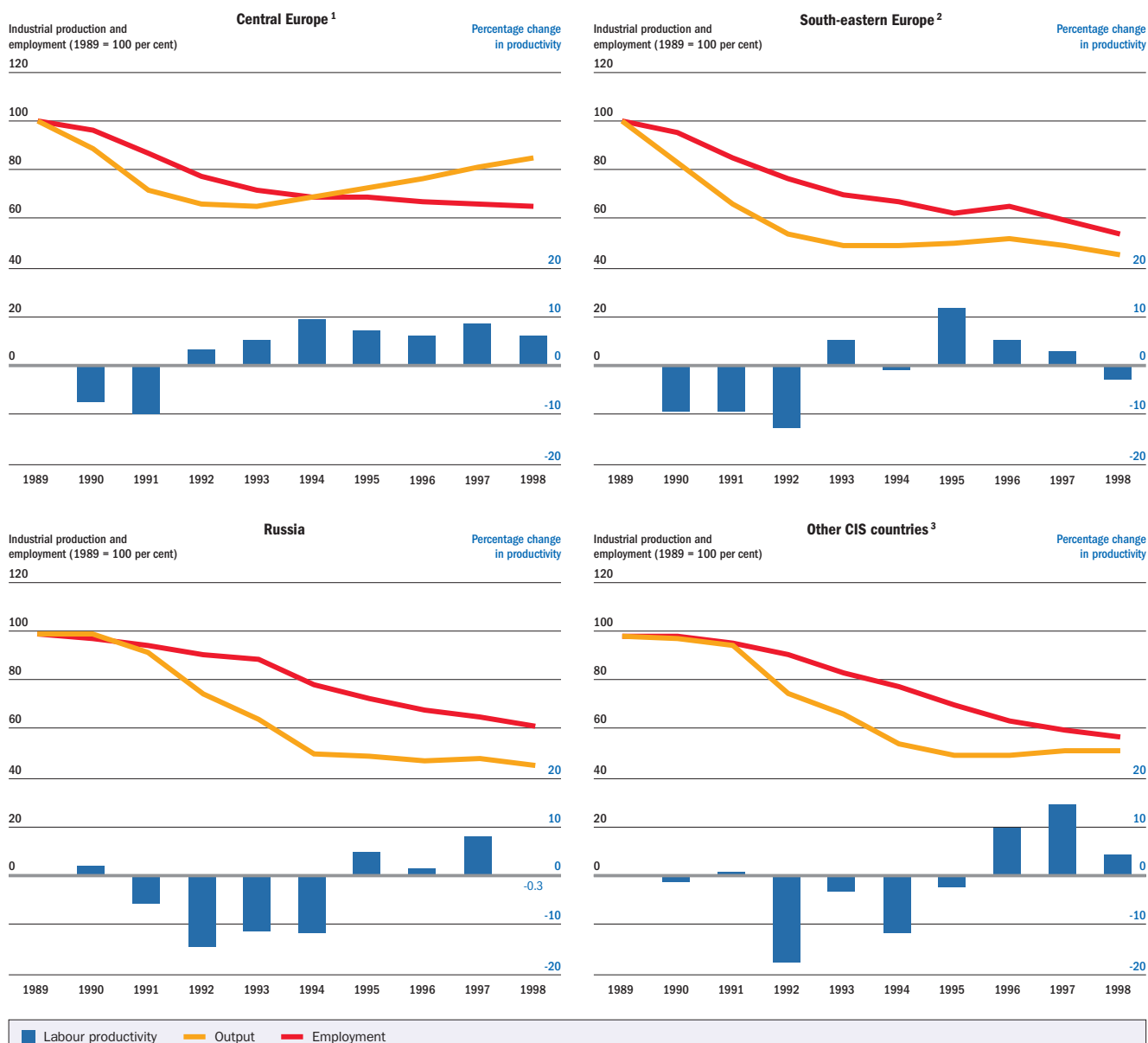
The resulting decline in the industrial sector has been dramatic. Chart 9.1 shows that during the first few years of transition, industrial production fell by about one-third in central Europe and by about one-half in other transition countries. The decline has been even more pronounced for certain industrial branches as free trade shifted the composition of exports towards each country’s comparative advantage. For most countries, this led – at least initially – to a steep decline in capital-intensive and technology-based industries, while labour- and resource-intensive industries were less affected.¹

At the enterprise level, a basic distinction can be drawn between “reactive” and “deep” restructuring. Reactive restructuring refers to the downsizing of production, workforce and capacity associated with the loss of old markets. Deep restructuring involves the development of new product lines, the identification of new markets and the implementation of new management techniques and business strategies. This type of restructuring ultimately leads to an expansion in output and the creation of new jobs.

¹ However, there is significant variation of comparative advantage across the region, as shown in Annex 9.1. For a detailed study on international competitiveness, see OECD (1998).

Chart 9.1

Industrial output, employment and productivity



Sources: National authorities and EBRD staff estimates.

¹ Unweighted average of Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia.

² Unweighted average of Bulgaria, FYR Macedonia and Romania.

³ Unweighted average of Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Moldova, Ukraine and Uzbekistan.

The sharp decline in industrial production and employment, as shown in Chart 9.1, is a sign of reactive restructuring. However, there is an important difference between transition countries in central Europe and those further east. Although employment reductions were severe in the CIS and south-eastern Europe, they did not match the sharp output fall, implying that labour productivity has remained below pre-transition levels. In recent years, productivity has been growing, but this was primarily due to employment reductions, indicating continued reactive restructuring. Central Europe, by contrast, has surpassed pre-transition productivity levels and productivity growth has been characterised by output expansion, with industrial output reaching 90 per cent of pre-transition levels. This suggests that industry has undergone

deeper restructuring in central Europe than in other transition economies.

The regional differences in industrial restructuring are also apparent from diverging trends in international trade. Annex 9.1 shows that central European countries have increased their net exports of capital and skill-intensive goods in recent years, often supported by strong inflows of foreign direct investment (FDI). By contrast, many CIS countries remain heavily dependent on resource-intensive industries. An analysis of trends in comparative advantage suggests that industrial restructuring of the large-scale capital-intensive industries is now a far greater challenge in the CIS than in central Europe.

9.2 Policy trends and obstacles to industrial restructuring

At the beginning of transition, some observers believed that enterprise restructuring required essentially two types of reform: liberalisation and privatisation. Private ownership would ensure profit-oriented corporate governance, while liberalisation of trade and prices would set free the competitive market forces that reward profitable activities. Firms would have therefore both internal and external incentives to restructure. However, ten years of experience have shown that it was not quite that simple.

Although privatisation and liberalisation have been rapid in most transition economies, progress in industrial restructuring has been unsatisfactory. Restructuring has largely remained reactive, especially in the CIS and south-eastern Europe. Deep restructuring has been hampered by slow progress in the more difficult institutional reforms, such as enforcing payments discipline, promoting competition and the new private sector, developing sound financial institutions and protecting creditor and shareholder rights.

Most transition countries did not embark upon an active industrial strategy to facilitate structural change or to cushion its social consequences. Rather, in general there has been an uncoordinated mix of policies and reforms, resulting in conflicting incentives for enterprise restructuring. As direct subsidies, price controls and trade protection were being phased out, industrial firms reacted by reducing output, capacity and their workforce. However, investment in new products and production methods has remained slow, because of weak financial sectors (constraining domestic borrowing), macroeconomic risks (constraining external borrowing) and soft budget constraints, such as payments arrears and ineffective bankruptcy (distorting profit incentives and inhibiting innovation).

Although privatisation of large firms has made reasonable progress, the lack of effective new owners in privatised companies has affected corporate governance and distorted strategic decisions on restructuring. A poor investment climate has inhibited the growth of new companies in the private sector in many countries, reducing competition and limiting alternative employment opportunities for workers in the old industries. In addition, some countries have failed to address the social challenge of large-scale structural change. Many CIS countries still lack effective social support for workers that might be laid off as a result of restructuring.

The impact of these policy trends on the restructuring of large industrial enterprises is discussed in more detail below. The discussion is complemented by empirical evidence from the Business Environment and Enterprise Performance Survey in 20 transition economies.²

Privatisation and ownership

The privatisation of large industrial enterprises has made significant progress in most transition countries, with the exception of a few CIS countries. The most rapid divestiture of large enterprises was seen in the Czech and Slovak Republics, Estonia, Hungary and Russia. There is some evidence that privatised firms have restructured more rapidly than remaining state-owned firms. Chart 9.2, for example, shows that in central and eastern Europe and the Baltic states, large state-owned industrial firms (more than 200 employees) have on average undertaken less restructuring than large privatised firms.³ The evidence from the CIS is less clear-cut, however. While state-owned firms infrequently undergo reorganisation or discontinue existing product lines, the proportion of state-owned firms that upgrade technology and expand production is higher than among privatised firms.⁴

While overall there is a mixed relationship between privatisation and various types of restructuring activities, the one ownership type that has proven to be consistently supportive of deep restructuring and growth is control by a foreign strategic investor (see Chart 9.2). This type of concentrated outside ownership can strengthen corporate governance and introduce new skills in marketing and business strategy, while linking the enterprise into a global network of trade and finance. Yet, only a few transition countries – Hungary and Estonia in particular – have pursued a privatisation strategy geared primarily towards foreign strategic investors.

Most large industrial firms in transition economies have widely dispersed ownership. This is the result of a privatisation process that primarily relied upon management-employee buy-outs and voucher privatisation in most countries. As a result, most large firms are owned by a variety of “insiders” and “outsiders”, including residual stakes by the state, but without a strong dominant shareholder. As mechanisms of corporate governance do not function well in most transition economies, such ownership structures often leave corporate control effectively in the hands of managers. This misalignment of ownership and control can in turn impede restructuring – for example, when managers divert resources to the detriment of other shareholders.

By contrast, when ownership is concentrated, there is less need to rely on corporate governance mechanisms to exercise firm control. Chart 9.3 shows that firms in transition economies with concentrated ownership structures (where majority ownership is held by three or fewer shareholders) tend to restructure more rapidly and perform better on average than firms with dispersed ownership.⁵

Even in privatised firms, the state often retains the ability – through a variety of channels, including residual ownership, control over crucial inputs, or tax claims – to intervene in corporate strategy and restructuring. This power is often used to

² See Annex 2.1 to Chapter 2 and Chapters 6 and 7 for detailed discussions of the survey.

³ The definition of “state-owned” refers here to the state being the dominant shareholder.

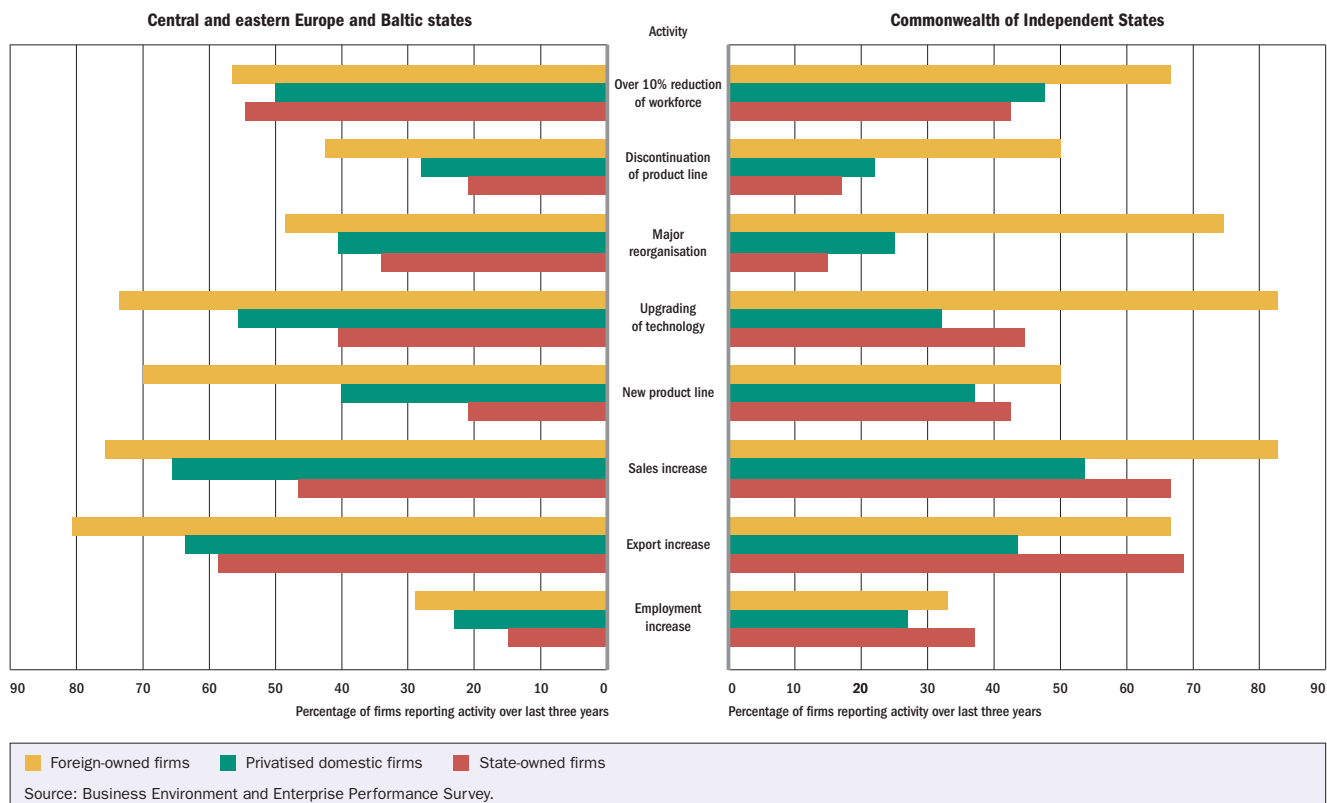
⁴ See Chapter 7 for a review of the evidence on the relationship between privatisation and enterprise restructuring and performance.

⁵ Pohl et al. (1997) find similar evidence for firms in central and south-eastern Europe, noting that the style of privatisation is less relevant for restructuring than the degree of ownership concentration.

Chart 9.2

Ownership and restructuring

(Survey of industrial firms with over 200 employees, excluding new enterprises)



persuade firms to maintain employment or to sell their products cheaply to other firms. Chart 9.4 shows that privatised industrial firms that experience frequent state intervention in their decisions on pricing, sales and/or investment tend to restructure less frequently, both in terms of reactive and deep restructuring.

Protectionism and implicit subsidies

Most transition countries have moved towards liberal trade regimes and low levels of direct subsidies. Protectionist policies, such as budgetary subsidies, input price controls, directed lending and import barriers, have been phased out rapidly in most countries during the first decade of transition.⁶ Yet, these direct forms of support have often been replaced with a wide variety of implicit forms of support or “soft budget constraints”, some of which are at least as damaging for economic efficiency. These implicit forms of support include ineffective bankruptcy enforcement, lack of creditor rights, weak tax discipline, connected lending, payment arrears and barter. Such soft budget constraints exist in all transition economies, but are particularly widespread in the CIS and south-eastern Europe.

The switch from explicit to implicit enterprise support has had important implications for enterprise restructuring. While produc-

tion and employment have been cut sharply, many loss-making industrial firms have remained operational, often accumulating substantial arrears. With a weak threat of bankruptcy and a significant overhang of arrears, managers of such firms have little incentive to undertake deep restructuring measures and have limited access to finance for the necessary investments. Chart 9.5 shows that large firms with significant arrears to the state are on average more involved in reactive restructuring but less active in deep restructuring, such as technological improvements and development of new product lines.

Other implicit forms of support – such as barter – have a similarly adverse effect on firm incentives.⁷ As non-monetary transactions often take place at arbitrary prices, financial reports become less meaningful. This severely undermines corporate transparency and thus reduces the ability of enterprises to obtain new loans from banks or to attract outside investors. Furthermore, barter transactions tend to lock enterprises into fixed supply and demand chains, which in turn can be a deterrent to innovation. Chart 9.5 shows that large firms with high levels of barter and debt offsets are on average more involved in reactive restructuring but less involved in technological improvements and the development of new product lines.⁸

⁶ Some countries have maintained high levels of protection for certain sectors, such as Russia for its automotive industry. Belarus, Turkmenistan and Uzbekistan have been employing a system of multiple exchange rates as an indirect form of state aid. Under this regime, “strategic” companies enjoy privileged access to foreign exchange and can import inputs at a heavily overvalued exchange rate.

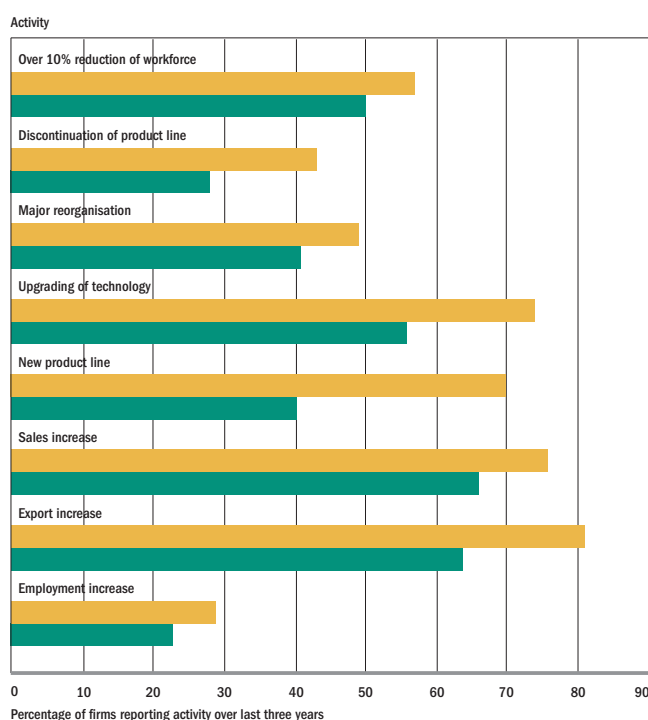
⁷ For a discussion of the effect of barter on enterprise restructuring, see Commander and Mumssen (1999).

⁸ This may also partly reflect the fact that barter is prevalent in those economies with a generally less favourable business environment, which can itself deter some forms of restructuring.

Chart 9.3

Ownership concentration and restructuring

(Survey of industrial firms with over 200 employees, excluding new enterprises)



Source: Business Environment and Enterprise Performance Survey.

The competitive distortions arising from implicit forms of support are even greater than those arising from direct subsidies. Under direct subsidies, all firms in receipt of these benefits have a competitive advantage over those firms not receiving subsidies. This creates an indirect tax on non-subsidised sectors, as the funds to subsidise certain industries are raised from the economy as a whole. The same redistributive effect applies to implicit support, with one important addition: as implicit subsidies are higher for less profitable firms, resources are shifted from profitable to unprofitable firms within a particular sector, undermining market competition in a particularly damaging way.

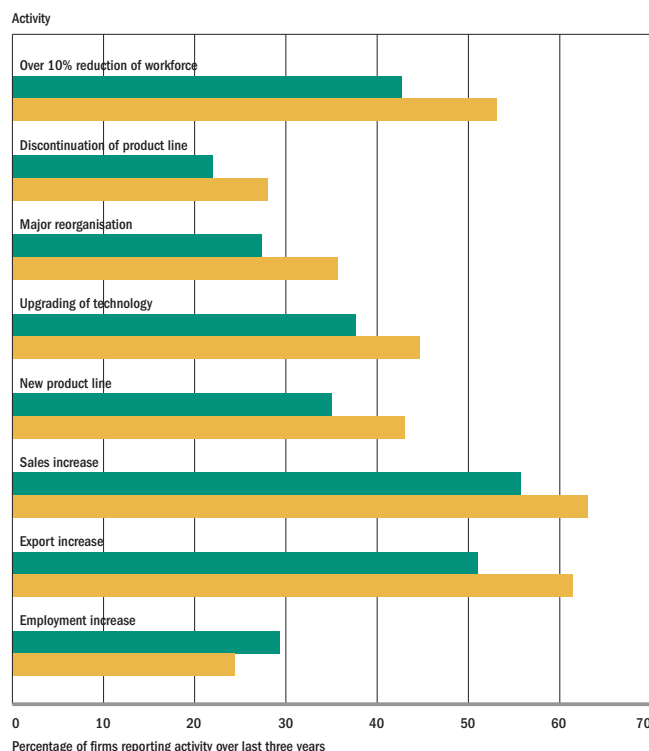
Investment climate

The poor investment climate in many transition countries, especially in the CIS and south-eastern Europe, has inhibited the entry of new private firms (including FDI) and the expansion of small and medium-sized enterprises (SMEs) (see Chapter 8). This has affected industrial restructuring in several ways. It has meant fewer outside opportunities for workers in declining industrial firms, making lay-offs socially more problematic. It has also weakened the degree of competition in the economy, reducing the incentive for existing firms to innovate and restructure (see Chapter 7). Lastly, it has deprived some large industrial firms of a solid base of efficient suppliers and distributors. This is especially true in the CIS, where SMEs continue to play a relatively minor role in industry.

Chart 9.4

State intervention and restructuring

(Survey of privatised industrial firms with over 200 employees)



Source: Business Environment and Enterprise Performance Survey.

¹ Intervention in the firm's decision-making on pricing, sales and/or investments.**Social and fiscal constraints**

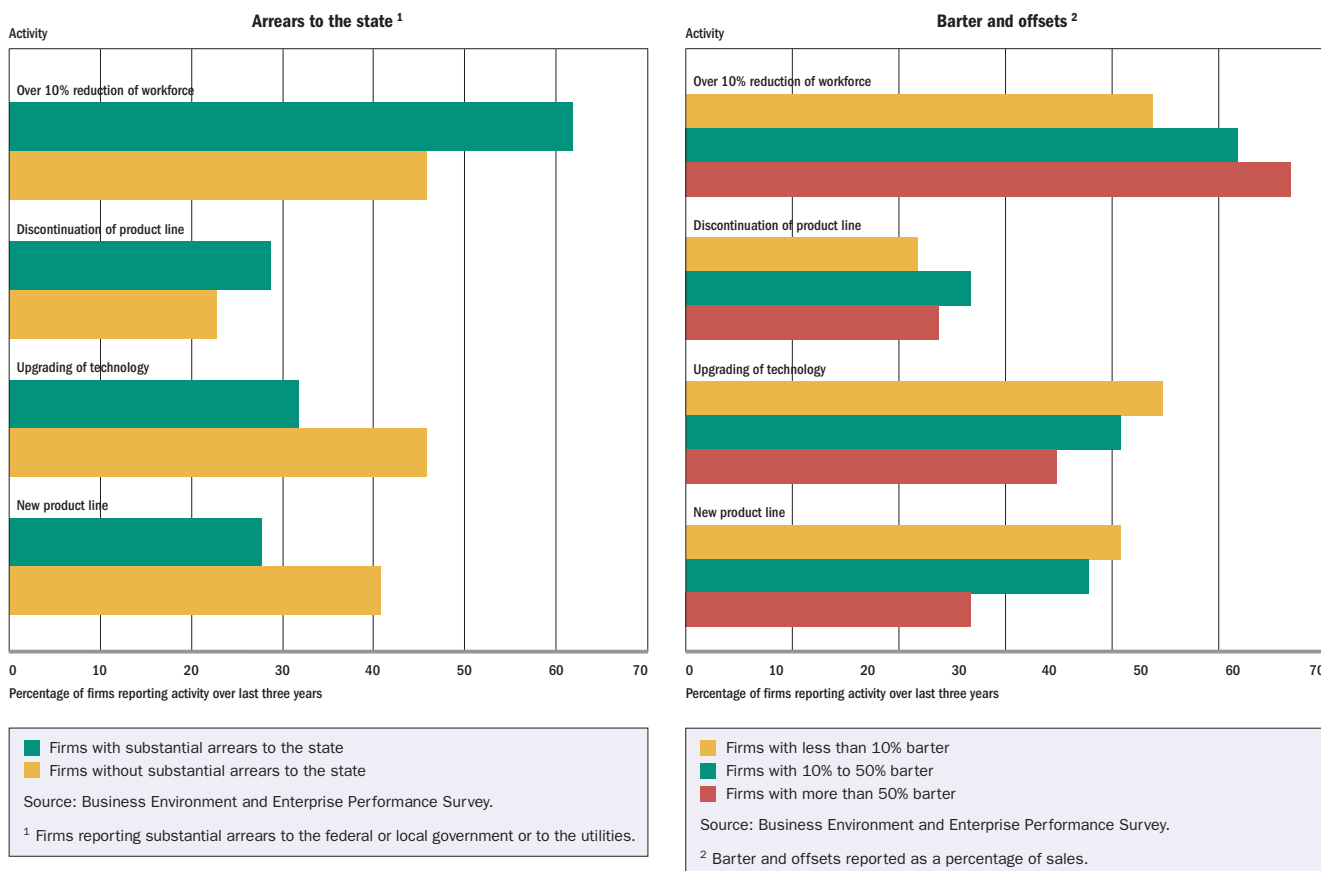
Countries in central Europe introduced universal cash-based social welfare systems at the beginning of transition, creating a safety net for workers laid off in the industrial restructuring process. As a result of these social welfare systems, central European countries experienced relatively little increase in poverty despite rising rates of unemployment. In contrast, social support in the CIS has remained tied to the firm, mostly in the form of housing. This has reduced labour mobility, while creating the threat of poverty for those losing their jobs. Fiscal constraints (see Chart 9.7) have prevented the creation of an effective cash-based social safety net for the newly unemployed. Therefore, lay-offs in the wake of large-scale restructuring were much more problematic in the CIS than in central Europe. This divergence is illustrated in Chart 9.6.

The absence of a cash-based social safety net combined with a persistence of enterprise-based social benefits has had important repercussions for restructuring in the CIS. Especially in large industrial enterprises, most of which are still partially owned by the state and also partly owned by employees, there has been strong pressure to avoid outright lay-offs. This has resulted in labour hoarding, hidden unemployment and wage arrears.

Chart 9.5

Soft budget constraints and restructuring

(Survey of industrial firms with over 200 employees, excluding new enterprises)

**9.3 Economic and social policy options**

The previous section highlighted that the policy environment for deep enterprise restructuring remains highly imperfect, especially in the CIS and south-eastern Europe. The privatisation process has resulted in weak corporate governance with ineffective ownership and control structures. Soft budget constraints have distorted corporate incentives and effectively subsidised unprofitable behaviour, undermining competition and innovation. A poor investment climate has restricted entry and growth of the new private sector and deterred FDI, inhibiting competition and new employment opportunities. Fiscal constraints and an ineffective social safety net have made large-scale restructuring in the CIS very difficult. This section discusses how governments can address these challenges by providing external incentives for deep restructuring, while Section 9.4 will discuss how to improve the firm's internal incentives.

Hard budget constraints and social welfare reform

The most direct way to force enterprises to restructure is to phase out implicit subsidies and soft budget constraints. Reform should be aimed at strengthening the institutional capacity of courts to enforce bankruptcy and contracts, and at strengthening the supervisory powers of central banks to reduce imprudent lending. There also needs to be a strengthening of the capacity of tax authorities and state utilities to enforce timely payments and reduce non-monetary transactions, particularly in Russia and Ukraine.

The introduction of hard budget constraints for industrial enterprises is inevitably a gradual process. A “shock therapy” of closing enterprises in arrears may overshoot the degree of desirable enterprise exit. Forcing one company into bankruptcy can cause a chain reaction through the economy. This is particularly problematic in economies such as Russia and Ukraine where firms are linked into complex networks of barter and arrears that cover both profitable and unprofitable firms. A clamp-down on barter and arrears between enterprises would force many potentially viable companies to close down, especially given the absence of bank lending.⁹

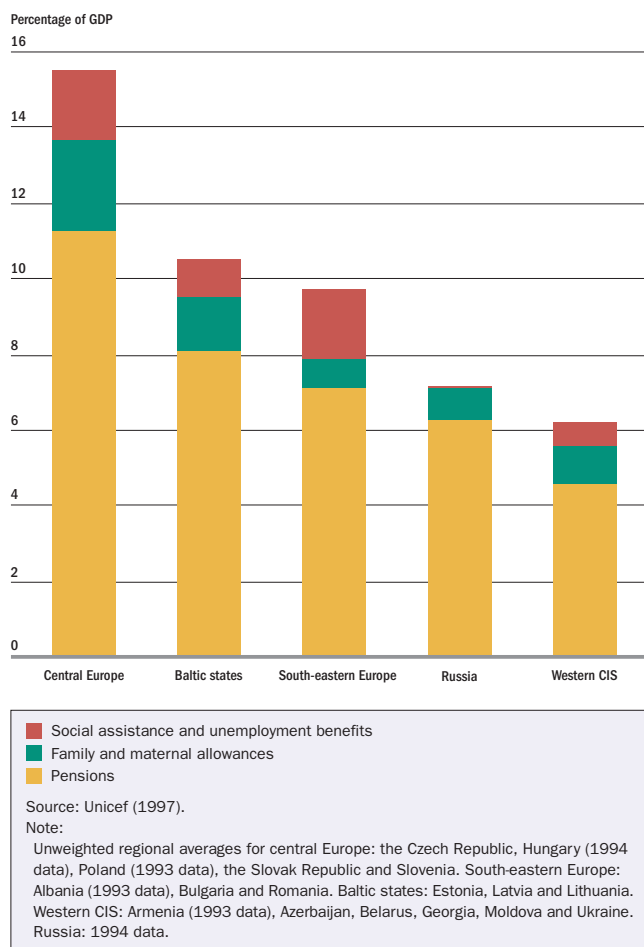
The process of hardening budget constraints requires some complementary policies, given that soft budget constraints not only reflect weak public institutions but also deeply rooted political constraints and vested interests. Tighter enforcement of tax discipline should be accompanied by a reduction and simplification of corporate tax rates, reducing the scope for “red tape” and corruption. More stringent application of bankruptcy should be supported by facilitating the entry of a new investor so as to avoid excessive liquidations. Non-tolerance of enterprise arrears should go hand in hand with the elimination of late or in-kind payments by the state or state enterprises.

The most important complementary policy for hardening budget constraints in the CIS is the overhaul of the social welfare system.

⁹ For a discussion of policy options in a barter-based economy, see Commander and Mumssen (1999).

Chart 9.6

Social transfers in 1995



Enterprise-based benefits, such as housing, should be replaced by a general cash-based social safety net. Reform of publicly owned housing would help to encourage labour mobility. Such reform is particularly important for supporting the restructuring of large enterprises that account for the livelihood of a whole town. The challenge for social policy in central Europe, by contrast, is primarily to reform the pension and health care systems in order to allow a reduction of non-wage labour costs.

Investment climate: entry and competition

The entry and growth of new private firms has proved to be a powerful tool for enterprise restructuring. The competitive effects of entry can force existing enterprises to accelerate deep restructuring (see Chapter 7), while the growth of new firms and the relative decline of old firms help in the restructuring of the economy as a whole.¹⁰ For example, the experience in China (see Box 9.1) strongly underlines the importance of new firm expansion in the restructuring process. In principle, fostering the growth of new private firms is a relatively uncontroversial policy. The growth of new private companies generates additional tax revenues and creates new employment opportunities for workers leaving declining industries. Moreover, the products sold by SMEs do not usually compete directly with the output of large firms in heavy industry but tend to link into their supply and distribution chain.

¹⁰ For a survey of the relationship between competition and restructuring, see Commander, Dutz and Stern (1999).

The growth of the new private sector, however, depends crucially on a sound investment climate, which is desperately lacking in many countries (see Chapter 8). Crucial challenges are to clamp down on red tape and corruption, to strengthen the financial sector and, in some countries, to implement macroeconomic stability. Countries that have been successful in building a relatively sound investment climate, such as Poland and Hungary, have also experienced the growth of a strong new private sector, including both FDI and domestic SMEs.

Industrial policy

Given the fiscal, social and political constraints on restructuring large industrial enterprises, what is the right method and degree of state support for declining industries? An industrial policy of supporting declining companies through subsidies and trade protection, as practised in many industrialised countries, is likely to fail in transition countries. Similarly, simply relying on new firm growth to attract resources out of failing state firms is unlikely to be sufficient, as Chinese experience (see Box 9.1) indicates.

In countries of the CIS where both GDP and tax revenues are very low, the resources for policies based on explicit subsidies are generally not available. For instance, in support of the restructuring of British Steel from 1976 to 1985, the UK Government paid annual cash contributions that would in today's money correspond to a quarter of all government revenues in Ukraine. Chart 9.7 shows that although the fiscal position has generally improved across the region, there is very little scope for industrial policies based on direct subsidies in countries outside central Europe.

A policy based on subsidies and trade protection would also run the risk of being exploited by vested interests. This makes industrial policy particularly unattractive in those transition countries where the special relationships between managers and the state have already undermined the general reform process. Trade protection is particularly problematic, given its detrimental effect on competition and innovation.

However, efforts to harden budget constraints on enterprises may require complementary policies to ease the social consequences and to avoid excessive insolvency. It is also clear that explicit support for declining firms is preferable to the implicit support they are currently enjoying as it would avoid many of the additional problems created by soft budget constraints, in particular the implicit tax on profit-oriented activities. Given the complex political nature of transition countries, explicit forms of state support for enterprises should ideally have the following characteristics:

- **Support should be targeted at "externalities":** The best way to support enterprises is for the state to pay for environmental improvements, take over social obligations (such as housing), or pay for re-training and relocation. This type of support avoids many of the economic distortions associated with production subsidies or import protection. It is also fiscally effective in that it replaces other forms of state spending.

Box 9.1

Enterprise restructuring in China

The experience of industrial restructuring in China differs significantly from the transition economies in central and eastern Europe and the CIS. Liberalisation and privatisation have been far more gradual in China, while output and productivity growth has been far more rapid. China has effectively followed a “dual-track” approach, whereby traditional state-owned enterprises (SOEs) co-exist with collectively owned enterprises and an emerging private sector. The engine behind China’s phenomenal growth rates over the past two decades has been the collectively owned Township Village Enterprises (TVEs). Their share in industrial production rose from 9 per cent in 1978 to 56 per cent by 1995. By this time, TVEs employed around 130 million workers, more than twice the number in SOEs. Total factor productivity growth of TVEs has far exceeded that of SOEs.

The evolution of market-oriented policies in China can be traced back to 1978 with the implementation of comprehensive agricultural reforms, including price liberalisation and the introduction of the “household responsibility system” in farming. These reforms boosted output and productivity growth in agriculture, which in turn led to the growth of privately owned small service enterprises. Collectively owned industrial enterprises (TVEs) emerged, directly or indirectly controlled by the local authorities. In 1980, four southern coastal cities were designated as “Special Economic Zones”, which subsequently attracted significant amounts of FDI in joint ventures aimed primarily at manufacturing consumer goods for export. In 1984, the Government relaxed restrictions on the private ownership of enterprises and officially acknowledged TVEs as community-owned enterprises supervised by the local government. In addition, the government started to liberalise the consumer goods market, which was dominated by TVE producers. By 1993, most retail sales were conducted at market prices.

China’s economic success is seen by some as a vindication of gradualist reforms that contrast with the rapid pace of market-oriented reforms implemented in central and eastern Europe and the CIS.¹ One cannot, however, assume that the Chinese path was a realistic option for these

countries. Furthermore, a key aspect of high GDP growth rates in China has been the shift from an agricultural towards an industrial economy, which involved the transfer of workers into industries with higher labour productivity.²

The rapid growth of new enterprises has clearly benefited the Chinese economy as a whole. Crucially, the dual-track strategy appears to have had a positive impact on the old state-owned sector. SOEs, while less dynamic, have benefited from the demand of non-state-owned enterprises for intermediate goods. Increased competition from TVEs in the consumer goods market has provided incentives for the restructuring of SOEs. Moreover, the growth of non-state enterprises has created the opportunity for a shift in labour away from the less productive SOEs.

Although the growth of the new enterprise sector has facilitated the restructuring process, the reform of loss-making SOEs cannot be delayed until they naturally “wither away”. While the state cut direct subsidies to SOEs in 1983, hidden subsidies in the form of preferential and directed credits have increased over time, consuming 3.4 per cent of GNP in 1991 according to one estimate.³ Employment in industrial SOEs declined only marginally, from 49 million in 1985 to 43 million in 1994. Social protection in the form of non-wage benefits (housing, health care and pensions) provided to SOE employees may explain this relatively modest labour transfer from SOEs to the growing new non-state sector. By the mid-1990s, the problems of loss-making state enterprises were perceived to be so urgent that the government began accelerating reforms. This involved privatisation of small rural SOEs, mass redundancies at urban SOEs, as well as mergers, corporatisations and initial public offering of large SOEs.

1 Jefferson and Rawski (1994) take this view. More recently, Stiglitz (1999) contrasted Chinese “incrementalism” with Russia’s “shock therapy” reforms.

2 See Sachs and Woo (1997).

3 See Cao, Fan and Woo (1997).

- **Explicit support should be directly linked to a reduction in implicit support:** Enterprises should qualify for explicit state support only if they lose access to implicit forms of support, such as tolerance of payments arrears. This condition has the advantage that soft budget constraints can be phased out more easily and fiscal costs are therefore partly offset.
- **Support must be linked to an explicit timeframe:** The best way to allow enterprises to restructure while being supported by the state is to establish a schedule that phases out support over time. This can help to avoid “moral hazard”, which can occur when firms expect continuing state support and therefore fail to restructure.
- **Enterprise selection must be based on clear objective criteria:** One way to do this is to make support available to all firms within a certain sector or firms with a certain threshold of regional importance. Selection must err on the side of equal treatment versus targeting in order to avoid excessive influence being exerted by vested interests.

9.4 Practical approaches to restructuring large industrial enterprises

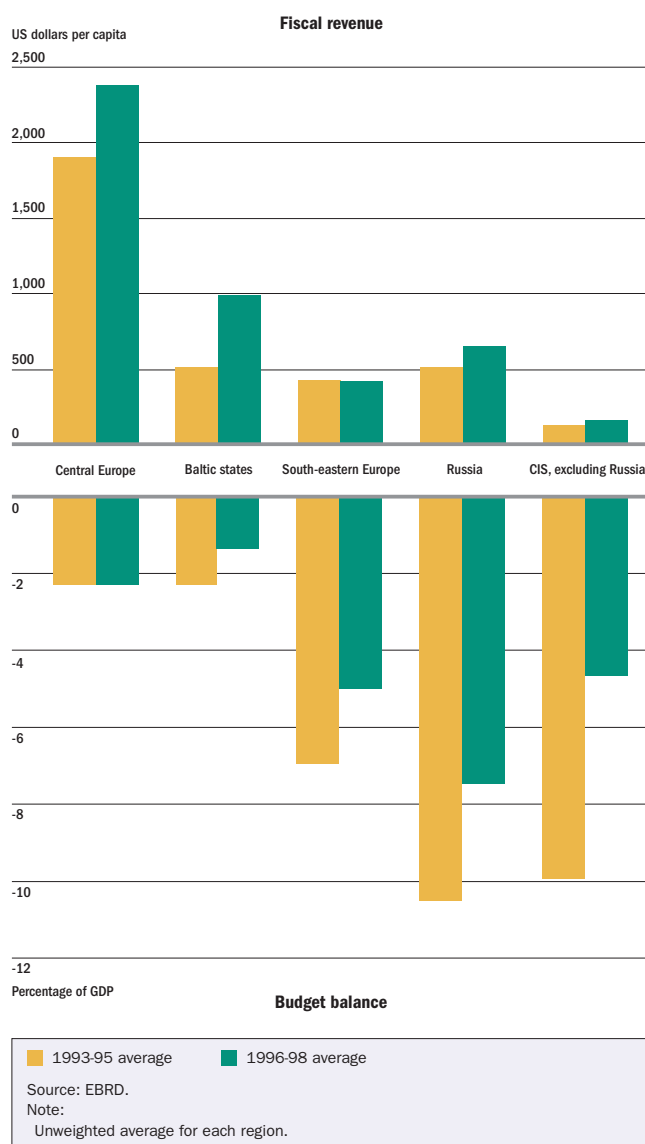
Many of the largest manufacturing firms in the region outside central Europe are either in arrears or insolvent. Most of these firms require substantial restructuring beyond pure capital expenditure. Bankruptcy is usually not an option, given the local importance of these large firms. In Russia, the 25 largest enterprises in the auto, aerospace and metals industries employ between 20,000 and 140,000 workers each. Some observers believe that many of Russia’s large manufacturing enterprises are “value-destroyers” (that is, the combined economic value of capital, labour and material inputs employed is greater than the economic value of outputs), surviving only by the mercy of a barter-based economy.¹¹ Even in Poland, where the enterprise sector as a whole has restructured relatively well, mostly thanks to the growth of new private companies, there are numerous remaining “problem” firms in heavy industry, mining and agriculture.

The persistence of unprofitable firms can impose significant costs on transition economies, including indirect costs, such as bad loan portfolios of banks, weak payments discipline and barter, a lack of labour mobility and retraining, as well as a weak tax base. The previous section discussed options for creating external incentives

¹¹ See Gaddy and Ickes (1998) for a discussion of Russia’s “virtual economy”.

Chart 9.7

Fiscal revenues and budget balance



for firms through improving the investment climate and public institutions. This section discusses how to create incentives for deep restructuring within the firm and lays out general lessons and guidelines for implementing the turnaround and deep restructuring of large enterprises.

Restructuring led by a strategic investor

There are numerous examples of successful restructuring led by capable local managers, even in those companies that were privatised in management-employee buy-outs. This is particularly the case in central Europe, partly thanks to a relatively favourable business environment.¹² However, in those cases where the turnaround challenge is very severe, experience has shown that strategic investors have usually been better able to lead

the restructuring process.¹³ Investor-led restructuring has four main advantages:

- **Industry and management expertise:** Although the workforce in transition countries is relatively skilled, modern management and industry expertise is often desperately lacking. Strategic investors usually bring in technical know-how to upgrade products and processes and help to link the enterprise into the global economy. Even more importantly, strategic investors tend to bring in managerial staff to organise finance, marketing and strategy, which are areas often responsible for the poor performance of enterprises in transition economies.
- **Access to finance:** Deep restructuring of large enterprises typically involves considerable capital expenditure to upgrade product quality and to reduce costs. While local companies are short of cash and local banks do not usually offer long-term loans, strategic investors bring in their own resources and tend to attract finance from foreign banks. Crucially, strategic investors can offer partial guarantees to lenders and investors co-financing the restructuring, which helps reduce the cost of capital, especially if perceived risks are significant.
- **Long-term strategic interest:** The level of country risk and restructuring challenges often imply significant equity risk. Strategic investors, with their resources and long-term strategic interests, are far better placed than banks or individual owner/managers to take on this type of risk.
- **Ownership change:** Section 9.2 highlighted that misalignment of ownership and control and vested interests can have a detrimental effect on incentives within the firm, affecting not only operational but also strategic decisions. The acquisition of a firm by a strategic investor can solve this problem by putting the enterprise under majority ownership of a single outside party.

Although the entry of a foreign strategic investor has proved the most effective way to restructure an enterprise, it is by no means a panacea. Cross-border acquisitions are typically fraught with considerable risks. This is even more so in transition economies, where the degree of restructuring required is often very significant and information very limited. As a result of these risks, many foreign investors remain cautious about investing in eastern Europe, especially in countries unlikely to accede to the European Union.

As opposed to “greenfield” investments, the acquisition of a local company typically involves significant restructuring risks. Resistance to restructuring on the part of employees and managers can undermine the investor’s ability to re-orient production processes. Local management may have different objectives than the foreign investor, including non-profit motives and implicit agreements with third parties. This risk is particularly high when

¹² One example is the Croatian pharmaceutical company Pliva, whose management led a restructuring process that included the flotation of shares on the London Stock Exchange.

¹³ An early example was Volkswagen’s investment in Czech automotive producer Skoda. VW bought a 70% stake in the company in 1991 and has since doubled production, modestly reduced employment, and raised exports from less than a third of total output to almost two-thirds.

Box 9.2

Ispat-Karmet: restructuring Kazakhstan's steel sector

The acquisition and turnaround of Kazakhstan's largest steel plant by the international steel group Ispat has perhaps been the most ambitious large-scale restructuring project in a transition country to date. After two unsuccessful turnaround attempts by hired Western management in the early 1990s, Ispat bought the integrated steel plant and its power station from the government in 1995 and subsequently acquired 15 coal mines that were supplying the plant. Significantly, Ispat did not acquire the steel company itself, but rather its physical assets and incorporated a wholly owned subsidiary, Ispat-Karmet.

At the time of Ispat's entry, the plant's steel production ran at 30 per cent of its 6 million ton capacity. There was little working capital and no solid customer base. Most sales were conducted in barter, with exports accounting for only 20 per cent of sales. There was no central control over sales and purchases, with various plant managers engaging in decentralised bilateral deals with trading companies. There was no adequate management information system, poor accountability and low transparency. Relationships with local government were fraught with vested interests, red tape and corruption. The plant's 33,000 employees lacked motivation, given internal favouritism and, more importantly, six months of overdue wages.

Of all these problems, the biggest obstacle to restructuring was the presence of vested interests. Ispat's solution to the problem was both radical and effective. First, barter deals were effectively banned in order to remove the possibility of non-transparent bilateral sales and pur-

chase agreements. Second, plant managers were rotated around posts (rather than fired) in order to break up insider relationships. To reduce corruption and red tape, Ispat-Karmet dealt with the state on a "single window" basis, whereby all transactions and communications between the company and the government (for example, those involving taxes and regulations) were undertaken at a central level, thereby avoiding bureaucracy and allowing for confidence-building between the investor and the government.

In order to phase out barter and build a solid customer base, Ispat-Karmet vastly strengthened its marketing efforts abroad, raising exports to 90 per cent of sales. Financial controls were another priority area for restructuring. It is revealing that of the 35 expatriate managers who were brought into the plant, only four were responsible for technical issues, while 22 were working on finance and marketing. The company was the first in Kazakhstan to implement international accounting standards, with an international auditor, therefore facilitating access to working capital finance from international banks.

Employment reduction and re-motivation were other central challenges. Ispat-Karmet's approach was to restrict lay-offs to disciplinary violations, such as absenteeism and drunkenness. This technique removed 6,000 people within the first year and strengthened the motivation of remaining employees. Improvements in health and safety standards, training and employee visits to Ispat's plants in other countries all helped raise employee confidence.

the foreign investor acquires a strategic minority stake in a firm and does not therefore have overall control.¹⁴ However, even when full ownership is acquired, there may be remaining vested interests among middle managers and labour unions. These types of restructuring risks imply the need for innovative solutions, as in the case of Ispat-Karmet (see Box 9.2).

Any foreign investment is also subject to political and regulatory risks. These include an unstable legislative and tax environment, uncertain access to public infrastructure, pressure to preserve jobs, macroeconomic instability, as well as corruption. The local partners can sometimes influence state authorities, but such connections can be a mixed blessing for foreign investors. Negotiated privileges that are not based on a general law but on ad hoc agreements tend to be renegotiable and therefore introduce an element of uncertainty into business planning. Furthermore, there is often some form of implicit quid pro quo in bilateral agreements with local authorities.

Creating a purchase opportunity

A policy of relying on foreign investors to promote enterprise restructuring is subject to a selection problem. Given the considerable risks involved, most foreign investors would understandably seek to acquire those enterprises that are already relatively profitable and in need of relatively little restructuring. Furthermore,

investor interest tends to concentrate on countries close to EU accession. It is therefore difficult to find strategic investors for exactly those large loss-making enterprises in the region where restructuring is most urgent and challenging and where ownership change and the entry of strategic investors would be particularly desirable.

Even in those cases where there is a willing investor, the state and the incumbent stakeholders may not want to give up control of the company. In firms with insider ownership, managers and employees will have to weigh the windfall gain of selling their shares against the possible loss of their job.¹⁵ To overcome these constraints on investor-led restructuring, there are a number of options available to governments to create or facilitate a purchase opportunity.

Residual privatisation

In partially privatised enterprises, the state can offer its remaining stake to a strategic investor, selected preferably through international tender. If the remaining state share in the firm is not large enough to give the investor effective control, the state may sometimes be able to convert the company's tax arrears into equity to raise the stake acquired by the investor. It is also often helpful to have the investor inject fresh cash into the enterprise as a capital increase to consolidate ownership.

¹⁴ The enterprise survey finds some evidence that firms with majority foreign ownership tend to engage more in expansion-oriented restructuring and less in reorganisation and downsizing in comparison with firms with minority foreign ownership. This is consistent with the finding discussed in Section 9.2 that ownership concentration tends to support deep restructuring.

¹⁵ Filatotchev et al. (1999) found evidence that Russian managers are generally hostile towards outside ownership and effectively collude with employees to preserve insider control, leading to entrenchment of incumbent management and persistence of excess employment. Aghion and Blanchard (1998) and Carlin and Aghion (1996) have analysed the interplay between privatisation methods and enterprise restructuring in a theoretical framework. Assuming that political constraints make insider privatisation necessary and that outsiders are needed to promote restructuring, the authors conclude that privatisation should be more generous to employees so as to reduce their reluctance to sell their shares to outsiders later.

A central problem is how to deal with existing explicit and implicit obligations of the enterprise. These can include payment arrears, purchase and supply agreements, long-term barter arrangements, environmental liabilities, and social obligations, such as housing and transport services. To attract a strategic investor, the state may have to take on a large portion of existing financial, social and environmental liabilities. Even then, the purchase price may still be very low if restructuring costs and risks are large. Although industrial restructuring through residual privatisation is therefore seldom an immediate revenue-raiser, it does help reduce explicit and implicit subsidies.

Asset privatisation and ring-fencing of joint ventures

Given the web of debt, arrears and the implicit social and other obligations of many large industrial firms, it is often more effective to sell the assets of a company, rather than its shares. If the company's capital stock is very outdated, the strategic investor may prefer to acquire only a few selected assets and set up new production facilities, while hiring employees from the old plant. This mixture of "greenfield" and "brownfield" characteristics in FDI has been successfully applied by Guardian Industries Europe, which set up new production facilities adjacent to an existing glass factory in Hungary, gradually hiring workers from the old company, but not taking on any of its liabilities.

In other cases, the strategic investor may actually purchase most tangible assets but incorporate a new company that is not liable for old contracts and obligations (see Box 9.2 on Ispat-Karmet). If the local company is already private, the investor can incorporate a joint venture with its owners, who can contribute physical assets as equity in-kind. The objective is to ring-fence the joint venture against explicit and implicit obligations of the local partner firm, while using its facilities, workers and networks of distribution and supply.¹⁶

Pre-privatisation restructuring

To make a loss-making state enterprise more attractive for potential buyers, the state may undertake some pre-privatisation restructuring. However, this approach has been problematic, especially when the state effectively left the restructuring to the incumbent management. General experience points towards deterioration of asset values under state ownership. Furthermore, major strategic decisions with high "sunk costs", such as the development or discontinuation of product lines, the closure of plants, and capital expenditure should ultimately be taken by a party that has a long-term profit interest. The state should therefore leave significant restructuring decisions to the eventual private owner.

Restructuring programmes

Some countries, such as Bulgaria, Moldova, Romania and Slovenia, have tried to establish centralised restructuring schemes and institutions (such as restructuring agencies or debt consolida-

tion banks) to deal with loss-making or insolvent enterprises in a more wholesale fashion. A programmatic approach has the advantage that participating enterprises face the same rules of the game, implying greater transparency and possible synergy with regards to social support. If there are sectoral challenges, such as Poland's coal and steel industries, this may also make a centralised approach desirable.

However, the success of such programmes has been decidedly mixed. Romania's enterprise "isolation" programme for firms in financial distress is thought to have actually delayed the restructuring process by failing to impose hard budget constraints on the enterprises involved.¹⁷ There is no blueprint for successful enterprise restructuring, and programmes can sometimes even hinder the negotiation of individual solutions. The most important element of a programme is the ability of the restructuring agent to attract strategic investors. This requires a high degree of flexibility in each case, undermining therefore the rationale for creating a centralised scheme. On the other hand, creating a central institution, especially if it is relatively independent of political pressures, can sometimes help to coordinate the process.

Management contracts

Rather than letting existing company managers implement restructuring, the state can hire an international management company to take over certain key management functions. The management contract would typically be based on a fee that partly reflects the performance of the enterprise and may also contain a buy-in option as an additional incentive. The main advantage of management contracts is that an outside company is not subject to the same constraints of existing management and brings in new expertise in finance, marketing and strategy.

While this approach has many of the benefits associated with foreign investor-led restructuring, there are important differences. Management companies often lack a genuine strategic commitment. They do not inject fresh cash into the enterprise and may focus on a path of least resistance to obtain their fee. Furthermore, as management companies are hired, they may lack clout in breaking up vested interests. As a result, experience with management contracts has been somewhat mixed in transition economies.¹⁸

Twinning contracts and management consultancy

Hired advice and support can play an important role in enterprise restructuring when the local management is dynamic and reform-oriented. The EBRD has run a programme of "turnaround management" (TAM), which has proven successful with smaller closely held companies where the owners/managers have a long-term profit interest. Twinning contracts have the added advantage that the partnership provides an international link for the local company. By contrast, in large industrial companies with dispersed ownership, outside advice can get easily lost in the

¹⁶ There are many joint ventures faced with this challenge, including high-profile cases such as the new joint venture between US Steel and VSZ in the Slovak Republic and the planned joint venture between Fiat and GAZ in Russia.

¹⁷ See Djankov (1998).

¹⁸ In Poland's mass privatisation programme, management contracts were awarded for the 15 National Investment Funds (NIFs), which were in turn responsible for restructuring some 500 companies. The experience with this indirect form of employing management contracts has disappointed many observers, such as Blaszczyk and Woodward (1999) and Kennedy (1997).

various power centres within the firm. As consultants and advisers have no real control over the company's decision-making, the most serious problems are unlikely to be addressed in such companies, especially since these problems are often the result of internal management problems.

Creditor-led restructuring

A change in ownership can occur naturally if lack of restructuring leads to an accumulation of arrears. While creditors may prefer to put the enterprise into bankruptcy and liquidate its assets, there is sometimes scope to develop a workout plan for the enterprise, involving debt rescheduling and possibly debt-for-equity swaps as well as restructuring measures, such as spin-off of non-core assets and management changes. Bank-led restructuring has so far not been very successful in transition countries. The Polish "Enterprise and Bank Restructuring Programme" gave insolvent enterprises some breathing space, but failed to generate ownership or management change and thus did not stimulate restructuring.¹⁹ Debt-equity swaps have been widely employed in many transition economies to deal with bad loans, but have usually not resulted in significant improvements in the corporate governance of enterprises.

Given the creditors' lack of restructuring and industrial expertise, they should seek to sell their stakes to a strategic investor. However, the search for a strategic investor may take time and this raises the question of who should manage the company in the interim. Leaving management in place is usually not desirable. Ideally, creditors would appoint a temporary restructuring administrator, who would devise a restructuring plan to facilitate the eventual sale to a strategic investor. The difficulty is to prevent asset stripping in this interim period (a similar problem exists in bankruptcy cases). Another problem is that creditors may have different interests. Some creditors may prefer to be repaid soon, while others may want to wait longer and hope for a greater recovery in the future. Such opposing interests can lead to disagreement on whether a serious turnaround attempt should be undertaken.

9.5 Conclusions

This chapter has given an overview of current policies affecting large enterprise restructuring and options for the future. The analysis has produced a number of key lessons and guidelines for how governments should try to approach the restructuring of large industrial enterprises.

Economic and social policies

- Even in environments where political and social obstacles to large-scale industrial restructuring are significant, the state can still work on improvements to the investment climate so as to foster the entry and growth of SMEs and FDI, increasing competition and creating new employment opportunities. This includes measures to reduce bureaucracy and corruption.
- The use of production subsidies or import protection will tend to hinder the restructuring process, given the detrimental effect on competition and the high likelihood of abuse by vested interests.
- To phase out soft budget constraints, there may be a case for replacing implicit subsidies, such as tax arrears, with explicit time-bound enterprise support (for example, for social or environmental purposes). This approach is less likely to succeed in countries with weak public governance, however.
- In the CIS, reform of the social safety net by enhancing cash benefits for the poor and unemployed is important to facilitate labour mobility and to allow enterprise restructuring.
- Ownership and management change in enterprises is crucial to break up vested interests. Whenever possible, corporate ownership and management should be transferred from the original beneficiaries of the privatisation process to committed strategic investors.

Practical approaches to restructuring large enterprises

- Deep restructuring of large industrial enterprises is best undertaken by an investor with a long-term strategic perspective. Ideally, such a strategic investor should enter as soon as possible and make all major strategic decisions concerning areas such as capital expenditure, product lines and spin-offs of non-core assets.
- The state should maintain a hands-off approach towards the activities of the enterprise after the entry of a strategic investor.
- To attract strategic investors to loss-making enterprises, the state should take responsibility for the social consequences of restructuring, and may need to take over some social, environmental and financial obligations as well. In this respect, asset sale is more effective than share sale, as it helps to ring-fence the investment against old obligations.

¹⁹ See Gray and Holle (1996).

- The financial difficulties of large enterprises, combined with the use of residual state shares, can help to bring about ownership change in privatised enterprises. If no strategic investor can be found for the firm as a whole, the state and the creditors could appoint a temporary restructuring administrator to prepare for the sale of viable parts of the enterprise and prevent asset stripping.
- Management contracts and consultancies have a mixed record, while state-led restructuring (including the use of restructuring programmes) has proven relatively ineffective.

A coordinated approach towards industrial restructuring

The chapter has emphasised that many of the obstacles to enterprise restructuring are ultimately linked to political, fiscal and social constraints, rather than mere legislative shortcomings. The above guidelines provide key elements of a strategy for restructuring that addresses these deeply rooted constraints. Given the complex institutional and financial challenges, coordination between governments, international organisations and private investors is crucial for their implementation. The chapter has shown that enterprise restructuring requires coherent complementary reforms in a number of areas, such as the investment climate, SMEs and the social safety net. Such a comprehensive approach not only requires a high degree of coordination but also strong political commitment. In this regard, it may be achieved more effectively at the regional rather than the federal level in large countries such as Russia and Ukraine.

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Annex 9.1: Recent trends in revealed comparative advantage

As the rate of structural change across the region has slowed, it is now easier to identify sectors with a future and those that are likely to shrink further. For this purpose, it is useful to analyse the long-term comparative advantages of countries in the region.¹ Labour costs in most transition countries are low compared with OECD countries, while the workforce is relatively skilled. The inherited capital stock is outdated, but in some cases able to produce commodities such as raw materials and metals. Investment is constrained by the relatively high cost of capital and the general absence of long-term lending. Furthermore, some countries are well-endowed with natural resources. Russia and Central Asia are rich in oil and gas, while the western CIS has abundant arable land. Given these endowments, the long-term comparative advantage would be expected to lie in labour-intensive industries and in those industries that do not necessarily require very modern capital. In addition, some countries should have a comparative advantage in the natural resources sector.

A detailed study of export structures and trends across commodity groups is summarised in Table 9.1.1 and Chart 9.1.1. Commodities are divided into five broad groups: agriculture, natural resources, capital-intensive goods (such as steel and automobiles), labour-intensive goods (such as clothing) and those goods requiring

special skills (such as high-tech products). The first part of each column in Table 9.1.1 indicates a country's "revealed" comparative advantage for each commodity group, calculated in terms of net exports. The second part of each column indicates the trend in revealed comparative advantage and exports from 1993 to 1997. The final column reports the two main export commodities for each country.

Comparative advantage is biased towards resource- and labour-intensive industries in virtually all transition economies, while there is a strong disadvantage in high-tech sectors and mild disadvantages in agriculture and capital-intensive industries. The weak showing of agriculture and heavy industry, the two sectors that were at the heart of socialism, illustrates the distortions caused by central planning.

Central Europe has a clear revealed comparative advantage in labour-intensive industries, clothing in particular. The Slovak Republic bucks the general trend by showing a comparative advantage in capital-intensive industries, partly as a result of recent FDI in the automotive sector. Almost all the other central European countries have experienced a significant improvement in capital-intensive industries. This reflects some success in the

Chart 9.1.1

Exports to OECD: shares of commodity groups



¹ A country's "comparative advantage" is determined by its factor endowments, such as labour, skills, capital, technology and natural resources. The traditional theory of international trade sees comparative advantage as the main determinant of trade. A country is assumed to specialise in those industries that make intensive use of factors with which the country is relatively well endowed. More recent trade theory has highlighted the importance of product differentiation which can explain the incidence of intra-industry trade. Table 9.1.1 reports both net exports and gross exports in order to capture the various aspects of trade and specialisation.

Table 9.1.1

Revealed comparative advantage (RCA) and exports

Sectors	Agriculture RCA Trend	Resources RCA Trend	Capital RCA Trend	Labour RCA Trend	Skills RCA Trend	Main export commodity groups
Central Europe	⬇️	⬇️	⬆️	(+) ⬇️	(-) ⬆️	
Croatia	(-) ⬇️	(+) ⬆️	(-) ⬆️	(+) ⬆️	(-) ⬆️	Clothing (24%), footwear (9%)
Czech Republic	(-) ⬇️	⬇️	⬆️		(-) ⬆️	Vehicles (12%), electrical machinery (9%)
Hungary	(+) ⬇️	(-) ⬇️	(-) ⬆️	⬇️	(+) ⬆️	Electrical (12%), power machinery (12%)
Poland	(+) ⬇️	(+) ⬇️	(-) ⬆️	(+) ⬆️	(-) ⬆️	Clothing (11%), vehicles (8%)
Slovak Republic	(-) ⬇️	(-) ⬆️	(+) ⬆️	(+) ⬆️	(-) ⬆️	Iron & steel (13%), vehicles (12%)
Slovenia	(-) ⬇️	(-) ⬆️	⬆️	(+) ⬇️		Vehicles (13%), electrical machinery (10%)
Baltic states	(-) ⬇️	(+) ⬇️	(-) ⬆️	⬆️	(-) ⬆️	
Estonia	(-) ⬇️	(+) ⬆️	(-) ⬇️	⬇️	(-) ⬆️	Oil (23%), wood (14%)
Latvia	(-) ⬇️	(+) ⬇️	(-) ⬆️	⬆️	(-) ⬆️	Oil (41%), wood (23%)
Lithuania	(-) ⬆️	(+) ⬇️	(-) ⬇️	(+) ⬆️	(-) ⬆️	Clothing (23%), oil (10%)
South-eastern Europe	(-) ⬇️		(-) ⬆️	(+) ⬆️	(-) ⬆️	
Albania	(-) ⬇️	(+) ⬇️	(-) ⬇️	(+) ⬆️	(-) ⬆️	Clothing (28%), footwear (22%)
Bosnia and Herzegovina	(-) ⬇️	(+) ⬆️	(-) ⬇️	(+) ⬆️	(-) ⬇️	Clothing (28%), footwear (22%)
Bulgaria	(+) ⬇️	(-) ⬆️	(+) ⬆️	⬇️	(-) ⬇️	Clothing (18%), non-ferrous metals (11%)
FYR Macedonia	⬇️		⬆️	(+) ⬇️	(-) ⬆️	Clothing (34%), iron & steel (20%)
Romania	⬆️			(+) ⬇️	(-) ⬆️	Clothing (30%), iron & steel (10%)
Western CIS	⬆️	⬇️	⬇️	⬆️	(-) ⬆️	
Armenia	⬆️	(+) ⬇️	(-) ⬆️	(-) ⬇️	(-) ⬇️	Diamonds (74%), metalliferous ores (9%)
Azerbaijan	⬆️	(++) ⬇️	(-) ⬆️	(-) ⬆️	(-) ⬆️	Cotton (29%), oil (21%)
Belarus	(-) ⬆️	⬆️	(+) ⬆️	(+) ⬆️	(-) ⬆️	Clothing (21%), fertilisers (9%)
Georgia	(-) ⬆️	(+) ⬆️	⬇️	(+) ⬇️	(-) ⬆️	Oil (23%), iron & steel (18%)
Moldova	(++) ⬆️	(-) ⬇️	(-) ⬇️	⬆️	(-) ⬆️	Clothing (25%), iron & steel (19%)
Ukraine	(++) ⬆️	(-) ⬇️	(+) ⬇️	(-) ⬆️	(-) ⬆️	Iron & steel (27%), metalliferous ores (15%)
Russia	(-) ⬆️	(++) ⬆️	⬆️	(-) ⬇️	(-) ⬆️	Oil (32%), non-ferrous metals (20%)
Central Asia	⬇️	(++) ⬇️	(-) ⬇️	(-) ⬆️	(-) ⬆️	
Kazakhstan	⬇️	(++) ⬆️	(-) ⬇️	(-) ⬆️	(-) ⬆️	Non-ferrous metals (39%), oil (29%)
Kyrgyzstan	(+) ⬇️	(++) ⬆️	(-) ⬇️	(-) ⬇️	(-) ⬇️	Gold (27%), cotton fibres (25%)
Tajikistan	(-) ⬆️	(++) ⬇️	(-) ⬇️	(+) ⬆️	(-) ⬆️	Cotton (62%), textiles (17%)
Turkmenistan	(-) ⬆️	(++) ⬇️	(-) ⬆️	(-) ⬆️	(-) ⬆️	Cotton (56%), textiles (18%)
Uzbekistan	(-) ⬆️	(++) ⬇️	(-) ⬆️	(-) ⬆️	(-) ⬆️	Cotton (82%), non-ferrous metals (7%)

Notes:

RCA:

- (++) strong revealed comparative advantage
- (+) revealed comparative advantage
- (-) revealed comparative disadvantage
- (--) strong revealed comparative disadvantage

Trend:

Change in gross and net exports to OECD between 1993 and 1997 (weighted measure)

Source: United Nations Comtrade database.

Revealed comparative advantage is a normalised measure of net exports.

Formula: $RCA_i = (ES_i - IS_i) / (ES_i + IS_i)$ for sector i , where ES is export share and IS is import share in each commodity group. Data are obtained from partner countries in SITC-2 digit (rev. 3) and commodity groups are:

Agriculture – 0, 1, 4, 22, 29; Skill-intensive – 54, 72, 75, 76, 87, 88; Labour-intensive – 26, 60, 61, 65, 77, 80-85, 89 (textiles, clothes, footwear, other); Natural resources – 21, 24, 26, 27, 28, 32-35, 63, 66, 68 (wood, oil, gas, electricity, coal, stone, non-ferrous metals, skins and furs, textile fibres); Capital-intensive – 23, 25, 51-53, 55-59, 64, 67, 69-71, 73, 74, 78, 79 (paper, chemicals, rubber, plastic, ferrous metals, transport and industrial machinery).

restructuring of heavy industries and strong inflows of FDI, attracted by the EU accession prospect for these countries. Central Europe has also become better at producing skill-intensive goods, while Hungary stands out as the only transition economy with a revealed advantage in this sector, again partly reflecting FDI in this field. The agricultural sector is fairly weak in central Europe, except in Hungary and Poland, and the trend has been towards further decline of net exports.

The Baltic states rely heavily on transit and refining of Russian natural resources and the export of wood. However, net exports of natural resources have decreased significantly in recent years. The Baltic states' comparative disadvantage in agriculture and capital-

intensive industries has generally intensified. Estonia has greatly expanded the international competitiveness of its skill-intensive sectors. The rapid growth of Lithuania's clothing industry has turned a comparative disadvantage in labour-intensive sectors into a comparative advantage that now exceeds that of Croatia and Slovenia, which are two traditionally strong exporters of clothing.

South-east European countries stand out in labour-intensive industries, with wages far below those in central Europe. Comparative advantage is relatively homogeneous in this region, with the exception of Bulgaria, which is a strong outlier. Bulgaria has increased its relative share of capital-intensive goods in net exports, especially ferrous and non-ferrous metals. However, this

probably reflects delayed downsizing rather than a genuine comparative advantage. The western CIS has moved strongly towards agriculture. However, most countries of the former Soviet Union still export their agricultural products primarily to Russia while importing most of the more expensive food items from OECD countries.

As expected, Russia and Central Asia have a very strong revealed comparative advantage in natural resources, which account for the majority of their exports. These countries are so well-endowed with oil, gas, gold and cotton that they have a comparative disadvantage in the other four commodity groups, despite extremely low labour costs. Russia stands out for the lack of change in its export structure and comparative advantage. The danger for these countries is that manufacturing outside the natural resources sector will struggle, especially as high exports of oil and gas may lead to real appreciation of the exchange rate, undermining the international competitiveness of other sectors. This effect – sometimes called “Dutch disease” – would make industrial restructuring a particularly difficult challenge in these countries (for example, in Russia’s heavy industry and automotive sectors).

The evolving pattern of comparative advantage has important implications for industrial restructuring. Transition economies have begun to adjust production and international trade in line with their long-term comparative advantages. However, comparative advantage differs significantly across the region and, as a result, the challenge of industrial restructuring is also varied. In particular, deep restructuring of large-scale capital-intensive industries will be a far greater challenge in Russia and Central Asia than in central Europe, where heavy industries have started to grow again, often supported by inflows of FDI.

Country assessments

Since 1994, the EBRD has presented annual assessments of progress in transition for each country in its *Transition Reports*. These assessments have highlighted key developments and issues central to the process of transition in a wide range of areas, including liberalisation, macroeconomic stabilisation, privatisation, enterprises, infrastructure, financial sector and social sector. The key reform challenges facing the country are summarised at the beginning of the text. The assessment is complemented by a timeline of important historical events in the transition process.

To provide a quantitative foundation for analysing progress in transition, each country assessment includes a table of structural indicators. This table is grouped into the same categories as the text of the transition assessment, except for macroeconomic stabilisation. This aspect is covered by a separate table on macroeconomic performance.

At the top of the structural indicators table are a set of “snapshots” to provide an overview of selected institutional and legal arrangements as of October 1999. The table itself provides indicators of progress in structural change within each category. These data help to describe the process of transition in a particular country, but they are not intended to be comprehensive. Given the inherent difficulties of measuring structural change, they cannot give a complete account or precise measurement of progress in transition. Moreover, some entries, such as the exchange rate regime and the privatisation methods, are useful only for information and carry no normative content. Other variables may have normative content, but their evaluation may vary depending on the specific country context.

The data should be interpreted with caution also because their quality varies across countries and categories. The data are based on a wide variety of sources, including national authorities, EBRD staff estimates, and other international organisations. To strengthen the degree of cross-country comparability, much of the data were collected through standardised EBRD surveys of national authorities. The technical notes at the end of this section provide definitions of the variables, along with country-specific qualifications.

Key reform challenges

- With the end of the conflict in neighbouring Kosovo, Albania will have an opportunity to benefit from regional reconstruction. Strengthening the country's weak infrastructure is a priority.
- Several strategic utilities and one of the main banks are scheduled for privatisation in 1999. A smooth implementation of this programme, with the participation of foreign investors, would send a strong positive signal to the international investor community.
- The investment climate remains difficult, particularly for foreign investors. Progress in improving security is necessary to attract significant investment from abroad.

Liberalisation

Albania is advancing towards WTO membership.

In the past year, Albania made significant strides towards meeting the requirements of WTO membership. Albania introduced in January 1999 a new maximum tariff rate of 20%, with about two-thirds of all goods rated at 10% or less. Current excise taxes on imported and domestically produced goods have been harmonised. Full membership of the WTO is expected soon. A new customs code was adopted by parliament in January 1999 and came into force in May 1999. Since April 1999, there are only three non-zero tariffs. The unweighted average tariff is now about 14%. The government has also taken recent steps to improve customs collection, including the recruitment of new anti-smuggling officers and the adjustment of reference prices for imports in line with market prices.

Closer cooperation with the EU is expected.

Following the crisis in Kosovo, the European Commission has proposed a new "Stabilisation and Association Agreement" for several non-member countries in the region, including Albania. Negotiations with Albania are expected to begin shortly. This agreement would lead to enhanced cooperation across a number of dimensions and eventually to free trade in industrial products.

Stabilisation

Stabilisation policies are holding firm despite pressures from the Kosovo crisis.

The Kosovo crisis and the influx of more than 400,000 refugees imposed a severe fiscal and social burden on Albania. However, the country has benefited from substantial support from the international community. Trade has remained resilient, since Albania conducted only a minimal amount of trade with or through Serbia. The economy is thus expected to grow this year. Prices and the exchange rate are holding steady. Prior to the conflict in Kosovo, Albania was making good progress in stabilisation, recovering strongly

from the 1997 crisis. GDP growth in 1998 rebounded to 8%. By June 1999, annual inflation had been reduced to below 0%.

A new tax law aims to simplify tax procedures and boost revenues.

Tax revenues remain very low, at around 13% of GDP. In an effort to boost tax revenues, the government introduced a new tax law, effective from January 1999. The law raised the top rate of income tax to 30% and set the rate of profit tax also at 30%. Strict limits on exemptions from profit tax have been introduced and tax holidays have been abolished. While the Albanian business community initially expressed concerns about aspects of the draft law, in particular the withholding of tax on interest payments and the calculation of depreciation allowances, subsequent clarifications have allayed these concerns.

Privatisation

Remaining state-owned SMEs are gradually being divested.

Small-scale privatisation proceeded rapidly in the early stages of transition. By mid-1998, 469 SMEs remained in state hands. Of these enterprises, more than 300 had been sold, liquidated, leased or closed by the end of June 1999. The divestment by the state of the remainder is expected before the end of the year.

Large-scale privatisation is proceeding slowly.

The crisis in Kosovo has contributed to delays in the privatisation of large, strategic enterprises. However, with the end of the conflict, there are new opportunities to attract foreign investors. Strategic sectors (in addition to infrastructure and finance) scheduled for privatisation in 1999 include mining and petroleum. Restructuring programmes are under way in both of these sectors. In addition, the government has liquidated two of the three remaining large, loss-making enterprises that had been placed under the control of the Enterprise Restructuring Agency (ERA). The sale of the third to a foreign company was delayed by the Kosovo war. It is important to regain momentum lost during the crisis.

Liberalisation, stabilisation, privatisation

1991

Mar Small-scale privatisation begins

1992

Jul Full current account convertibility introduced
Jul Exchange rate unified
Jul All quantitative controls on foreign trade removed
Aug Most prices liberalised

1993

Apr Restitution law for non-agricultural land adopted
May Privatisation of housing begins
Jun Privatisation agency established

1994

Jan Modernisation of tax administration begins
Aug T-bills market initiated

1995

Apr Voucher privatisation begins
Jul Land titles introduced

1996

Feb Central bank independence law adopted
Jul VAT introduced

1997

Mar Widespread rioting and looting
Oct VAT increased
Nov Emergency IMF assistance approved

1998

May Three-year ESAF programme agreed with IMF
Dec Comprehensive new tax law adopted

Land registration in the agriculture sector is proceeding rapidly.

The authorities have made considerable progress in land registration. By March 1999, land registration had been completed in more than 1,000 cadastral zones, about 40% of the total land by area. This process is enabling a viable market in agricultural land to emerge. By December 1998, more than 2,000 sales of agricultural land had taken place, and by March 1999 the number had increased sharply to around 5,000.

Enterprises, infrastructure, finance and social reforms

1992

Apr Two-tiered banking system established

1993

Jul First foreign-owned bank opened
Jul Enterprise restructuring agency established

1995

Jul Competition law enacted
Oct Bankruptcy law enacted

1996

Mar Securities and exchange commission established
May Stock exchange established
Jul First large enterprise liquidated
Dec First pyramid scheme collapsed

1997

Jul Law on transparency adopted
Nov Pyramid schemes placed under international administration

1998

Mar State-owned Rural Commercial Bank closed
Jul Banking law amended

Enterprise reform

The enterprise sector remains dominated by SMEs, which continue to face numerous obstacles to growth.

Around 98% of Albanian enterprises consist of ten employees or fewer, with the majority comprising just one person or family. These account for about 40% of employees in the enterprise sector. Surveys show that enterprises encounter many bureaucratic obstacles that prevent their growth and development. According to a 1998 survey funded by the EC, most rely on personal savings or remittances from family members living abroad in order to establish or expand their business, as other sources of capital are either too expensive or simply unavailable. An EBRD survey of more than 100 enterprises in mid-1999 revealed that competition from the informal sector is a key concern of many businesses, in addition to high tax rates.

Infrastructure

The energy sector remains in crisis, with the state electricity company near to bankruptcy.

A state-owned enterprise continues to dominate the energy sector. This company, the Albanian Energy Corporation (KESH), is on the verge of bankruptcy because of non-payment and theft of electricity. Planned foreign investments by the World Bank and EBRD are frozen because KESH is unable to meet targets on non-technical losses and tariff collection. Distribution losses were running at nearly 50% in 1998. A package of laws designed to address these problems was presented to the Council of Ministers earlier this year, but has not yet been implemented. Although there has been very little progress towards privatisation in this sector, a pilot privatisation programme for regional distribution companies is under way in Shkoder, Elbasan and Vlorë.

Private participation in telecommunications is to increase.

Telecommunications is likely to be the first infrastructure sector scheduled for comprehensive privatisation. At present, there are two state-owned companies in this sector: the fixed-line company Albanian Telecommunications (AT) and Albanian Mobile Company (AMC), which is at present the sole provider of GSM mobile telephone services. The government approved a new sector policy in June 1999, which provides for the full privatisation of AMC through the sale of at least 85% of shares to strategic investors, with the remainder to prescribed parties. Commercial competition in the mobile sector is expected once the second GSM licence is awarded in 2000. In July 1999, AT entered a joint venture agreement with a US company. The implications of this for privatisation and competition in the sector are unclear at present.

Financial institutions

Progress in privatisation of the two state-owned banks is proceeding gradually.

Albania's banking sector remains dominated by two state-owned banks, the National Commercial Bank (NCB) and the Savings Bank (SB), which together account for over 70% of total banking assets. A strategic investor for NCB was selected through a competitive tender in May 1999. The EBRD and IFC will also participate in the privatisation as minority investors. Under an agreement with the IMF, the government has agreed to submit a privatisation law on SB to parliament before October 1999 and to select a buyer before April 2000.

The central bank is relaxing credit ceilings.

Following the pyramid scheme crisis of 1997, the Bank of Albania (the central bank) applied tight credit controls over all individual banks. These ceilings are now being removed for most private banks. While the ceilings were non-binding in most cases, they were perceived as a deterrent to new investment in banks. The two state-owned banks, however, are still prohibited for prudential purposes from expanding net credit, as their ratio of bad loans to total loans continue to exceed the legal limit.

Social reform

Poverty remains widespread throughout the country, although the effects of the Kosovo crisis have been smaller than anticipated.

Despite strong growth last year, Albania remains the poorest country in Europe, with a per capita GDP of around US\$ 800. Unemployment is widespread and the full extent of the problem is masked by non-registration, since benefits are not paid to the long-term unemployed, and by large-scale emigration. The influx of more than 400,000 refugees from Kosovo during the first half of 1999 imposed an enormous strain on social services and the budget. However, the end of the conflict in June 1999 was quickly followed by the return of most refugees. The vast majority were back in Kosovo by the end of July.

Improved targeting of social benefits and pension reform are planned.

The government plans to implement a number of measures over the next two years to increase social assistance to vulnerable groups. These include setting up a database of recipients and moving towards community-based delivery of social assistance to improve the efficiency of the distribution of social benefits. With regard to pension reform, the government intends to develop a system for rural residents based on actuarial principles and to link pension payments to contributions. The present system is not financially viable over the long term.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator ¹ – yes	Share of the population in poverty – not available
Interest rate liberalisation – limited de jure	Secondary privatisation method – vouchers	Separation of railway accounts – no	Private pension funds – no
Wage regulation – no	Tradability of land – limited de facto	Independent electricity regulator ¹ – yes	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 15.8%	Competition office – yes	Capital adequacy ratio – 6%	
Exchange rate regime – managed float		Deposit insurance system – no	
		Secured transactions law – restricted	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of exports to non-transition countries (per cent)	na	na	na	na	na	na	na	na	na
Share of trade in GDP (per cent) ²	14.6	15.7	45.4	30.1	18.8	18.3	21.4	18.8	17.3
Tariff revenues (per cent of imports)	na	na	3.5	5.7	10.9	9.9	8.0	8.7	10.2
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	1.0	1.8	2.9	3.1	3.3	3.5	3.6
Private sector share in GDP	5.0	5.0	10.0	40.0	50.0	60.0	75.0	75.0	75.0
EBRD index of small-scale privatisation	na	na	na	na	3.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	1.0	2.0	2.0	2.0	2.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	7.6	1.9	1.2	0.6	0.4	0.5	na
Efficiency of tax collection for social security (per cent)	na	na	na	na	na	na	na	37.3	na
Share of industry and construction in total employment (per cent)	na	na	na	na	na	na	na	na	na
Change in labour productivity in industry (per cent)	na	na	na	na	na	na	na	na	na
Investment rate (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	1.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	1.2	1.3	1.3	1.3	1.4	1.3	1.9	2.3	3.7
Railway labour productivity (1989=100)	103.4	47.9	34.0	33.7	33.6	33.3	37.6	21.4	28.5
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	na	na	3 (50%)	3 (50%)	na
Electricity consumption/GDP (1989=100)	110.1	132.1	135.9	148.2	154.7	163.5	198.2	204.7	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.8
Financial institutions									
Number of banks (of which foreign-owned) ³	na	na	na	na	6 (3)	6 (3)	8 (3)	9 (3)	na
Asset share of state-owned banks (in per cent) ³	na	na	na	na	97.8	94.5	93.7	89.9	na
Bad loans (per cent of total loans) ⁴	na	na	na	na	na	34.9	40.1	91.3	na
Credit to private sector (per cent of GDP)	na	na	na	na	3.8	3.7	3.9	3.8	3.3
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	2.0	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	72.3	72.3	71.3	71.3	72.5	71.3	71.7	71.7	na
Basic school enrolment ratio (per cent)	90.7	88.5	85.9	86.6	87.6	na	na	na	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ Independent regulators are in place, but most regulatory functions are still carried out by the government.

² In 1992, shows large increase as a result of devaluation.

³ Excludes branches of foreign banks.

⁴ Includes loans of banks under forced administration.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-27.7	-7.2	9.6	9.4	8.9	9.1	-7.0	8.0	8.0
Industrial gross output	-42.0	-51.2	-10.0	-2.0	1.0	15.8	-5.6	4.1	na
Agricultural gross output	-17.4	18.5	10.4	10.3	10.6	0.5	1.0	5.0	na
Employment	(Percentage change)								
Labour force (annual average)	6.2	-4.2	0.4	1.3	1.8	1.8	1.8	na	na
Employment (annual average)	0.0	-28.9	-3.2	9.7	5.7	-2.5	-0.8	na	na
	(In per cent of labour force)								
Unemployment (annual average) ¹	8.9	27.9	29.0	19.6	16.9	12.4	14.9	17.7	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	35.5	226.0	85.0	22.6	7.8	12.7	32.1	20.6	2.0
Consumer prices (end-year)	104.1	236.6	30.9	15.8	6.0	17.4	42.1	8.7	2.0
Wages in budgetary institutions (end of period)	na	na	64.5	46.9	25.6	20.0	0.0	26.1	na
Government sector ²	(In per cent of GDP)								
General government balance	-31.0	-20.3	-14.4	-12.4	-10.3	-12.1	-12.6	-10.4	-13.8
General government expenditure	61.9	44.0	34.9	31.2	34.3	30.4	29.5	30.7	na
Monetary sector	(Percentage change)								
Broad money (end-year)	104.4	152.7	75.0	40.6	51.4	40.0	28.5	20.6	na
Domestic credit (end-year)	100.1	68.0	27.7	35.3	23.6	26.4	8.6	na	na
	(In per cent of GDP)								
Broad money	69.1	54.1	40.2	37.7	47.8	55.0	58.0	52.0	na
Interest and exchange rates	(In per cent per annum, end-year)								
Refinancing rate	na	40.0	34.0	25.0	20.5	24.0	32.0	23.0	na
Treasury bill rate (3-month maturity)	na	na	na	10.0	14.7	21.1	35.3	19.9	na
Deposit rate (one year) ³	5.0	32.0	23.0	16.5	13.7	19.1	28.5	16.5	na
Lending rate (one year) ⁴	8.0	39.0	30.0	20.0	21.0	28.8	43.0	35.0	na
	(Lek per US dollar)								
Exchange rate (end-year)	25.0	98.7	100.9	95.0	94.5	103.7	149.8	140.1	na
Exchange rate (annual average)	14.6	81.3	105.6	95.4	93.0	104.8	149.6	150.0	na
External sector	(In millions of US dollars)								
Current account	-249	-434	-365	-279	-176	-245	-276	-186	-450
Trade balance	-208	-454	-490	-460	-474	-692	-518	-620	-1,151
Exports	73	70	112	141	205	229	167	206	234
Imports	281	524	602	601	679	921	685	826	1,385
Foreign direct investment, net	8	32	45	65	89	97	42	45	43
Gross reserves (end-year), excluding gold	1	72	147	204	240	275	306	384	na
External debt stock	628	811	936	1,012	683	732	757	874	na
	(In months of current account expenditures, excluding transfers)								
Gross reserves (end-year), excluding gold	0.0	1.4	2.3	3.2	3.5	3.1	4.5	4.5	na
	(In per cent of current account revenues, excluding transfers)								
Debt service	33.0	37.2	16.8	19.6	2.4	6.0	6.2	6.1	na
Memorandum items	(Denominations as indicated)								
Population (in millions, annual average)	3.3	3.2	3.2	3.2	3.2	3.3	3.3	3.2	na
GDP (in billions of lek)	16.5	53.2	125.3	187.9	224.7	281.0	338.9	446.2	492.0
GDP per capita (in US dollars)	346.1	205.1	374.8	615.1	743.8	816.7	681.5	929.6	na
Share of industry in GDP (in per cent)	32.1	16.9	13.9	12.4	11.5	12.2	na	na	na
Share of agriculture in GDP (in per cent)	42.5	54.2	54.6	55.1	55.9	55.4	62.6	na	na
Current account/GDP (in per cent)	-22.1	-66.3	-30.8	-14.2	-7.3	-9.1	-12.2	-6.3	-12.5
External debt minus reserves (in US\$ millions)	627.0	739.0	789.0	808.0	443.0	457.0	451.0	490.0	na
External debt/GDP (in per cent)	55.7	123.9	78.9	51.4	28.3	27.3	33.4	29.4	na
External debt/exports (in per cent)	860.3	1,158.6	835.7	717.7	333.2	319.7	453.3	424.3	na

¹ Figures do not account for emigrant workers abroad who accounted for an estimated 18% of the total labour force in 1995.

² General government includes the state, municipalities and extrabudgetary funds. Budget balance on a commitment basis.

³ Until 1995 the figures show the floor of the band set by the central bank. Thereafter, data refer to weighted average interest rates on new 12-month deposits in commercial banks.

⁴ Until 1995 data refer to the guideline rate announced by the central bank. Thereafter data refer to weighted average interest rates for 1-year loans by commercial banks.

Key reform challenges

- **Armenia is heavily reliant on external financial assistance as national savings are negative. Cutting the budget deficit, promoting private savings and improving export competitiveness are essential in order to reduce external imbalances.**
- **The development of the private sector will remain limited without further efforts to improve access to finance, to strengthen financial intermediation, and to complete the nascent regulatory and legal framework for capital markets.**
- **The ongoing restructuring of the energy sector is essential to remove bottlenecks in power supply and reduce budget subsidies. Next reform steps are the creation of a wholesale market for electricity and the privatisation of distribution companies.**

Liberalisation

A new customs code paves the way for WTO accession.

Armenia applied to join the WTO in early 1995. Since then, it has advanced rapidly in trade liberalisation and accession to the WTO is expected by the end of 1999. The laws on customs duties and customs tariffs, approved in late 1998, resolved remaining inconsistencies with WTO provisions. The Partnership and Co-operation Agreement between the European Union and the South Caucasus countries, which include Armenia, Georgia and Azerbaijan, came into effect in July 1999. The Agreement aims to improve economic cooperation and trade within the region and with the European Union.

Stabilisation

Low national savings constrain domestic investment.

Domestic savings in Armenia, public and private, have been estimated at a negative 15% of GDP in 1998, reflecting the high public deficit and large private transfers and remittances inflows. As a result, investment as a share of GDP is low at 14%, and reliance on external financial assistance is significant. Following the major overhaul of the tax system in 1997, the government is now focusing on tax administration. Measures to improve fiscal management include the reduction in the number of extrabudgetary funds and the close monitoring of foreign loan disbursements. Late in 1998, the government established the Armenian Investment Company, which together with the Armenian Development Agency promotes foreign investment and export-oriented activities. Sustained growth of exports, which remain modest relative to GDP, is essential to maintain Armenia's debt service burden at manageable levels and reduce dependence on external savings.

Privatisation

The government aims to complete privatisation by 2000.

By mid-1999, 75% of medium-sized and large enterprises and over 85% of small enterprises had been privatised. The voucher programme, covering the majority of SMEs, ended in December 1998. The majority of vouchers were bought by enterprise insiders, leaving them effectively in control of privatised firms. Privatisation now takes place only through cash sales. The 1998-2000 Privatisation Programme envisages to complete privatisation by the end of 2000. However, the privatisation process has decelerated since late 1998 partly due to the economic slow-down that followed the Russian crisis and the reduced reform momentum during the campaign for parliamentary elections in May 1999. Also, the number of failed sales has increased as the majority of the remaining SMEs on offer have limited potential and a large amount of arrears. In late 1998 the government started liquidation procedures for 22 unsold firms.

The government faces criticism over sales of large companies to international investors.

By mid-1999, 10 out of 18 firms offered through international tender had been privatised. However, lack of transparency in the implementation of some deals and criticisms over selling prices have fed domestic opposition to international sales and undermined the investment climate for foreign investors. FDI inflows in 1998 reached US\$ 228 million, up from a cumulative total of US\$ 102 million during 1991-97, largely owing to revenues from international sales. Sales to foreign investors during the first half of 1999 have included holdings in tourism, a diamond factory, a chemical complex (sold to Russian investors) and the Yerevan Cognac Factory, which was sold for US\$ 28 million to a French investor, after lengthy negotiations.

Liberalisation, stabilisation, privatisation

1991

Jan	Land reform begins
May	Small-scale privatisation begins
Sep	Independence from Soviet Union

1992

Jan	VAT introduced
Jan	Foreign trade registration abolished
Aug	Privatisation law adopted

1993

Nov	New currency (dram) introduced
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1994

Jan	First privatisation programme adopted
Feb	Tradability of land permitted
May	Cease-fire in Nagorno-Karabakh
Oct	Voucher privatisation begins

1995

Apr	Large-scale privatisation begins
Apr	Export surrender requirement eliminated
Jul	Most prices liberalised

1997

May	Full current account convertibility introduced
May	Major tax reform
Nov	First international tenders launched
Dec	New privatisation law adopted

1998

Dec	New customs law adopted
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1999

Apr	New law on property rights adopted
Jun	Privatisation tender for power distribution companies announced
Jul	Partnership Agreement with EU effective

The main elements of the legal framework for commercial activities are in place.

A new civil code, which came into effect in January 1999, creates the legal framework for property rights and contract enforcement, and the legal and institutional framework for commercial banking activities. Late in 1998 and during 1999, the government has adopted several amendments to the recently overhauled tax system. In November 1998, following the adoption of the law on accountancy in May, the government mandated the transition to IAS accounts for certain sectors (e.g. energy, airlines) by January 2000. Although the main elements of corporate law are now in place, enforcement of laws and contracts remains weak, creating barriers for effective private sector development.

Enterprises, infrastructure, finance and social reforms

1992

Dec Central bank law adopted

1993

May Stock exchange established

1995

May Bankruptcy law adopted
Jun Foreign bank ownership allowed
Sep Banking crisis peaked
Sep T-bills market initiated

1996

Mar First foreign-owned bank opened
Jun Banking law amended
Jul IAS audit of banking system

1997

Jan Bankruptcy law enacted
Jun Energy Regulatory Commission established
Jun Energy law adopted
Jul Financial rehabilitation plan for the energy sector adopted
Dec National telecommunications operator privatised

1998

Feb Telecommunications law adopted
Feb Transport law adopted
Mar IAS accounting for banks introduced
May Law on accountancy adopted
Nov Securities and Exchange Commission established

1999

Jan New poverty benefits system introduced
Jan New civil code introduced
Jan Increase in Energy tariffs
Apr New reserve requirements for commercial banks

The industrial sector has undergone limited restructuring ...

Industrial output declined by 2.5% in 1998 and reached only around 45% per cent of the 1990 level. Industrial restructuring has been limited due to the accumulation of tax and energy arrears and limited capacity for bankruptcy enforcement, which have allowed insolvent enterprises to continue operations. Other factors hampering enterprise restructuring are the low levels of foreign investment, limited access to domestic finance and difficulties in accessing foreign markets, in part because of lack of border security. Moreover, the insider-dominated privatisation process has left enterprises with little new capital to undertake modernisation investments and no injection of new management skills.

... while the recovery of agriculture in 1998 may prove to be temporary.

In 1998, an exceptional harvest and declining employment led to productivity gains of 20% in agriculture. The trend over previous years had been sharp declines in productivity (-7.5% on average between 1994 and 1997), reflecting stagnating output and increases in employment in this sector. The development of the agricultural sector is constrained by land fragmentation, the lack of adequate distribution and transport infrastructure, and an underdeveloped food processing industry. In late 1998, the government approved a strategy for the financial rehabilitation of the irrigation sector. As a result of low tariffs and weak payment discipline, operational subsidies extended by the water sector to the economy represented 1.5% of GDP in 1998.

Infrastructure

Electricity distribution companies are offered for privatisation.

In September 1998 the government approved the revised reform programme for the energy sector, which includes efficiency improvement measures, debt workouts and tariff increases. After a rate increase in January 1999, tariffs now cover operating (but not full) costs. However, disappointing collection rates have affected planned investment and maintenance and the ability to import fuel. A net loss of US\$ 62 million is expected for the energy sector in 1999, equivalent to 3% of GDP. In the next stage of reforms the government plans to privatise distribution companies, with majority stakes offered to strategic investors, and to develop a regulatory and licensing framework for a wholesale electricity market. Tenders for the privatisation of the four electricity distribution companies were announced in June 1999. The privatisation of generation companies is scheduled for 2001.

Armentel, the national telecommunications operator, has encountered several difficulties since its privatisation.

The operations of Armentel, privatised to the Greek telecommunications company OTE in December 1997, have prompted public discontent and severe criticisms. New investments were below the levels originally pledged by the new owner, and tariffs increased in January 1999 at the same time as customers experienced unexpected disconnection and misdirection of cellular calls. In July 1999, the new government formed after the May 1999 elections brought a lawsuit against OTE and another former foreign shareholder for unpaid taxes, mostly accumulated during the pre-privatisation period.

Financial institutions

The banking sector strengthens as a result of tighter regulation ...

The central bank of Armenia has continued to tighten regulatory requirements on the country's 31 commercial banks. From April 1999, obligatory reserves can be held only in domestic currency and limits on open foreign exchange positions have been lowered to 30% of capital, with a reduction to 25% from January 2000. Minimal capital requirements for commercial banks are to increase to US\$ 1 million from January 2000, and will gradually rise to US\$ 5 million by 2007. The government completed the planned sale of residual stakes in commercial banks with the sale of its remaining 14% stake in Ardhbank in June 1999. A strategy for the restructuring and privatisation of the Saving Bank, the only state-owned bank, is being prepared.

... but financial intermediation remains very limited.

The banking system is still small and experiences difficulties in attracting deposits. Although deposits in commercial banks increased by over 50% in the 12 months to June 1999, they represent less than 10% of GDP. Most lending is available at short maturities only and at high interest rates. By mid-1999 real interest rates on loans with maturity less than a year were over 40%. Non-banking financial institutions, such as leasing organisations, insurance companies and investment funds are either non-existent or at a very early stage of development. A Securities and Exchange Commission was established in November 1998 and the preparatory work on a law on securities and a central depository was under way by mid-1999.

Social reform

The social safety net is being overhauled.

Amendments to the law of obligatory social security payments in December 1998 unified the social security tax to a single flat rate of 28% paid by employers (employees pay a flat 3% payroll tax). In January 1999, the government introduced a new system of family allowances, aiming to cut the number of families receiving benefits and to redirect allowances to the most needy. On average, the monthly benefit was raised around 30% to AMD 8,000 (US\$ 16). As part of a decentralisation effort, local governments were given more responsibility for the administration of poverty benefits, and the provision and financing of health and education services. The new State Health Agency, which started to operate in January 1999, will contract out health care services to public and private sector providers. The first law on education in Armenia was adopted in April 1999, introducing new financing mechanisms, and regulating the distribution of responsibilities between schools and other public bodies. Preparatory work on the introduction of pension reforms is expected to be completed in 1999.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Share of the population in poverty ¹ – 44%
Interest rate liberalisation – full	Secondary privatisation method – MEBOs	Separation of railway accounts – no	Private pension funds – no
Wage regulation – no	Tradability of land – full except foreigners	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 17.9%	Competition office – no	Capital adequacy ratio – 10%	
Exchange rate regime – managed float		Deposit insurance system – no	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	8.9	12.8	6.2	7.7	7.0	6.9
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	3.0	3.0	2.0	2.0	1.0	1.0	0.0
Share of exports to non-transition countries (per cent)	na	na	na	na	28.4	29.7	33.9	46.5	na
Share of trade in GDP (per cent)	na	na	48.5	42.1	43.2	34.8	32.9	31.5	29.8
Tariff revenues (per cent of imports)	na	na	0.2	1.5	0.8	1.1	1.9	2.7	2.3
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	2.0	3.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	4.4	4.4	7.7	28.1	55.8	77.8	82.6
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	0.0	0.1	0.1	0.1	0.1	6.6
Private sector share in GDP	10.0	30.0	35.0	40.0	40.0	45.0	50.0	55.0	75.0
EBRD index of small-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	na	na	na	na	1.0	2.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	12.8	0.9	0.1	0.4	na
Efficiency of tax collection for social security (per cent)	na	na	74.4	na	12.9	19.1	19.3	na	na
Share of industry and construction in total employment (per cent)	41.6	38.0	34.3	31.1	30.4	25.7	22.5	21.0	na
Change in labour productivity in industry (per cent)	-9.9	-0.2	-41.4	0.4	7.4	20.0	20.2	-2.2	4.8
Investment rate (per cent of GDP)	44.3	28.5	17.1	12.5	10.8	10.2	7.7	9.4	na
EBRD index of enterprise reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	1.0	1.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	15.7	15.8	15.7	15.6	15.6	15.5	15.4	15.0	na
Railway labour productivity (1989=100)	91.3	91.5	43.2	28.8	26.3	20.3	16.9	19.9	20.6
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	0.4 (na)	1.5 (na)	2.2 (76%)	3.3 (80%)	4.0 (81%)
Electricity consumption/GDP (1989=100)	105.6	121.9	185.8	149.6	128.1	109.8	119.8	100.8	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.1
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	na	41 (1)	35 (1)	33 (1)	30 (1)	32 (1)
Asset share of state-owned banks (in per cent)	na	na	na	na	1.9	2.4	3.2	3.4	3.7
Bad loans (per cent of total loans)	na	na	na	na	34.0	36.1	22.6	7.9	na
Credit to private sector (per cent of GDP)	na	na	na	8.5	11.1	7.3	5.6	6.1	8.6
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	0.2	1.0	1.2
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	2.0	2.3	2.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	1.0	1.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	9.7	10.3	11.7	7.9	3.4	4.4	3.4	2.9	3.1
Life expectancy at birth, total (years)	71.7	72.2	71.5	71.1	71.4	72.3	72.7	73.7	na
Basic school enrolment ratio (per cent)	94.6	91.6	91.1	86.4	82.2	81.4	82.8	82.9	na
Earnings inequality (Gini coefficient)	na	29.6	35.5	36.6	32.1	38.1	na	na	na

¹ Calculated using an international poverty line of US\$ 4 per day at PPP exchange rules (see methodological notes). World Bank estimates based on national data give a lower figure of 28% for 1998.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-17.1	-52.6	-14.8	5.4	6.9	5.8	3.1	7.2	4.0
Industrial gross output	na	na	-28.0	5.6	2.6	1.2	0.9	-2.5	na
Agricultural gross output	na	na	-18.5	3.1	4.0	1.7	-5.9	13.1	na
Employment	(Percentage change)								
Labour force (end-year)	na	na	1.4	-2.2	-0.8	0.1	-2.4	-2.4	na
Employment (end-year)	2.6	-5.6	-2.2	-3.6	-0.8	-2.7	-1.6	2.0	na
	(In per cent of labour force)								
Unemployment ¹	4.0	1.8	5.3	6.7	6.7	9.2	10.7	9.3	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	100.0	825.0	3,500	5,273	177	18.7	14.0	8.7	2.5
Consumer prices (end-year)	25.0	1,341.0	10,896	1,885	32	5.8	21.8	-1.3	8.0
Gross average monthly wages (annual average)	na	na	na	2,760	240	71.0	30.0	36.6	na
Government sector ²	(In per cent of GDP)								
General government balance	-1.9	-13.9	-54.7	-10.5	-11.0	-9.3	-5.9	-5.2	-5.5
General government expenditure	28.0	46.7	82.9	42.9	26.6	23.7	25.7	27.2	na
Monetary sector	(Percentage change)								
Broad money (end-year)	na	na	1,077	729	62.5	35.1	29.1	37.0	na
Domestic credit (end-year)	na	na	865	1,437	66.4	27.6	8.2	27.3	na
	(In per cent of GDP)								
Broad money	na	na	71.5	13.5	7.9	8.3	8.9	10.2	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate (weighted average)	na	na	na	na	na	48.6	36.4	41.0	na
Treasury bill rate (3-months)	na	na	na	na	37.8	41.4	45.9	58.7	na
Deposit rate ³	na	na	na	na	63.2	32.2	32.0	24.0	na
Lending rate ³	na	na	na	na	11.9	66.4	55.0	46.0	na
	(Dram per US dollar)								
Exchange rate (end-year)	na	2.1	75.0	405.5	402.0	435.0	495.0	518.4	na
Exchange rate (annual average)	na	na	9.1	288.7	405.9	414.0	491.0	504.9	na
External sector	(In millions of US dollars)								
Current account (excl. official transfers)	na	-194.8	-315.3	-231.4	-483.0	-428.0	-455.9	-503.0	-480.0
Trade balance	na	-102.4	-77.6	-128.3	-354.4	-470.0	-560.0	-681.9	-620.1
Exports	na	82.9	156.2	215.5	271.0	290.0	233.0	220.5	205.2
Imports	na	185.3	233.8	343.8	625.4	760.0	793.0	902.4	825.3
Foreign direct investment, net	na	0.0	0.0	2.6	19.1	22.0	51.9	232.4	150.0
Gross reserves (end-year), excluding gold	0.0	0.0	0.0	32.3	107.1	168.0	247.0	323.0	na
External debt stock	na	na	na	200.0	371.0	611.0	786.0	801.0	na
	(In months of imports of goods and services)								
Gross reserves (end-year), excluding gold	na	na	na	0.7	1.6	2.3	3.1	3.6	na
	(In per cent of exports of goods and services)								
Debt service	na	na	na	3.0	20.6	20.3	14.7	12.3	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.7	na
GDP (in millions of dram)	na	na	4,218	187,049	522,284	660,311	798,555	951,901	1,014,726
GDP per capita (in US dollars)	na	na	124	173	344	426	435	510	na
Share of industry in GDP (in per cent)	48.6	43.4	30.7	34.8	27.8	27.7	28.8	24.0	na
Share of agriculture in GDP (in per cent)	20.1	28.7	46.3	41.8	36.7	31.7	30.2	34.2	na
Current account/GDP (in per cent) ⁴	na	na	-68.1	-35.7	-37.5	-26.8	-28.0	-26.7	-25.8
External debt minus reserves (in US\$ millions)	na	na	na	167.7	263.9	443.0	539.0	478.0	na
External debt/GDP (in per cent)	na	na	na	30.9	28.8	38.3	48.3	42.5	na
External debt/exports (in per cent)	na	na	na	92.8	136.9	210.7	337.3	363.3	na

¹ Registered unemployment. Unofficial estimates place the true rate of unemployment at 25% in 1997.

² Consolidated accounts of the Republican government and the local authorities.

³ Weighted average rate for maturities of 15 days to less than one year.

⁴ Excludes official transfers.

Key reform challenges

- **Public sector reforms, including improvements in tax administration, customs procedures and the adoption of a new civil service law, are needed to enhance the investment climate.**
- **Privatisation needs to be restarted in order to safeguard public confidence in the process. The government should above all emphasise transparency in all future sales.**
- **With power sector reforms stalled, the government should set a clear timetable for privatisation of distribution companies and implementation of a new regulatory framework.**
- **The unbundling and restructuring of SOCAR, the integrated state oil company, would give a significant boost to upstream and downstream energy sectors, while greatly enhancing the transparency of how oil rents are distributed.**

Liberalisation

Azerbaijan consolidates trade liberalisation.

Azerbaijan has largely liberalised its trade and foreign exchange regime. Tariff rates are low and relatively uniform and tariff exemptions are few. A plan to lower the general tariff from the current 15% to 12% in 1999 was postponed due to revenue considerations. In January, Azerbaijan moved to the destination principle for VAT for most countries, while its application to trade with CIS countries is envisaged for January 2000. Although full current account convertibility applies in effect, official acceptance of the IMF's Article VIII is still outstanding.

Inefficient customs process could delay WTO accession.

The working party on Azerbaijan's accession to the WTO issued a review of the foreign trade regime in May 1999. In the run-up to WTO accession, envisaged around 2002, Azerbaijan is likely to face questioning over its customs administration, which remains characterised by bureaucratic bottlenecks and predatory practices. For instance, it is not uncommon for shuttle traders to face three separate customs inspections at the Azerbaijani border.

Stabilisation

After months of tight liquidity, the manat is devalued.

On 9 July 1999, the manat was devalued by 7% against the US dollar, after having remained the only CIS currency immune to the Russian crisis. However, this stability came at the price of increasing deflation and extremely tight liquidity in the economy. Given the Azerbaijan National Bank's comfortable reserve level and strong support from the IFIs, more devaluation and currency instability are unlikely.

Tax reforms are introduced to improve revenue performance.

Half of Azerbaijan's budget relies on oil and oil-related revenues. The fall in oil prices in 1998 led to a revenue shortfall of 24.5% relative to plan. In January 1999, the government presented a new draft tax code, presently awaiting presidential approval. Revenue-raising measures this year include increases in excise duties, the introduction of minimum taxes for small businesses in some branches of services, and stronger powers for the tax inspectorate to recover tax debts through the courts. However, large discretionary powers by the tax inspectorate continue to be an obstacle to local and foreign businesses.

Privatisation

Privatisation slows as the voucher programme faces resistance.

In voucher and cash auctions since May 1997, 954 mainly medium-sized enterprises (accounting for an estimated 10% of total assets of state firms) had been offered to private investors by July 1999. Of these, 170 were fully privatised. However, only one voucher and two cash auctions have taken place in the first eight months of 1999 and only around 10% of all issued vouchers have been redeemed. The process has been slowed by the opposition of key interests within the government, fuelled by allegations of untransparent practices of the State Privatisation Committee. Lack of attractive enterprises on offer had reduced prices of vouchers on the secondary market to around US\$ 10 by the middle of 1999 from around US\$ 45 a year earlier.

A new privatisation programme for strategic enterprises is delayed.

A new privatisation programme for 1999-2000, providing for the use of investment tenders in the sale of strategic state enterprises, still awaits presidential approval. It is unclear at present whether this will

Liberalisation, stabilisation, privatisation

1991

Jun Law on private ownership adopted
Oct Independence from Soviet Union

1992

Jan Most prices liberalised
Jan VAT introduced
Apr Foreign investment law adopted
Aug New currency (manat) introduced

1993

Jan Small-scale privatisation law adopted
Aug Inter-bank currency exchange begins trading

1994

Jan Manat becomes sole legal tender
May Cease-fire in Nagorno-Karabakh

1995

Mar Exchange rate unified
Apr First IMF programme approved
Sep Law on large-scale privatisation adopted

1996

Mar Small-scale privatisation begins
Jun Export surrender requirement abolished
Aug Land reform law adopted
Sep T-bills market initiated

1997

Mar Voucher privatisation begins
Jun New customs code adopted
Jul Adoption of new simplified tariff schedule

1999

Jan New tax code proposed by government
Jan New labour code adopted

complement or substitute the voucher programme – leaving voucher holders (the majority of them foreigners) in doubt over the value of their claims. Crucially, the list of qualifying enterprises under the new programme has not been published. The one strategic tender concluded in 1999 so far suggests that a combination of vouchers and cash will be used in future privatisations. In June a 56% stake in the Garadag cement factory was sold to a UK-US consortium for US\$ 2.56 million plus 400,000 vouchers (and 400,000 privatisation options – foreigners need to submit one option for each voucher). Additional investment commitments of US\$ 22.8 million over three years were also agreed. In September, the tender came under review by the SPC for non-fulfilment of commitments and may be cancelled.

Enterprises, infrastructure, finance and social reforms

1992

Aug Central bank law enacted

1994

Jul Bankruptcy law adopted
Jul Bank consolidation begins
Sep First international oil PSA
Nov Law on joint-stock companies adopted

1995

Jun Law on unfair competition adopted
Aug Railway law adopted

1996

Jun Revised central bank law and law on banking activity adopted
Aug Law on natural monopolies adopted
Sep Bank restructuring begins

1997

Feb Law on competitive government procurement adopted
Jun BIS capital adequacy enacted
Jun Amended bankruptcy law adopted
Jul Telecommunications law adopted
Dec Northern pipeline to Novorossiisk opened

1998

Apr Electricity law adopted
Aug Pledge law adopted
Sep New securities law adopted
Nov Tender for privatisation of International Bank authorised
Dec Western pipeline to Georgia opened

1999

Aug State Securities Committee begins work

Enterprise reform

The lack of bankruptcy enforcement exacerbates the arrears crisis.

The bankruptcy law of June 1997 has been little used, due to the lack of specific enforcement provisions as well as the requirement for a claimant to make a non-refundable deposit of 10% of the claimed sum with the economic court prior to consideration of the case. With slow progress in enterprise reform, the Russian crisis contributed to a surge in inter-enterprise arrears, rising from 177% of GDP to 222% of GDP between end-1997 and end-1998. Implicit state subsidies are being provided through arrears to the energy sector, the stock of which totalled 2.5% of GDP at end-1998.

Growth of the private sector is hampered by high effective tax rates and excessive bureaucracy.

Outside agriculture and retail trade outlets, private sector development remains stunted. In January 1999, corporate profit tax rates were reduced to 30% from 32%. However, due to the lack of deductibility for legitimate expenses (including interest charges), effective tax rates are considerably higher. Licensing requirements are onerous and often a source of corruption. The licensing authority in key sectors (e.g. domestic freight and passenger haulage, air transport, shipping and ports, as well as energy production and distribution) continues to rest with branch ministries with direct commercial interests in these sectors.

SOCAR is set to complete its financial audit by November 1999.

The State Oil Company of Azerbaijan (SOCAR) is the owner of the country's natural resource deposits and a partner to all 19 Production Sharing Agreements signed to date. SOCAR also owns all state-managed oil service enterprises and the country's two major refineries, and effectively acts as a regulatory authority over the hydrocarbons sector. To gain access to international capital markets, SOCAR is undergoing a financial audit of its 1997-98 results by Arthur Andersen. Whether this leads to the restructuring of SOCAR remains unclear.

Infrastructure

Reform of the power sector awaits government decision.

The April 1998 law on electricity provides for the unbundling of Azerienergy and the liberalisation and privatisation of power generation and distribution. However, implementation of reforms has been delayed due to resistance within the government and poor policy coordination. A proposal for the creation of a Ministry of Energy to take over present regulatory functions from Azerienergy (as well as Azerigas and SOCAR) is still under consideration. There is no firm commitment on the privatisation of the electricity distribution companies.

Transport bottlenecks impede SOCAR crude exports.

The majority of Azerbaijan's crude oil exports flow through two pipelines, each with an annual capacity of about 5 million tons. However, the northern pipeline, running through Chechnya to the Russian Black Sea port of Novorossiisk, has experienced several shut-downs this year, leading to export shortfalls for SOCAR of 350,000 tons of oil by June. The western pipeline, transporting oil from the Chirag production field to the Georgian port of Supsa, is operating at full capacity. While Russia has recently proposed an alternative rail transport route bypassing Chechnya, transport capacity may continue to constrain SOCAR.

Bank privatisation and restructuring are delayed.

Following a presidential decree in November 1998, a 20% stake in the country's largest and best-capitalised bank (International Bank of Azerbaijan, IBA) is to be offered for tender to a strategic investor. Although financial advisers for the sale have been retained, privatisation is unlikely before the end of 1999. Savingsbank is also to be privatised. The other two state banks, Agroprombank and Prominvestbank, are effectively insolvent, but the government has so far been reluctant to liquidate them. Gradual consolidation in the banking sector continues, with the number of banks declining to 74 in June 1999 from 84 a year ago. However, real competition is limited and several prominent foreign banks still wait for their licences.

A State Securities Commission is created.

The State Securities Commission (SSC) was created by the September 1998 securities law. The SSC plans to take a broad regulatory role, but its authority has been contested by the central bank and the Ministry of Finance. A July 1999 decree confirms the regulatory authority of the SSC and places it directly under presidential authority. The SSC plans new regulations allowing the issuance of simple debt securities, including promissory notes, bank drafts and cheques.

Social reform

Expenditure retrenchment in 1998 falls disproportionately on human capital spending.

Budget execution in 1998 was extremely tight, at only 70% of planned expenditures. Education and health care were particularly affected, with 68% and 53% of planned expenditures realised. At the same time, social transfers (mainly pensions) overshot spending targets by 44% last year. The 1999 budget envisages a reversal of these trends, but given estimated revenue shortfalls of 1.5% of GDP in 1999, further cuts in education and health care are likely.

Better targeting of social transfers is necessary to alleviate poverty among internally displaced persons.

Azerbaijan hosts around 800,000 Azeri refugees, displaced by the war with Armenia of 1988-94. The poverty rate among these people is far above average, with 75% below the poverty line (60% national average) and 35% earning less than half the amount required to purchase a subsistence food basket (20% national average). Given budgetary constraints, better-targeted social transfers are needed to alleviate their poverty.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Share of the population in poverty – 60%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – no	Private pension funds – no
Wage regulation – yes	Tradability of land – limited de jure	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 15.3%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system – no	
		Secured transactions law – restricted	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	77.0	77.0	8.0	6.0	6.0
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	12.0	12.0	4.0	3.0	3.0
Share of exports to non-transition countries (per cent)	na	na	na	na	15.8	22.2	24.5	29.9	na
Share of trade in GDP (per cent)	na	na	63.3	54.9	58.4	33.8	33.5	28.3	29.2
Tariff revenues (per cent of imports)	na	na	na	1.4	1.1	1.6	1.9	4.3	4.4
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	1.0	2.0	2.0	2.3	3.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	33.0	71.0	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	0.0	0.0	0.0	0.1	1.1	2.0
Private sector share in GDP	10.0	10.0	10.0	10.0	20.0	25.0	25.0	40.0	50.0
EBRD index of small-scale privatisation	na	na	na	na	1.0	1.0	2.0	3.0	3.0
EBRD index of large-scale privatisation	na	na	na	na	1.0	1.0	1.0	2.0	2.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	11.2	4.6	5.4	2.2	2.1	0.7	na
Efficiency of tax collection for social security (per cent)	na	na	39.2	44.8	39.6	23.5	31.0	34.5	na
Share of industry and construction in total employment (per cent)	24.8	23.1	22.4	20.7	19.8	18.9	15.4	13.6	na
Change in labour productivity in industry (per cent)	-3.5	7.3	-19.0	-12.0	-21.0	-16.6	16.1	17.3	3.0
Investment rate (per cent of GDP)	na	na	na	19.0	23.5	13.1	23.5	27.1	na
EBRD index of enterprise reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	8.7	8.7	9.0	8.8	8.5	8.3	8.5	8.7	8.9
Railway labour productivity (1989=100)	91.4	76.1	36.9	28.3	19.2	8.5	9.2	11.7	16.1
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	0.67 (na)	1.98 (39%)	2.48 (41%)	2.7 (56%)	na
Electricity consumption/GDP (1989=100)	108.6	102.4	92.7	121.5	141.2	156.3	152.7	146.6	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.8
Financial institutions									
Number of banks (of which foreign-owned)	13 (na)	43 (na)	120 (na)	164 (1)	210 (1)	180 (2)	136 (3)	99 (3)	79 (3)
Asset share of state-owned banks (in per cent)	na	na	88.7	80.4	77.6	80.5	77.6	80.9	65.5
Bad loans (per cent of total loans) ¹	na	7.1	6.7	26.6	15.7	22.3	20.2	19.9	19.6
Credit to private sector (per cent of GDP)	na	na	10.8	9.6	3.3	1.2	1.2	2.5	3.3
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	1.0	1.0	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.3	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	1.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	1.0	9.4	10.9	6.8	4.9	5.2	5.0	na
Life expectancy at birth, total (years)	70.8	70.3	69.5	69.4	69.4	68.3	69.2	70.9	na
Basic school enrolment ratio (per cent)	90.5	90.5	91.3	92.4	94.2	94.4	95.4	96.6	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	45.8	na	na

¹ Refers to overdue credits.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.1	3.7
Industrial gross output	-8.9	-30.4	-19.7	-24.8	-21.4	-6.7	0.2	2.2	0.0
Agricultural gross output	-2.6	-25.0	-15.4	-13.0	-6.8	3.1	-6.9	4.0	2.0
Employment 1	(Percentage change)								
Labour force (end-year)	na	na	0.5	-3.1	1.6	5.1	0.2	na	na
Employment (end-year)	na	-1.7	-0.2	-2.3	-0.5	2.0	0.2	na	na
Unemployment	na	15.4	16.0	15.2	17.0	19.4	19.3	na	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	107.0	912.0	1,129.0	1,664.0	411.7	19.7	3.4	-0.8	-8.3
Consumer prices (end-year)	126.0	1,395.0	1,294.0	1,788.0	84.5	6.5	0.3	-7.6	2.0
Gross average monthly wages in industry (annual average)	83	871	701	576	355	53	33	20	na
Government sector 2	(In per cent of GDP)								
General government balance	na	na	-15.3	-12.1	-4.9	-2.8	-1.7	-4.2	-4.0
General government expenditure	na	na	55.9	45.9	22.4	20.4	21.4	21.5	na
Monetary sector	(Percentage change)								
Broad money M3 (end-year)	na	na	821.2	1,114.0	24.0	18.9	33.6	-9.7	na
Domestic credit (end-year)	na	na	480.0	841.0	61.0	33.2	11.1	11.4	na
Broad money (M3)	na	39.0	54.9	55.9	12.2	11.3	13.4	10.2	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate 3	na	13.0	144.0	406.0	144.0	36.0	22.9	23.2	na
Treasury bill rate (three-month maturity)	na	na	na	na	na	26.4	13.6	14.8	na
Deposit rate 4	na	10.0	34.0	406.0	90.0	13.0	11.5	10.9	na
Lending rate 4	na	60.0	257.0	406.0	107.0	33.0	21.5	27.7	na
Exchange rate (end-year)	na	45	238	4,330	4,440	4,098	3,888	3,883	na
Exchange rate (annual average)	na	na	120	1,432	4,417	4,301	3,983	3,869	na
External sector	(In millions of US dollars)								
Current account	153	488	2	-121	-317	-811	-914	-1,363	-1,082
Trade balance	-41	489	-5	-163	-275	-549	-567	-1,046	-800
Exports	295	1,275	716	682	680	789	808	678	850
Imports	336	786	721	845	955	1,338	1,375	1,724	1,650
Foreign direct investment, net 5	na	na	20	22	282	661	1,093	1,024	780
Gross reserves (end-year), excluding gold	na	0	0	2	119	214	467	448	na
External debt stock	na	na	na	230	420	560	570	684	na
Gross reserves (end-year), excluding gold	na	0.0	0.0	na	1.1	1.4	2.6	2.2	na
Debt service	na	na	na	4.2	9.3	7.3	5.2	6.7	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	7.24	7.30	7.36	7.42	7.47	7.51	7.57	7.62	na
GDP (in billions of manat) 6	2.7	24	157	1,873	10,669	13,663	15,352	15,930	16,525
GDP per capita (in US dollars) 7	na	364	223	176	323	423	510	540	na
Share of industry in GDP (in per cent)	23.6	29.4	25.0	20.4	27.3	25.8	24.8	na	na
Share of agriculture in GDP (in per cent)	30.4	25.9	26.9	32.2	25.1	24.7	20.0	na	na
Current account/GDP (in per cent)	190.8	458.0	0.2	-9.2	-13.1	-25.5	-23.7	-33.1	-27.2
External debt minus reserves (in US\$ millions)	na	na	na	228	301	346	103	236	na
External debt/GDP (in per cent)	na	na	na	17.6	17.4	17.6	14.8	16.6	na
External debt/exports (in per cent)	na	na	na	33.7	61.8	71.0	70.5	100.9	na

1 Employment and labour force estimates differ from official statistics. Labour force data are corrected for the working age population outside the labour force. Unemployment is based on survey data. Less than 5% of all unemployed are registered.

2 General government includes the state, municipalities and extrabudgetary funds.

3 Central bank's compounded refinancing rate 1992-95. Inter-bank offer rate thereafter.

4 1993-95: minimum rate for household time deposits, minimum lending rate for private enterprises, respectively. From 1996, 3-month deposit and lending rates, weighted average, compounded.

5 Includes portfolio investment and oil bonus payments to the government.

6 GDP figures in roubles for 1991 were converted at the rate of 10 roubles per manat.

7 GDP per capita figures for 1992-93 are estimates from the IMF. The manat became official legal tender only in January 1994.

Key reform challenges

- **Belarus has yet to implement consistent liberalisation of prices and trade, and to establish basic market mechanisms to lay the foundation for sustainable growth and private sector development.**
- **Monetary and credit tightening are crucial first steps in regaining macroeconomic stability and in strengthening an increasingly fragile banking sector.**
- **Rapid and determined privatisation and enforcement of hard budget constraints on state-owned enterprises are needed to kick-start the process of restructuring industrial and agricultural firms and to raise the low levels of foreign investments.**

Liberalisation

Price controls are being tightened in an attempt to curb accelerating inflation.

Since late 1996, the government has gradually reversed the process of price liberalisation, replacing informal price controls with administrative measures. In May 1999, a presidential decree banned any price rise that is not compensated for by measures of social protection, and mandated the Council of Ministers and the National Bank of Belarus (NBB) to set annual limits for price indices. The decree also introduced a wide-ranging list of goods and services subject to state price regulation, including products and services supplied by monopolies, rents, and basic food products and spirits. Despite the strict price regulations in place, inflation has continued to increase far above the 2% monthly target.

Access to foreign currency remains limited despite exchange rate unification.

In March 1999, in the context of resumed talks with the IMF, the government unified the official exchange rate and the "rate set by the National Bank", the latter introduced in November 1998 for accounting purposes, and eliminated the afternoon official currency trading session. However, by September 1999 the government had failed to make further progress towards convertibility. The afternoon trading session was reinstated in September, the interbank market was closed for transactions above 1,000 units of foreign currency, and enterprises were prohibited from buying foreign currency from foreign entities. Moreover, following the unification in January 1999 of currency surrender requirements at 30% of revenues for exporters, commercial banks and domestic retailers, this was subsequently raised to 40%, the rate that had applied to exports prior to the unification.

A tax on barter is introduced following an increase in non-monetary transactions with Russia.

The combination of price controls, exchange rate distortions and the difficulties faced by Russian companies has led to an increase of barter operations with Russia to over 50% of trade turnover during the first five months

of 1999. A presidential decree, effective from July 1999, introduced a 15% general tax on barter transactions, with a lower rate of 5% applying to imports of raw materials and intermediaries. Some socially important goods (such as medicines and basic foodstuffs) and selected companies are exempted. The decree also calls for the reduction of barter deals by 15% by mid-2000, which could lead to a contraction of external trade as exporters have limited access to hard currency.

Stabilisation

Falling real incomes and increasing demonetisation may jeopardise recent attempts to regain monetary control.

Output growth in Belarus has been fuelled by directed credits, estimated at 4% of GDP in 1998, to all sectors in the economy. Although the NBB has tried to tighten monetary emissions during the first quarter of 1999, the monetary target for 1999 had already been exceeded by September. Monetary growth has prompted increasing currency substitution while fuelling currency depreciation. The ratio of M2 to GDP was around 15% by the end of 1998, while private holdings of US\$ were estimated at around 20% of GDP. Although the official exchange rate has devalued by over 400% between September 1998 and June 1999, the premium on the parallel market remains high at 77%.

Privatisation

The privatisation of large state enterprises remains stalled.

Privatisation of communal enterprises, mainly SMEs, has been significantly faster than privatisation of republican assets, mainly large industrial and agricultural companies. By mid-1999, 40% of the communal property and only 10% of republican property targeted for privatisation in 1993 had been privatised. The latter figure increases to 20% if firms are included that have been transformed into joint-stock companies or have sold minority stakes. None of the 40 firms transformed into joint-stock companies during 1998 were privatised. The voucher programme launched in 1994 has resulted in less than 40%

Liberalisation, stabilisation, privatisation

1990

Oct Small-scale privatisation begins

1991

Jul Independence from Soviet Union

1992

Jan VAT introduced
May New currency (Belarussian rouble) introduced

1993

Jan Privatisation law adopted

1994

Feb T-bills market initiated
Apr Voucher privatisation begins
Aug Belarussian rouble becomes sole legal tender

1995

Jan Customs union with Russia and Kazakhstan
Jun Most prices liberalised

1996

Jan Currency corridor established
Dec Price controls reintroduced

1997

Feb Currency corridor abandoned
Apr Belarussian-Russian Union Treaty

1998

Jul New custom code adopted
Jul First voucher auction held in two years
Nov Dual exchange rates introduced

1999

Mar Profit and income tax laws amended
Mar Dual exchange rates abolished

of vouchers being redeemed for shares. The re-purchase of the remaining vouchers, originally planned for mid-1999, is likely to be postponed as it would imply budgetary costs of 10% of GDP.

Despite plans to accelerate trade sales, the government is likely to retain majority control.

In mid-1999, the government announced plans to accelerate the sale of shares in state-owned companies, aiming to increase privatisation revenues which amounted to just US\$ 0.2 million in 1998. Although the government is willing to attract foreign capital, it is unlikely that it will offer majority stakes – thus discouraging foreign investors. According to the existing legislation, sales of stakes over 50% in industrial companies

Enterprises, infrastructure, finance and social reforms

1991

May Bankruptcy law adopted

1992

Dec Competition law adopted

1993

Mar Stock exchange established

1995

Apr Investment funds' licences suspended

1996

Feb All enterprises required to re-register
Apr Inter-bank currency exchange nationalised
May State share in commercial banks increased

1997

Dec Energy regulation transferred to ministry of economy

1998

Jan Golden share rights for state in private companies introduced
Mar NBB control transferred to government
Jul Belarus Stock Exchange nationalised
Sep Registration of new private businesses suspended

1999

Jan Railway law adopted
Jan New civil code adopted
Jan New land code adopted
Mar New (unfavourable) business registration procedures adopted

are forbidden, while sales of shares with a book value over US\$ 40,000 require the approval of the President. In May 1999, the parliament decided that utilities, local infrastructure and energy companies will remain under full state control.

Enterprise reform

Industry is being sustained by state orders and the accumulation of unsold products and energy arrears.

Reported year-on-year industrial output growth slowed to 4% in the first quarter of 1999, down from 13% a year earlier. Inter-enterprise arrears increased to 70% of GDP by the end of 1998 and unsold stocks represented nearly 40% of total industrial output by March 1999. The share of loss-making enterprises in the state sector is estimated at 27%. Belarus's industry continues to be highly dependent on energy imports, especially on gas supplies from Gazprom (see Infrastructure below).

State control over the private sector increases with the introduction of new registration procedures.

In September 1998, a presidential decree suspended the registration of new enterprises on the grounds that around 17% of registered business were idle or used to evade taxes. The new re-registration procedures, adopted in March 1999, oblige all firms and banks to re-register by January 2001 and to increase their statutory capital in accordance with the growth of the minimum wage, an onerous requirement in a country with high inflation and hence frequent adjustments. The decree holds owners and shareholders of insolvent companies personally liable for corporate debts, practically eliminating the concept of limited liability in Belarus. A decree in February 1996 requiring re-registration resulted in a sharp decline in the number of private enterprises due to the administrative burden this entailed.

The government continues to subsidise an increasingly inefficient agricultural sector.

Agricultural production in Belarus remains mostly within the large state-owned or collective farms, 40% of which are estimated to make losses. Direct NBB loans and directed credits extended by commercial banks to agriculture totalled US\$ 40 million (over 2% of agricultural output in 1998) during the first half of 1999. These credits are typically extended at highly negative real interest rates and often not repaid on time, at no additional cost. Private farms operate significantly better as evidenced by their share in agricultural output, at 38% in 1998, while cultivating less than 1% of agricultural land. A new Land Code adopted in January 1999 allowed legal and physical entities to acquire property rights on land, subject to case-by-case approval by the President.

Infrastructure

The privatisation of state telecommunications is under preparation.

The government plans to privatise the national telecommunications operator, Beltelekom, by 2000, with an international privatisation tender (specifying the stake on offer) to be announced by mid-1999. The telephone network is undergoing modernisation, with the installation of automatic exchanges. However, facilities such as rapid data transmission are still underdeveloped. A GSM cellular digital communications system was launched in April 1999 by a joint network between two state-owned companies, which hold a controlling stake, and a Swiss investor. This breaks the monopoly enjoyed by Belsel, formerly Belarus's only cellular operator, and is likely to result in a significant reduction in cellular rates.

Belarus's economy continues to be sustained by energy subsidies from Gazprom.

Although Gazprom has repeatedly announced its intention to demand increased cash payment from Belarus, around 90% of gas deliveries are still paid through barter agreements with Belarussian firms. In March 1999, Gazprom agreed to reduce the price of gas supplies to Belarus to US\$ 30 per 1,000 cubic metres (half the price charged to Ukraine), down from US\$ 50. Despite subsidised prices, gas arrears were at US\$ 300 million by mid-1999.

Financial institutions

The banking sector is undercapitalised and its solvency threatened by directed credits.

The banking sector in Belarus remains dominated by state-owned banks, used to channel soft credits to the economy. Of the 28 commercial banks operating by mid-1999, the largest six, four of which are state-owned, controlled 80% of total assets. Due to considerable exposure in the GKO market, the banking sector was severely hit by the Russian crisis with estimated losses of US\$ 70 million. Exchange rate depreciation, moreover, led to a sharp fall in total share capital, to US\$ 110 million by April 1999, down from US\$ 240 million a year earlier.

Social reform

Poverty is on the increase, particularly among people dependent on state transfers.

Living standards have deteriorated despite high GDP growth rates. The share of population with disposable income below US\$ 90 per month (the national poverty threshold) had increased to nearly 44% by the end of 1998, compared with 32% in 1997. Although pension payments amounted to 10% of GDP in 1998, the average monthly pension was only US\$ 60 per month, or less than the poverty threshold. The ratio of pensioners to the active population is one half. Amendments to the pension legislation, mainly aimed at increasing the age of retirement, passed preliminary readings in the parliament late in 1998, but they have not yet been approved.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – limited	Primary privatisation method – MEBOs	Independent telecoms regulator – no	Share of the population in poverty – 23%
Interest rate liberalisation – limited de facto	Secondary privatisation method – vouchers	Separation of railway accounts – no	Private pension funds – no
Wage regulation – yes	Tradability of land – limited de jure	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 27.2%	Competition office – no	Capital adequacy ratio – 10%	
Exchange rate regime 1 – managed float		Deposit insurance system – yes	
		Secured transactions law – restricted	
		Securities commission – no	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	100.0	90.0	80.0	70.0	60.0	45.0	30.0	27.0	na
Number of goods with administered prices in EBRD-15 basket ²	na	6.0	5.0	5.0	5.0	5.0	5.0	5.0	na
Share of exports to non-transition countries (per cent)	na	na	na	na	18.4	20.6	14.1	9.9	na
Share of trade in GDP (per cent)	na	na	63.6	61.5	56.7	49.4	46.2	59.3	54.9
Tariff revenues (per cent of imports) ³	na	na	na	0.4	5.4	3.2	3.7	4.1	3.2
EBRD Index of price liberalisation	na	na	na	na	2.0	3.0	3.0	3.0	2.0
EBRD Index of forex and trade liberalisation	na	na	na	na	1.0	2.0	2.0	1.0	1.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	0.3	0.6	0.6	0.7	na
Private sector share in GDP	5.0	5.0	10.0	10.0	15.0	15.0	15.0	20.0	20.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	1.0	1.0	1.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	0.9	1.6	6.3	3.4	2.9	3.6	na
Efficiency of tax collection for social security (per cent)	na	na	56.1	45.7	49.3	58.7	59.9	63.4	na
Share of industry and construction in total employment (per cent)	42.0	41.5	39.9	38.2	36.9	34.4	34.7	34.7	na
Change in labour productivity in industry (per cent)	3.6	0.7	-3.5	-7.5	-13.2	-0.9	4.7	18.6	11.3
Investment rate (per cent of GDP)	22.2	22.3	25.4	33.9	33.2	25.0	22.0	24.7	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	1.0	1.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	15.4	16.4	17.1	17.8	18.6	19.0	20.8	22.6	24.1
Railway labour productivity (1989=100)	92.5	67.4	52.6	46.5	33.6	29.9	na	na	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	na	na	1.5 (80%)	1.1 (87%)	na
Electricity consumption/GDP (1989=100)	104.4	107.5	104.6	101.3	103.4	107.9	103.3	99.8	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.1
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	na	48 (na)	42 (1)	38 (1)	38 (2)	37 (3)
Asset share of state-owned banks (in per cent)	na	na	na	na	69.2	62.3	54.1	55.2	59.5
Bad loans (per cent of total loans) ⁴	na	na	na	na	8.4	11.8	14.2	12.7	16.5
Credit to private sector (per cent of GDP)	na	na	na	na	17.6	6.2	6.7	8.5	17.1
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	1.1	11.1	10.3	11.2	11.9	11.7
Life expectancy at birth, total (years)	70.8	70.4	70.0	69.0	68.8	68.5	68.6	68.5	na
Basic school enrolment ratio (per cent)	94.9	94.2	94.2	93.7	93.6	94.1	93.8	94.1	na
Earnings inequality (Gini coefficient)	na	na	34.1	39.9	na	na	na	na	na

¹ The exchange rate regime is characterised by multiple exchange rates (official non-cash rate, market cash rate, black market rate and parallel inter-bank market); the official rate is set administratively and the market cash rate is subject to a maximum.

² Data on price controls for coal, wood, rents and inter-city bus services were not available. Adding these to the number of controlled prices would bring the total up to 10 in 1991 and 9 in all subsequent years.

³ Refers to taxes on international trade.

⁴ Includes prolonged and doubtful debts.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	(Percentage change in real terms)								
GDP	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.3	1.5
Private consumption	-6.1	-7.9	-1.5	-13.4	-12.3	4.5	10.9	9.0	na
Public consumption	-7.7	-15.3	-10.5	-3.0	-2.9	-0.2	6.0	5.8	na
Gross fixed investment	4.4	-18.1	-15.4	-17.2	-28.7	7.2	14.7	9.4	na
Industrial gross output	-1.0	-9.4	-10.0	-17.1	-11.7	3.5	18.8	11.0	na
Agricultural gross output	-4.9	-8.5	3.7	-14.4	-4.7	2.4	-5.9	-0.9	na
Employment	(Percentage change)								
Labour force (annual average)	-2.2	-2.9	-0.6	-2.4	-5.7	0.1	-0.7	-0.3	na
Employment (annual average)	-2.5	-2.6	-1.3	-2.6	-6.2	-1.0	0.1	1.1	na
	(In per cent of labour force)								
Unemployment (end-year) ¹	0.1	0.5	1.4	2.1	2.7	3.9	2.8	2.3	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	84	971	1,190	2,221	709	53	64	73	265
Consumer prices (end-year)	93	1,559	1,996	1,960	244	39	63	182	155
Producer prices (annual average)	150	2,327	1,536	2,171	462	34	89	70	na
Producer prices (end-year)	na	3,275	2,316	1,867	122	31	89	200	na
Gross average monthly wages (annual average)	103	829	1,107	1,504	669	61	196	105	na
Government sector ²	(In per cent of GDP)								
General government balance	na	0.0	-1.9	-2.5	-1.9	-1.6	-0.7	-0.3	-3.0
General government expenditure	na	46.1	56.2	47.3	43.0	42.7	46.8	46.4	na
Monetary sector	(Percentage change)								
Broad money (end-year)	na	510	953.7	1,851.7	164.0	52.4	111.4	276.0	na
Domestic credit (end-year)	na	1,582	677.5	2,030.9	226.5	58.5	115.5	297.4	na
	(In per cent of GDP)								
Broad money	na	0.4	35.3	38.1	15.0	14.8	16.2	32.8	na
Interest and exchange rates	(In per cent per annum, end-year)								
Refinancing rate	na	30	210	300	66	35.0	40.0	48.0	na
Treasury bill rate (3-month maturity)	na	na	na	320	70	37.0	38.4	43.2	na
Deposit rate (1 year)	na	na	65	90	101	32.3	15.6	14.3	na
Lending rate (1 year)	na	na	72	149	175	62.3	31.8	27.0	na
	(Belarussian roubles per US dollar)								
Exchange rate (end-year) ³	134.0	51.0	698.0	10,600	11,500	15,500	30,740	107,000	na
Exchange rate (annual average) ³	33.7	17.2	269	3,666	11,529	13,292	26,193	46,376	na
External sector	(In millions of US dollars)								
Current account	na	na	-1,113	-641	-253	-503	-799	-944.6	-472.0
Trade balance	na	377	-1,051	-710	-761	-1,287	-1,388	-1,447.0	-903.0
Exports	na	3,580	2,812	2,641	4,803	5,652	7,301	7,081.0	6,537.0
Imports	na	3,203	3,863	3,351	5,564	6,939	8,689	8,528.0	7,440.0
Foreign direct investment, net	na	na	18.0	10.5	15.0	73.0	198.0	141.0	188.3
Gross reserves (end-year), excluding gold	na	na	91	101	377	369	394	345	na
External debt stock ⁴	na	570	1,014	2,197	2,689	2,142	2,345	2,518	na
	(In months of imports of goods and services)								
Gross reserves (end-year), excluding gold	na	na	0.1	0.4	0.8	0.6	0.5	0.5	na
	(In per cent of exports of goods and services)								
Debt service ⁵	na	0.0	0.4	4.3	2.9	2.3	2.0	1.6	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	10.2	10.3	10.3	10.3	10.3	10.2	10.2	10.2	10.2
GDP (in billions of Belarussian roubles)	87	92	986	17,815	119,813	184,174	356,079	662,370	2,452,491
GDP per capita (in US dollars)	251	518	355	472	1,012	1,354	1,332	1,396	na
Share of industry in GDP (in per cent) ⁶	na	40.4	30.9	30.8	31.4	34.6	36.9	38.4	na
Share of agriculture in GDP (in per cent) ⁶	na	23.8	18.3	15.0	17.7	16.0	14.1	12.7	na
Current account/GDP (in per cent)	na	na	-30.4	-13.2	-2.4	-3.6	-5.9	-6.6	-4.8
External debt minus reserves (in US\$ millions)	na	na	923	2,096	2,307	1,773	1,951	2,173	na
External debt/GDP (in per cent)	na	10.7	27.7	45.2	25.8	15.5	17.2	17.6	na
External debt/exports (in per cent)	na	15.9	51.5	87.5	55.9	37.0	31.8	35.6	na

¹ Officially registered unemployment.

² General government includes the state budget, social funds, and extrabudgetary funds, excluding interbudgetary transfers.

³ Official non-cash exchange rate. The premium on the parallel market was 30% by the end of 1997, but reached 300% by December 1998. 1998 Belarus US-dollar GDP would decline from a projected 14.3 billion, at the official non-cash rate, to 4.9 billion at the parallel market rate.

⁴ Medium and long-term public and publicly guaranteed debt. From 1994 the debt stock includes short-term external debt.

⁵ Amortisation of public and publicly guaranteed debt and total interest payments.

⁶ Figures are based on current prices.

Key reform challenges

- **After the long-delayed start of privatisation, the challenge is now to ensure rapid implementation. In the Federation, several small enterprises have been auctioned off against vouchers. Efforts must now move towards dealing with the large conglomerates that remain under unclear governance and towards attracting strategic investors.**
- **Progress in restructuring state banks and preparing their privatisation has been encouraging. To strengthen the banking system's credibility, it is crucial that the authorities follow through on commitments to liquidate insolvent banks.**
- **Economic governance must be improved. Unclear and contradictory legislation and administration of the business environment impede development of the new private sector and present obstacles to foreign investment.**

Liberalisation

Important tax and customs impediments to the common economic area are removed.

While a common customs tariff was agreed in March 1998, containing four rates and a low average, its effective implementation was being delayed by free-trade agreements between the Federation and Croatia, and RS and Federal Republic of Yugoslavia (FRY), respectively. Tax avoidance through the re-routing of trade was further encouraged by sharp differences in excise and sales taxes across the Entities. As a result, non-tariff impediments on the internal border abounded. Recently, the RS took steps towards reducing sales taxes and adjusting excises, bringing rates broadly into line with the Federation. After long delays, the free trade arrangements with Croatia and FRY were terminated in May 1999. At the same time, temporary import surcharges imposed by the Federation were replaced by a common list for the State of Bosnia and Herzegovina (BH). BH obtained observer status at the WTO in July 1999 and the promise of an EU Stabilisation and Association Agreement (under the Stability Pact) offers prospects for preferential access to the EU market.

Common currency finds increasing acceptance.

Monetary liabilities of the central bank have more than doubled since the introduction of the common currency Konvertibilna Marka (KM) in August 1997. Acceptance is highest in the Bosniak-majority areas, and lowest in Bosnian-Croat areas. In RS more than 50% of commercial bank deposits are now in KM. The Kosovo conflict has increased demand for the KM by further destabilising the Yugoslav dinar. There is agreement to ban the use of the Deutschmark and Croatian kuna in government transactions in the Federation (originally by June 1999), and mandate it as the unit of account for all financial transactions. However, target dates are slipping. Increased use of a common

currency is expected to promote the integration of payment systems across the country.

Stabilisation

Stability is sustained under the currency board arrangement.

The currency board arrangement, linking the KM to the DM at a 1/1 rate, is functioning well. KM-inflation is subdued at low single digits. Official reserves have been increasing rapidly and now represent around 3 months of imports (with virtually no non-official capital movements). Currency board rules prevent BH's different levels of government from contracting domestic debt. The IMF is enforcing strict limits on external borrowing (concessional debt only). Nevertheless, there have been breaches of financial discipline over the past year, with the occasional build-up of domestic arrears (for example, to pensioners and veterans), Federal government borrowing from the new Federation Investment Bank (FIB) and delays in settling Entity transfers to the State budget to cover external debt service. However, confronted with severe revenue shortfalls following the Kosovo conflict in early 1999, Federation and RS sharply compressed expenditures (each by around 30%).

Privatisation

Sales begin under small-scale privatisation scheme ...

Beginning in May 1999, several Federation cantons have conducted auctions and tenders for the sale of small-scale assets. Lists of eligible assets remain incomplete in several cantons, in particular in those with a Croat majority. The sales process is expected to stretch over 2-3 years. In the Federation, it covers enterprises of less than 50 employees and less than KM 500,000 book value, apart from parts, shares and/or property of enterprises and business premises. Bids under both auctions and tenders must include a cash component of at least 35%, with the remainder payable in "certificates"

Liberalisation, stabilisation, privatisation

1992

Mar Independence from Yugoslavia

1995

Dec Civil war ends

1996

Oct Law on privatisation agencies in the Federation enacted

1997

Aug Central bank of BH established

Aug Currency board established

Dec Federation law on privatisation enacted

1998

Jun Enterprise privatisation law adopted in RS

Jun Konvertibilna Marka bank notes introduced

Jul State umbrella law on privatisation adopted

Aug VAT introduced in RS

1999

Apr KM becomes convertible abroad

May Preferential trade regime with Croatia and FRY abolished

Jun Small-scale privatisation begins

(claim accounts). Given lacklustre demand at the early auctions, the cash requirement is likely to be lowered. Auctions cover price only, while tenders encompass buyer commitments to employment and investment targets. Certificates were issued in May to 1.9 million citizens of the Federation, against military back-pay, the value of frozen foreign currency savings (DM 2.4 billion), and "general claims" against employment history. There is public pressure to convert claims against frozen savings into government debt, a decision that would cause severe budgetary difficulties. RS held the first auctions under its cash privatisation programme in July 1999. In the RS, small-scale cash privatisation covers assets of less than KM 300,000 book value.

... but large-scale privatisation continues to be delayed.

While small-scale privatisation is now moving ahead, large-scale privatisation ("privatisation through public offering of shares") continues to be bogged down by delays and obstruction. Basic company data have still not been provided to the Federation Privatisation Agency by the cantonal agencies in Croat-majority cantons. Legal deadlines for ownership revision, preparation of opening balance sheets and presentation by companies of privatisation plans have been missed throughout the Federation. Of more than

Enterprises, infrastructure, finance and social reforms

1996

Jan Federation banking agency established

1998

Mar RS banking agency set up

Apr Law on bank privatisation enacted in the Federation

Jun New company law adopted

Jun Federation bank privatisation agency established

Jul RS bank privatisation agency set up

Sep New telecommunications law adopted

Oct New banking law adopted in the Federation

Dec Joint Power Coordination Center (JPCC) established

1999

Apr Minimum capital requirements raised

Apr Securities Commission established in the Federation

Jul Banking law adopted in RS

1,700 companies targeted for this mode of privatisation, less than 5% had complied by early August, raising serious doubts over commitments to initiate public offerings before the end of 1999. In large-scale privatisation, preference is given to strategic investors. Offerings of residual shares can be paid for with certificates, with no minimum cash requirement. The government is encouraging the creation of privatisation investment funds (none created so far), and there has been considerable controversy over “ethnic” political party sponsorship of such funds. Foreigners can use certificates in privatisations only through means of local intermediaries, but some have been active on the secondary market with certificates quoted at around 30% of their face value. RS follows essentially the same privatisation model but lags further behind in preparations. Certificate distribution in the RS is expected shortly, with first sales targeted for the second quarter of 2000.

Enterprise reform

Continuing impediments for business block restructuring.

The economy is burdened with the pervasive influence of bureaucracy and by the lack of capital and unclear governance in the state enterprise sector. Management remains effectively in charge in most enterprises. Delays in the privatisation process have limited access to investment finance and given rise to asset stripping (often through creation of “joint ventures” between state and private firms). Private businesses generally face a difficult or even hostile tax and administrative environment that has shed little of its socialist legacy. Inconsistent tax treatment tends to distort competition

and tops the list of concerns of businesses in surveys. The Council of Ministers has wide discretionary powers to grant tax exemptions, a system which is prone to abuse and has contributed to unfair competition. Business legislation in both Entities remains a patchwork of sometimes-inconsistent laws and regulations, dating back mostly to the Socialist Federal Republic of Yugoslavia and to wartime administrations, inviting informal activity. Legislative initiatives to address these problems have been subject to delay.

Infrastructure

Progress is made with inter-Entity infrastructure links.

The efficiency of infrastructure services has suffered from separation along ethnic lines. There has been recent progress in the power sector, with the establishment of a Joint Power Co-ordination Centre (JPCC) in late 1999. The JPCC is to work with the World Bank in preparing an electricity law and to coordinate the exchange of electricity between power providers. Other developments over the past year include the signing of an agreement which guarantees BH access to Croatia's Ploce port and customs-free trans-shipment. A new telecommunications law was imposed by the High Representative in September 1998, regulating international and inter-Entity traffic and establishing a single regulatory agency. Infrastructure throughout BH continues to be characterised by highly inadequate organisational, accounting and commercial practices. Power tariff collection ratios have not improved over the past year in the Croat and Bosniak areas (65% and 80%, respectively), but seem to have increased in the RS (now 98%). Telecommunications and the power sector are to be privatised in a “second wave”, beginning perhaps as early as 2000.

Financial institutions

A new banking law initiates sector restructuring.

A new and modern law on banks came into force in April 1999. Among its provisions is a doubling of minimum capital requirements to KM 5 million, which, together with impending privatisation, has been initiating a consolidation of the banking sector. In the Federation, the number of banks had fallen from 55 to 47 over the year to July 1999 and a further eight banks have been placed under provisional administration by the banking agency. Banking regulators expect another 10 banks to close or merge before the end of the year. Nevertheless, banks remain very small and their role in investment finance limited to the intermediation of credit lines from donors (only KM16 per capita were collected in savings by the financial system in 1998). Deposit insurance has been introduced in the Federation and is expected in RS before year-end 1999.

Bank privatisation remains on track.

Under legislation passed in 1998, majority state-owned banks in both Entities had to prepare opening balance sheets, their solvency was to be judged by regulators and the licences of insolvent banks were to be revoked. These banks are to be liquidated by the first half of 2000 and privatisation programmes are to be drawn up for solvent banks. Banks in both Entities are at various stages of this process, with first privatisations expected in late 1999 in the Federation (Union Banka, with a capital of US\$ 31 million), and in early 2000 in RS. Impaired assets and liabilities of banks have been identified and are being transferred to the Finance Ministries, reducing their balance sheets by approximately 80% in both Entities. Disagreements remain over the solvency of Privredna Banka Sarajevo, formerly the largest state bank.

Payments system reform is promised but delayed.

The Payments Bureaux is a Yugoslav remnant that has prevented banks from offering payment services and has provided opportunities for bureaucratic interference and control. Under a recent agreement with the IMF, their role is to be gradually phased out, ending in their liquidation at end-2000. Legislation to permit commercial banks to offer payment services to their customers, a key step under the agreement, has, however, been delayed from its July deadline.

Social reform

Pension reform is increasingly a priority.

Significant social and long-term fiscal problems in both Entities are the vast, unfunded obligations to pensioners and veterans. The problem is essentially the low ratio of contributors to beneficiaries (two beneficiaries for each contributor). Standard social insurance contribution rates are 45% of payroll, but tax evasion and avoidance erode the tax take. A World Bank programme is set to tackle these issues, partly by scaling down pensioner rights, which may be politically difficult. With its recent history of war, BH faces severe social problems in a number of further areas. Unemployment is stagnating at high levels (30-40%) after improvements in 1996-98 and though refugees have returned, this has not happened at the hoped-for scale and pace. Out of an estimated 1.2 million refugees, 310,000 had returned from abroad by the end of 1998. A further 250,000 internally displaced persons have also returned to their place of origin, with 860,000 remaining.

¹ The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia-Herzegovina (FBH), the Republika Srpska (RS) and the cantons of the Federation. FBH and RS are referred to as the “Entities”.

Liberalisation	Privatisation	Infrastructure	Financial sector
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – not available	Capital adequacy ratio – 8%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – not available	Deposit insurance system – no
Wage regulation – no	Tradability of land – limited de jure	Independent electricity regulator – no	Secured transactions law – restricted
Stabilisation	Enterprises		Social reform
Share in general government tax revenues in GDP ¹ – 32%; 16%	Competition office – no		Share of the population in poverty – not available
Exchange rate regime – currency board			Private pension funds – no

Bosnia and Herzegovina	1994	1995	1996	1997	1998	1999
Liberalisation						
Share of trade with EU and rest of the world	26.39	31.14	44.39	48.36	48.42	na
Share of trade in GDP	39.27	33	40.5	42.5	41.5	36.9
Tariff revenues (per cent of imports)	na	na	10.45	8.62	8.83	na
Enterprises						
Share of industry and mining in total employment	na	na	na	na	na	na
Labour productivity in industry	na	na	na	16.52	27.05	na
Financial institutions						
Number of banks (of which foreign-owned)	na	na	na	na	na	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na
Federation	1994	1995	1996	1997	1998	1999
Liberalisation						
Share of trade with EU and rest of the world	na	na	na	na	na	na
Share of trade in GDP	na	na	na	na	na	na
Tariff revenues (per cent of imports)	na	na	na	na	na	na
Enterprises						
Share of industry and mining in total employment	na	na	32.1	37.4	na	na
Labour productivity in industry	na	na	na	na	na	na
Financial institutions						
Number of banks (of which foreign-owned)	na	29	41(5)	52(9)	53(9)	na
Asset share of state-owned banks (in per cent)	na	94.7	78.7	83.9	73.9	na
Republika Srpska	1994	1995	1996	1997	1998	1999
Liberalisation						
Share of trade with EU and rest of the world	na	na	na	na	na	na
Share of trade in GDP	na	na	na	na	na	na
Tariff revenues (per cent of imports)	na	na	na	na	na	na
Enterprises						
Share of industry and mining in total employment	na	na	na	na	na	na
Labour productivity in industry	na	na	na	na	na	na
Financial institutions						
Number of banks (of which foreign-owned)	17	11	12	12	18	na
Asset share of state-owned banks (in per cent)	98.7	99.4	99.3	99.8	99.9	na

¹ The figures refer to the Federation and Republika Srpska, respectively.

² Federation only.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-20	na	na	na	21	69	30	18	12
Federation	na	na	na	na	225	44	32	15	na
Republika Srpska	na	na	na	na	-56	138	26	23	na
Industrial output									
Federation	na	na	na	na	341	122	34	24	na
Republika Srpska	na	na	na	na	-13	20	31	22	na
Employment	(Percentage change)								
Labour force (end-year)	na	na	na	na	na	na	na	na	na
Employment ¹	na	na	na	na	53	54	1	20	na
Prices and wages	(Percentage change)								
Consumer prices (annual average) ²									
Federation (KM-based)	114	73,109	44,069	780	-4	-25	14	5	3
Republika Srpska (YUD-based) ³	114	7,461	2,233	1,061	118	66	3	38	na
Republika Srpska (DM-based) ⁴	na	na	na	na	21	17	-7	2	5
Gross average monthly wages (KM/month)									
Federation	na	na	na	na	76	296	466	574	na
Republika Srpska ⁵	na	na	na	na	60	85	138	210	na
Monetary sector	(Percentage change)								
Broad money ⁶	na	na	na	na	8	96	52	31	na
Domestic assets ⁶	na	na	na	na	-33	45	68	28	na
	(In per cent of GDP)								
Broad money ⁶	na	na	na	18	15	19	20	21	na
Exchange rates	(Dinar/KM per DM)								
Exchange rate (annual average) ⁷	na	na	na	na	100	100	1	1	na
Government sector	(In per cent of GDP)								
Consolidated government balance ⁸	na	na	na	-17	0	-4	-2	-3	na
Federation	na	na	na	na	na	-3	-1	-2	-2
Republika Srpska	na	na	na	na	na	0	0	-5	-4
Consolidated government expenditure ⁸	na	na	na	44	39	53	42	36	na
Federation	na	na	na	na	na	13	14	15	na
Republika Srpska	na	na	na	na	na	24	15	24	na
External sector	(In millions of US dollars)								
Current account	na	na	na	-177	-193	-748	-1,060	-1,097	-896
excluding official transfers	na	na	na	-492	-570	-1,306	-1,482	-1,287	-990
Trade balance	447	66	-53	-803	-930	-1,546	-1,758	-1,756	-1,443
Exports ⁹	2,120	495	7	91	152	336	575	817	955
Imports ⁹	1,673	429	60	894	1,082	1,882	2,333	2,573	2,398
of which humanitarian aid in-kind	na	na	na	561	459	246	360	136	52
Foreign Investment ¹⁰	na	na	na	0	0	0	504	100	60
Gross official international reserves	na	na	na	93	207	412	279	327	na
External debt stock ¹¹	na	na	na	na	3,361	3,620	4,076	2,879	na
(In months of merchandise imports)									
Gross official reserves	na	na	na	1.2	2.3	2.6	1.4	1.5	na
	(In per cent of exports of goods and non-factor services)								
Debt service ¹¹	na	na	na	na	118	53	16	17	na
Memorandum items	(Denominations as indicated)								
Population (in millions) ¹²	4.4	4.2	4.1	4.2	4.2	4.1	4.2	4.2	na
GDP (in US\$ millions)	8,670	na	na	1,254	1,867	2,741	3,423	4,082	4,533
Federation	na	na	na	615	1,370	2,026	2,634	3,039	na
Republika Srpska	na	na	na	639	497	715	789	1,043	na
GDP per capita (US dollars)	1,979	na	na	299	445	669	815	972	na
Current account (excluding official transfers)/GDP (in per cent)	na	na	na	-39	-31	-48	-43	-32	-22
External debt minus reserves (in US\$ millions)	na	na	na	na	3,154	3,208	3,797	2,552	na
External debt/GDP (in per cent)	na	na	na	na	180	132	119	71	na
External debt/exports (in per cent)	na	na	na	na	2,211	1,077	709	352	na

¹ Bosniak-majority area prior to September 1996, Federation thereafter. Before September 1996 data include personnel that are not actually working but for whom contributions (pension, health) are paid.

² Before 1995, Retail Price Index (RPI) is used. After 1995, included, Consumer Price Index (CPI) is used.

³ Index based on prices denominated in FRY dinars.

⁴ YUD-based index, converted into DM using parallel market exchange rate.

⁵ Measured in DM using the RS parallel market exchange rate for the FRY dinar.

⁶ Country-wide monetary aggregates.

⁷ Refers to Bosnian dinar. Since August 1997, Bosnia and Herzegovina has a common central bank. The new currency, the Konvertibilna Marka (KM) is pegged to the Deutschmark at 1:1 under currency board rules.

⁸ In per cent of entity GDP. Excludes municipal government operations for RS. Data for 1996 and subsequent years exclude military expenditures financed by external grants. No net financing of the budget deficit, other than arrears, in 1996-98.

⁹ Data for 1992-93 are based on limited customs data for the Bosniak-majority area. 1994-98 data are rough estimates for the whole territory of Bosnia and Herzegovina.

¹⁰ Excludes capital transfers for reconstruction.

¹¹ Projected external debt and debt service for 1998 exclude debt relief.

¹² Includes refugees abroad.

Key reform challenges

- Following earlier delays, several important sales in the middle of 1999 have pushed forward privatisation. A number of large companies, including in infrastructure, remain to be privatised.
- Most remaining state enterprises are non-viable and in need of liquidation, but rapid and efficient bankruptcy arrangements have yet to be put in place.
- Financial intermediation remains weak. Creditor rights need to be improved and privatisation of remaining state-owned banks would help to increase the efficiency of the sector.
- Reform of the pension system, which was initiated in 1999, will help control public expenditures and foster development of the local capital market.

Liberalisation

Substantial progress has been achieved in the liberalisation of the trade and forex regime.

The tariff regime has been simplified, with reductions in the number of tariff bands, in the dispersion of rates and in the level of certain tariffs. Most export taxes have been eliminated and the number of products subject to licensing requirements has been greatly reduced. The temporary import surcharge that was introduced during the crisis of 1996 and the customs clearance fees were abolished ahead of schedule on 1 January 1999. On that same date, Bulgaria became a full member of CEFTA and a free trade agreement with Turkey came into effect. Bulgaria has applied to join the European Union, but is currently not among the "first-wave" candidates. In September 1998, Bulgaria accepted the obligations of IMF Article VIII.

Important progress has been made in price liberalisation.

The law on prices, which formed the legal basis for state intervention in price setting, was abolished in July 1999. This liberalisation has left only prices of coal, electricity, central heating, telephone, postal services, gas and cigarettes administered. Prices for energy and central heating increased by 30% in September 1998 and 12% in July 1999, and prices for household electricity by 14% in January 1999 and 10% in July 1999.

Stabilisation

The currency board has been effective in maintaining stability.

The currency board, introduced in July 1997 as the centrepiece of a comprehensive stabilisation and reform programme, registered remarkable results very quickly, with a dramatic decline in inflation, a fall in interest rates and a reduction of the fiscal deficit to sustainable levels. In spite of the deterioration in the external environment (Russian crisis, Kosovo conflict, downturn

in the EU), the currency board continues to be effective in maintaining macroeconomic stability and is backed by a large pool of reserves.

Public external debt is large but decreasing and the maturity structure is becoming more favourable.

Gross external debt decreased significantly in the first half of 1999, with short-term debt declining particularly significantly. However, sovereign access to private international markets has not been established. The first municipal (by the city of Sofia) and corporate Eurobond issues took place in mid-1999.

Privatisation

Strategic sales in mid-1999 are pushing forward the privatisation process.

The main channels for privatisation have been: direct privatisation by the Privatisation Agency or Line Ministries, privatisation through advisers or consultants, two rounds of mass privatisation (the second one started in January 1999), and the sale of shares on the Bulgarian Stock Exchange (only marginal so far). Measured by the number of transactions concluded, 1998 saw an acceleration in privatisation over previous years as MEBOs proliferated. However, few large deals were concluded and privatisation receipts to the budget fell to US\$ 150 million (from US\$ 340 million in 1997). In the middle of 1999, significant progress was made in the privatisation of state-owned enterprises, and several of the country's largest enterprises were sold (including Balkan Airlines and Kremikovtski). The sale of the telecommunications operator is near completion, and, at more than US\$ 500 million, it will be the largest privatisation to date in Bulgaria.

Privatisation of agriculture and development of a land market gained momentum in 1998.

By the end of 1998, 80% of agricultural land had been restituted, and over 18% of the land subject to restitution had been titled.

Liberalisation, stabilisation, privatisation

1991

Feb	Most consumer prices liberalised
Feb	Import controls removed
Feb	Interest rates liberalised
Feb	Unified exchange rate introduced
Jul	T-bills market initiated

1992

Feb	Restitution law enacted
Apr	Privatisation law adopted

1993

Jan	Small-scale privatisation law adopted
Feb	Large-scale privatisation begins
Jul	EFTA membership

1994

Mar	Currency crisis
Apr	VAT introduced
Jun	Privatisation law amended
Nov	Debt-equity swaps added to privatisation

1995

Jan	EU association agreement
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1996

Oct	First round of voucher privatisation starts
Dec	WTO membership

1997

Feb	Macroeconomic crisis peaks
Jul	Currency board introduced
Jul	Reform of tax administration begins
Oct	New foreign investment act adopted

1998

Mar	Privatisation law amended to broaden range of methods
May	First company privatised through the stock exchange
Sep	Full current account convertibility introduced

1999

Jan	Comprehensive tax reform begins
Jan	CEFTA membership
Jan	Second round of voucher privatisation begins
May	First municipal Eurobond issued
Jul	Currency re-denominated

More than half of the agro-industrial companies (measured by long-term assets) and virtually all grain warehouses have been privatised. A number of steps have been taken to provide an impetus to a functioning land market, including improvements in the process of land registration.

Enterprises, infrastructure, finance and social reforms

1991

May	Competition law adopted
May	Competition agency established
Jun	Commercial code enacted
Nov	First Bulgarian stock exchange established

1992

Mar	Banking law adopted
Mar	Loan classification and provisioning introduced
May	Stock exchange begins trading

1993

Mar	BIS capital adequacy enacted
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1994

Jul	Bankruptcy law adopted
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1995

Feb	Railway law adopted
Jul	Securities law adopted
Jul	Securities commission established
Dec	Social insurance law adopted

1996

May	Bankruptcy law amended
May	Special restructuring programme enacted
Jun	Banking sector restructuring begins

1997

Feb	Financial crisis peaks
Jul	First bank privatisation
Jul	New banking law adopted
Oct	Stock exchanges consolidated

1998

Jul	New telecommunications law adopted
Sep	Energy sector reform begins
Sep	Coal and district heating prices raised

1999

Jul	Law on additional voluntary pension insurance passed
Jul	New energy law enacted
Aug	First corporate Eurobond issued

Enterprise reform

With the privatisation of most viable enterprises, the liquidation of remaining state enterprises is a priority.

Although legislation on bankruptcy and insolvency has improved in recent years, its application remains largely ineffective. Progress in implementation has been hampered by the absence of international accounting, asset evaluation and appraisal standards and by a lack of experience in its application. The process is further complicated by a lack of trained bankruptcy judges, and incentive problems of court-

appointed liquidators who receive a fixed salary as long as the bankruptcy proceedings are under way.

A programme to promote financial discipline was completed in mid-1999.

A programme of “isolation” and liquidation targeting the largest loss-making state-owned enterprises was launched in 1996 when 30 state-owned utilities (group A) and 48 state-owned commercial enterprises (group B) were cut off from bank credit, thereby forcing a fundamental restructuring of their operations. The programme has helped to improve the operational and financial performance of many targeted enterprises. All group B enterprises have now exited the programme, with 31 privatised and 16 under liquidation or insolvency proceedings. The financial performance of some of the group A enterprises remains a source of concern and arrears of a number of these enterprises are increasing.

Infrastructure

Comprehensive reform strategy for the energy sector is being implemented.

The strategy envisages the phasing out of energy subsidies over a three-year period that began in September 1998, when prices for coal and district heating increased by 30%. A new energy law was adopted in mid-1999, providing the legal and regulatory framework for the market-based development of the energy sector and for an independent regulatory agency. It prepares the ground for unbundling the National Electricity Company (NEK) into separate corporate entities specialised in generation, transmission and distribution, and it allows for some third-party access to the transmission and distribution networks for electricity and natural gas once prices are liberalised in 2001. The strategy, which will take several years to implement, also launches an effort to confront deep structural problems relating to district heating, including persistent energy losses and little incentive for final consumers to control consumption.

Privatisation of the telecommunications company is almost complete.

Following the adoption of a new telecommunications law in late 1998, the privatisation of 51% of the dominant operator, Bulgarian Telecommunications Company (BTC), is now close to completion. As laid out in the telecommunications law, the fixed-line monopoly of BTC will end in 2002.

Financial institutions

Bank privatisation is progressing, albeit at a slow pace.

A second bank was privatised in late 1998, when 78% of a share of Post Bank, the third-largest of the six remaining state-owned banks, was sold to a foreign strategic investor. Two well-established financial institutions have been appointed as advisers

for the privatisation of Expressbank and Bulbank, two of the country's largest banks. The Bank Consolidation Company (BCC) is handling directly the privatisation of Hebrosbank, in which eight potential buyers have expressed interest. Biochim Bank, which was run under contract by foreign management, had its contract terminated after less than a year due to disagreements over management. The BCC has now accelerated its privatisation plan for the bank.

Banking supervision capacity has been strengthened.

Several steps have been taken to improve the soundness and performance of the banking system over the past year. A number of new regulations were adopted: on the foreign exchange positions of banks, on capital adequacy, on the assessment of risk and provisioning, on management of the banks' liquidity and on minimum reserve requirements. In January 1999, a self-financing deposit insurance system was introduced. The financial crisis in emerging markets had an impact on some banks and the government acted quickly to withdraw a licence of one private bank that was heavily exposed to foreign assets.

Private sector access to capital remains limited.

The share of domestic credit to GDP fell to 20.3% at the end of 1998 from 28.7% a year earlier, resulting from a decline in government lending. Commercial banks suffer from a weak protection of their rights as creditors. This affects their ability to collect collateral, to control the management of firms in default on loans, or to pursue effectively bankruptcy and liquidation through the courts. Non-banking financial intermediation remains limited. The nascent stock exchange is still facing difficulties. The protection of minority shareholders remains weak and reliable financial information on listed companies is difficult to obtain and analyse (particularly due to the difficulty in properly and consistently applying accounting standards).

Social reform

Pension reform took a step forward with the adoption of a new law.

In 1998, the government began a much-needed reform of the pension system. The proposed three-pillar system would consist of a public pay-as-you-go system, a mandatory privately managed second pillar, and a voluntary third pillar. Legislation for the additional voluntary private contributions was passed in the middle of 1999, and regulated private pension funds are expected to start operating by end-1999. A reformed pay-as-you-go system, including a higher minimum retirement age and fewer early retirement categories, is to be introduced in 2000.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – yes	Share of the population in poverty – 33%
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Separation of railway accounts – yes	Private pension funds – yes
Wage regulation – yes	Tradability of land – full except foreigners	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 26.6%	Competition office – yes	Capital adequacy ratio 2 – 12%	
Exchange rate regime 1 – currency board		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	70.0	24.0	16.0	26.0	43.0	46.0	52.0	14.4	15.8
Number of goods with administered prices in EBRD-15 basket	9.0	6.0	6.0	6.0	7.0	8.0	7.0	1.0	1.0
Share of exports to non-transition countries (per cent)	11.7	42.5	69.8	74.8	73.5	70.8	74.0	77.6	na
Share of trade in GDP (per cent)	24.1	33.8	47.1	38.5	40.6	40.4	48.8	46.6	40.8
Tariff revenues (per cent of imports)	na	2.4	4.1	7.1	6.9	6.1	4.6	4.8	na
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	2.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	0.9	2.6	7.2	15.2	21.1	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	0.4	1.5	0.9	2.9	5.6	5.3
Private sector share in GDP	10.0	15.0	25.0	35.0	40.0	45.0	45.0	50.0	65.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	2.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	2.0	1.8	2.9	1.3	1.2	0.8	0.8	na
Efficiency of tax collection for social security (per cent)	na	49.7	47.8	45.3	45.2	43.1	43.6	44.2	na
Share of industry and construction in total employment (per cent)	44.8	41.6	38.8	36.9	35.0	33.8	33.1	32.8	na
Change in labour productivity in industry (per cent)	-8.6	-5.3	-3.1	-2.8	12.6	7.3	2.1	-3.4	-4.4
Investment rate (per cent of GDP)	21.3	18.2	16.2	13.0	13.8	15.3	13.6	11.3	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.3	2.3
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	24.2	24.7	26.3	27.2	33.5	30.6	31.3	32.3	32.9
Railway labour productivity (1989=100)	88.9	58.2	62.9	69.9	73.1	77.4	73.8	83.2	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	1.42 (82%)	2.18 (85%)	3.5 (85%)	3.5 (85%)	na
Electricity consumption/GDP (1989=100)	100.4	101.9	102.7	103.3	101.3	108.6	123.8	137.3	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.7
Financial institutions									
Number of banks (of which foreign-owned)	67 (0)	75 (0)	79 (0)	41 (0)	40 (1)	41 (3)	42 (3)	28 (7)	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	82.2	66.0	na
Bad loans (per cent of total loans)	na	na	na	6.6	6.8	12.6	14.6	12.9	na
Credit to private sector (per cent of GDP) ¹	na	7.2	5.8	3.7	3.8	21.1	35.6	12.6	14.2
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	2.0	2.0	2.0	2.7	2.7
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	10.8	11.0	12.6	na	na	na	na	na	na
Life expectancy at birth, total (years)	71.4	71.3	71.2	71.1	71.0	70.9	70.8	70.7	na
Basic school enrolment ratio (per cent)	98.6	97.3	95.1	94.0	94.3	93.7	93.6	94.0	na
Earnings inequality (Gini coefficient)	21.2	26.2	na	25.1	na	na	29.1	na	na

¹ The exchange rate is fixed at a rate of 1,000 leva to the DM.

² Credit expansion in 1995 and 1996 was followed by a banking crisis in 1997, greatly reducing the stock of credit to the enterprise sector.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	<i>(Percentage change in real terms)</i>								
GDP	-11.7	-7.3	-1.5	1.8	2.1	-10.1	-7.0	3.5	0.0
Private consumption	-15.7	1.0	-0.7	-2.6	-1.8	-1.9	-17.2	8.2	na
Public consumption	-10.3	-14.6	-12.6	-11.5	-7.4	-28.9	-1.4	4.0	na
Gross fixed investment	-19.9	-7.3	-17.5	1.1	8.8	-21.2	-23.9	16.4	na
Industrial gross output	-22.2	-15.9	-10.8	8.5	4.9	-11.8	-11.3	4.3	na
Agricultural gross output	4.3	-14.8	-30.2	9.5	14.5	-7.4	32.9	1.4	na
Employment	<i>(Percentage change)</i>								
Labour force (end-year)	-4.3	-3.3	-0.1	-3.1	-0.6	1.6	-2.2	na	na
Employment (end-year)	-13.0	-8.1	-1.6	0.6	1.3	0.1	-3.9	-1.6	na
	<i>(In per cent of labour force)</i>								
Unemployment	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	333.5	82.0	73.0	96.3	62.0	123.0	1,082.0	22.3	2.0
Consumer prices (end-year)	338.9	79.4	63.8	121.9	32.9	310.8	578.6	1.0	2.0
Gross average monthly earnings in industry, public sector (annual average)	na	132.8	55.1	53.9	57.7	79.0	896.7	na	na
Government sector ¹	<i>(In per cent of GDP)</i>								
General government balance	na	5.2	-10.9	-5.8	-6.4	-10.4	-3.0	1.0	na
General government expenditure	45.6	43.6	48.1	45.7	41.3	42.3	35.6	40.3	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	110.0	53.6	47.6	78.6	39.6	124.5	359.3	9.6	na
Domestic credit (end-year)	148.0	51.8	56.0	37.1	15.7	219.9	255.5	-11.7	na
	<i>(In per cent of GDP)</i>								
Broad money	76.0	79.0	78.3	79.5	67.2	74.9	35.2	30.6	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (up to 30-day maturity)	na	na	68.3	108.0	44.2	448.8	1.6	2.9	na
Treasury bill rate (less than one-year maturity)	na	na	58.4	92.0	42.7	477.2	7.9	na	na
Deposit rate (one month)	57.7	45.3	53.6	72.3	25.3	211.8	3.0	3.3	na
Lending rate (less than one year)	83.9	64.6	83.7	117.8	51.4	481.1	13.9	13.5	na
	<i>(Leva per US dollar)</i>								
Exchange rate (end-year)	22	25	33	66	71	487	1,777	1,675	na
Exchange rate (annual average)	18	23	28	54	67	178	1,682	1,760	na
External sector	<i>(In millions of US dollars)</i>								
Current account	-406	-801	-1,386	-203	-59	117	433	-252	-650
Trade balance	404	-213	-885	-17	121	187	381	-316	-1,000
Exports	2,734	3,956	3,727	3,935	5,345	4,890	4,925	4,293	3,200
Imports	2,330	4,169	4,612	3,952	5,224	4,703	4,544	4,609	4,200
Foreign direct investment, net	56	42	40	105	82	100	497	401	700
Gross reserves (end-year), excluding gold	331	935	655	1,002	1,236	518	2,121	2,679	na
External debt stock	11,802	12,548	13,890	11,411	10,229	9,514	9,677	10,101	na
	<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold	0.8	1.9	1.2	2.1	2.2	1.3	5.4	7.0	na
	<i>(In per cent of exports of goods and nonfactor services)</i>								
Debt service	na	38.1	33.7	19.3	15.4	20.0	16.5	20.0	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	8.6	8.5	8.5	8.4	8.4	8.4	8.3	8.3	na
GDP at market prices (in billions of leva)	136	201	299	526	880	1,749	17,103	19,203	19,500
GDP per capita (in US dollars)	872	1,016	1,280	1,157	1,559	1,170	1,228	1,315	na
Share of industry in GDP (in per cent) ²	37.4	40.5	35.0	32.1	32.7	28.5	25.3	25.5	na
Share of agriculture in GDP (in per cent) ²	14.3	11.7	10.3	12.0	13.1	14.5	23.8	18.7	na
Current account/GDP (in per cent)	-5.4	-9.3	-12.8	-2.1	-0.5	1.2	4.3	-2.3	-5.7
External debt minus reserves (in US\$ millions)	11,471	11,613	13,235	10,409	8,993	8,996	7,556	7,422	na
External debt/GDP (in per cent)	157.4	145.6	128.3	117.5	78.1	96.8	95.2	92.6	na
External debt/exports (in per cent)	431.7	317.2	372.7	290.0	191.4	194.6	196.5	235.3	na

¹ General government includes the state, municipalities and extrabudgetary funds.

² After 1995, the industrial classification was changed. Using the old classification, industry as a share of GDP was 32.4% in 1996 and the share of agriculture in GDP was 12.8%.

Key reform challenges

- **Containing public expenditure growth and pressing ahead with pension reforms are necessary to stave off further deterioration of the fiscal position.** IMF and World Bank support would help maintain macro-economic stability.
- **Recent momentum in privatisation should be maintained, with an increased focus on attracting foreign strategic investors.** Greater inflow of FDI into already privatised firms should also be encouraged to advance corporate governance and restructuring.
- **To strengthen the fragile financial sector, insolvent banks should continue to be liquidated or restructured.** The insurance company and the four state-owned rehabilitated banks should be sold to suitable strategic investors.

Liberalisation

WTO accession is expected soon.

On the final stretch towards WTO accession, parliament passed a number of laws in June 1999, including a new customs law, a new law regulating technical barriers to trade such as quality and sanitary regulations, an amendment to the law on trade affecting provisions on subsidies and countervailing duties, and a set of laws regulating intellectual property rights. The last remaining differential excise tax, that on tobacco products, has also been eliminated.

Stabilisation

Russian contagion and weak banking sector tip economy into recession.

After years of stability, the Croatian kuna came under downward pressure, depreciating by 9% against the Deutschmark in the seven months following the Russian crisis. A currency crisis was avoided as the central bank tightened liquidity and intervened heavily in the foreign exchange market, before raising €300 million through a 7-year Eurobond issue in February 1999. Spreads on Croatia's Eurobonds had increased sharply after the Russian crisis, but have remained in the range between 300 and 500 basis points since then. The lack of domestic liquidity, coupled with growing banking sector problems, tipped the economy into recession by the end of 1998. Weakened domestic demand and a depreciated currency have helped to reduce the (still large) trade deficit in 1999, offsetting the loss of tourism receipts resulting from the Kosovo crisis.

As fiscal pressures grow, the government looks towards privatisation receipts and IMF finance.

After a budget surplus of almost 1% of GDP in 1998 (largely a result of the introduction of VAT), the fiscal position has deteriorated markedly. The 1999 budget amounted to significant fiscal loosening, driven largely by public sector wage rises. As tax revenues have not grown as anticipated (partly due to the recession) and as claims arising from insured deposits of failed banks have accumulated, the government was forced

to revise the budget in mid-year. To finance the remaining deficit, the government has tried to accelerate privatisation, in particular the sale of Croatia Telecoms (see below), and to arrange the resumption of an IMF programme.

Privatisation

The voucher programme accelerates divestiture of residual stakes by the state ...

The privatisation process has recently gained momentum. The voucher privatisation programme in 1998 has reduced the residual holdings of the Croatian Privatisation Fund by almost half to 17% of the book value of commercialised enterprises covered by the original privatisation law of 1991. Another 15% of the equity in these companies is held by the state pension fund. Most stakes held by the two funds are passive minority holdings. Only 5% of commercialised firms covered by the 1991 law (accounting for less than 10% of total book value) are still in majority state ownership.

... and shares of voucher funds are now tradable.

In the voucher privatisation programme, certificates were distributed to 225,000 refugees and war invalids, who have invested some 90% of these vouchers in the seven Privatisation and Investment Funds (PIFs). These funds have acquired stakes in 471 companies in three bidding rounds in 1998. The PIFs have been listed in a separate segment of the Varaždin over-the-counter market and began trading in May 1999. Turnover has so far been very low, with only US\$ 200,000 traded in June. The two most liquid PIFs (both foreign-owned) traded at an 89% discount on the face value of shares and vouchers, while the other five funds traded at even deeper discounts, up to 97%. This low value reflects the deterioration of profitability of the companies included in the voucher privatisation programme and questions about the PIFs' ability to improve corporate governance in these firms.

Liberalisation, stabilisation, privatisation

1991

Apr	First privatisation law adopted
Jun	Independence from Yugoslavia
Dec	New currency (Croatian dinar) introduced

1992

Jul	Large-scale privatisation begins
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1993

Jan	Croatian privatisation fund established
Oct	Macroeconomic stabilisation programme

1994

May	New currency (kuna) introduced
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1995

May	Full current account convertibility introduced
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1996

Mar	New privatisation law enacted
Jul	Most non-tariff import barriers removed
Jul	T-bills market initiated

1997

Jan	Restitution law enacted
Feb	First sovereign Eurobond

1998

Jan	VAT introduced
Jun	Voucher privatisation programme begins

Strategic companies are being prepared for privatisation.

There are a number of large state-owned entities not covered by the 1991 privatisation law, accounting for about a quarter of employment in originally state-owned companies. Preparations for privatising some of these assets in accordance with the 1996 privatisation law have gained pace. First on the list are state telecommunications, rehabilitated banks and the former insurance monopoly, with strategic stakes being offered to foreign investors (see sections below). Plans to sell a stake in INA, the large oil and gas company, have also progressed. The method of privatisation is decided on a case-by-case basis.

Enterprise reform

Industry continues to decline as the economy slides into recession.

Enterprise restructuring has progressed at a moderate pace, with an emphasis on industrial downsizing. Employment in manufacturing has continued to dwindle, falling to below half of the 1989 level. Labour productivity growth, rapid in previous years, has stagnated since late 1998 as the economy went into recession. Gross fixed

Enterprises, infrastructure, finance and social reforms

1993

Jan	IAS becomes effective
Oct	Banking law adopted
Nov	Company law enacted

1994

Mar	Stock exchange begins trading
Jun	Railways established as joint-stock company
Jun	Bank rehabilitation law enacted

1995

Jan	Electricity law adopted
Jun	Competition law adopted
Nov	Bank rehabilitation begins
Dec	Capital adequacy requirement becomes effective
Dec	Securities and investment fund laws adopted

1996

Mar	Pliva lists shares in London
Oct	Securities and exchange commission established

1997

Jan	New bankruptcy law becomes effective
Mar	Competition agency established

1998

Apr	Dubrovačka Banka crisis
Jul	First pension reform law adopted
Jul	First rehabilitated bank privatised
Dec	New banking law becomes effective

1999

Jan	Post and telecommunications separated
Mar	New bankruptcy law adopted
Jun	Telecommunications privatisation law adopted

investment, having reached 24% of GDP in 1997, has become increasingly constrained by liquidity problems of the banking sector. Investment fell by 7.5% in real terms year-on-year in the last quarter of 1998 and the first quarter of 1999.

Arrears and insolvencies have risen.

Enterprise arrears have doubled in the year to April 1999, reaching 17% of GDP. This worrying development reflects tight liquidity in the banking sector, constraining firms' access to working capital finance, as well as deteriorating economic conditions. Several large companies have become insolvent, including the second-largest retailer and largest press distributor. The bankruptcy system has proved relatively ineffective so far and the law was amended in March 1999 to strengthen creditors' rights and accelerate the process.

Foreign investment has not reached the wider economy and corporate governance remains weak.

Inflows of foreign direct investment (FDI) more than doubled from 1997 to 1998, reaching 4% of GDP. More than half of foreign investment has so far gone into the banking sector and Pliva, a large pharmaceutical company. There has been little FDI in other sectors, reflecting a privatisation process that was dominated by management and employee buy-outs. The lack of effective outside ownership in privatised companies has constrained the quality of restructuring and corporate governance.

Infrastructure

Telecommunications is to be partially privatised.

In January 1999, post and telecommunications were corporatised as separate entities. Croatia Telecoms (HT) is being prepared for privatisation. In June, parliament passed a law on the privatisation of HT, allowing for a sale of at least 25-35% to a foreign strategic investor. The law also stipulates a preferential share sale to employees and war veterans of 14%, as well as a domestic and international public offering of 20-35% of shares, with preferential terms for domestic citizens. The state would retain 30%, with dividends accruing to the state pension fund. Parliament has also adopted the new law on telecommunications which sets the regulatory framework for the sector. The sector will be opened for competition in January 2003, in line with WTO commitments.

Financial institutions

The central bank prepares several insolvent banks for bankruptcy.

Following the Dubrovačka Banka crisis of early 1998, the Croatian banking sector has been shaken repeatedly by a combination of weak confidence, exchange rate worries and low liquidity, leading to a number of bank failures. Bad loans increased drastically during 1998, reaching 15% of total loans at year end, up from 10% at the end of 1997. At the same time, the number of banks meeting capital adequacy requirements fell from 60 to 53. The new banking law, effective from December 1998, has raised the capital adequacy requirement from 8% to 10%. The law has also increased the central bank's power to take control of insolvent banks. In January 1999, it placed administrators in two small and two mid-sized banks before bankruptcy proceedings were initiated by the courts in May. By June, there were 12 financial institutions (out of 60 banks and 35 savings cooperatives) under initiated or pending bankruptcy. Although their share in total banking sector assets is below 10%, the implied costs of deposit insurance of some 2.5% of GDP are a considerable drain on public finances, given the state's obligation to meet the shortfall of the deposit insurance agency.

The second-largest bank and the largest insurance company are to be privatised.

After the successful privatisation (with EBRD participation) of the first rehabilitated bank, Slavenska Banka, the other four banks under rehabilitation (accounting for 33% of banking sector assets) are now ready for privatisation. The country's second-largest bank, Privredna Banka, is likely to be sold to a foreign strategic investor. The government has also announced plans to privatise the state insurance company, Croatia Osiguranje, which still commands a 60% market share, by selling a controlling stake to a strategic investor.

Capital market reform continues, but trading remains thin.

The stock market remains underdeveloped. Average daily turnover fell from US\$ 1.7 million in 1997 to US\$ 0.7 million in 1998 and US\$ 0.6 million in the first quarter of 1999. The capital market is highly concentrated, with pharmaceutical producer Pliva, whose GDRs are listed in London, accounting for two-thirds of market capitalisation. The institutional development of the stock market has continued, with technical assistance from the World Bank. In April 1999, the Croatian Securities and Exchange Commission issued a licence to the new Securities Depository Agency, which began operations in July and should facilitate the growth of the stock market and foreign investment. An important stimulus to the development of the capital market will be the introduction of fully funded mandatory pensions (see section below), which could raise demand for domestic bonds and shares by up to US\$ 300 million per year.

Social reform

Pension reform is progressing.

Public sector spending in Croatia has grown from 40% of GDP in 1994 to over 50% in 1999. An unfavourable ratio of employees to pensioners (3:2), has contributed to the growing funding gap of the extrabudgetary funds (mainly health and pensions) which rose from 3.9% of GDP in 1996 to 5.0% in 1997 to 6.6% in 1998. In response to the growing imbalance, the government has initiated pension reforms, with support from the World Bank. Parliament approved the principle of a "three-pillar" pension system in mid-1998 and is considering a package of bills that would implement the new system. According to government plans, employees younger than 40 would shift 5% of their 21% payroll contribution to the fully funded mandatory second pillar, starting in January 2000. A new central registry would be in charge of channelling mandatory contributions to these private pension funds, which would be regulated by a new supervisory agency.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator – no	Share of the population in poverty – not available
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Separation of railway accounts – yes	Private pension funds – yes ²
Wage regulation – no	Tradability of land 1 – full	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 42.7%	Competition office – yes	Capital adequacy ratio – 10%	
Exchange rate regime – managed float		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	4.0	4.0	4.0	3.0	3.0	3.0	na
Share of exports to non-transition countries (per cent)	na	na	na	73.4	75.8	73.9	70.9	72.3	na
Share of trade in GDP (per cent)	18.6	19.6	32.0	40.2	33.7	33.2	32.1	33.6	30.6
Tariff revenues (per cent of imports) ³	na	5.4	10.9	7.1	10.4	9.6	8.9	8.1	7.6
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP) ⁴	na	na	na	na	0.4	0.9	1.4	1.5	1.6
Private sector share in GDP	15.0	20.0	25.0	30.0	35.0	40.0	50.0	55.0	55.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	3.9	3.8	3.6	2.0	1.8	1.9	1.8	na
Efficiency of tax collection for social security (per cent)	na	na	na	na	na	na	na	na	na
Share of industry and construction in total employment (per cent)	45.4	43.5	42.1	41.1	40.6	40.1	37.5	na	na
Change in labour productivity in industry (per cent)	-10.4	-13.1	-0.8	-2.8	1.6	5.8	11.4	14.1	7.3
Investment rate (per cent of GDP)	13.8	11.3	13.8	14.4	13.6	15.7	20.5	24.4	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	3.0	2.7	2.7
EBRD index of competition policy	na	na	na	na	na	1.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	17.2	18.6	20.0	21.5	25.2	27.2	30.9	33.5	34.8
Railway labour productivity (1989=100)	93.3	56.9	35.7	40.9	42.4	49.4	44.2	46.1	52.2
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	7.3 (na)	8.2 (na)	7.9 (na)	7.0 (na)	na
Electricity consumption/GDP (1989=100)	99.6	108.5	102.2	109.3	107.1	103.9	98.0	110.6	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.3
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	43 (na)	50 (na)	54 (1)	57 (4)	61 (7)	60 (11)
Asset share of state-owned banks (in per cent)	na	na	na	58.9	55.5	51.9	36.2	32.6	37.5
Bad loans (per cent of total loans)	na	na	na	na	12.2	12.9	10.7	9.8	14.6
Credit to private sector (per cent of GDP)	na	na	na	47.3	28.6	30.8	28.9	36.4	40.1
Stock market capitalisation (per cent of GDP)	na	na	na	na	1.6	2.4	15.3	21.4	na
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	2.7	2.7
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	4.0	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	19.0	15.7	na	15.1	na	na	na	na
Life expectancy at birth, total (years)	72.2	72.2	71.2	na	na	72.1	72.4	72.5	na
Basic school enrolment ratio (per cent)	94.0	81.0	79.0	85.0	89.0	88.0	89.0	na	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ Land is tradable, but the right to trade land applies to foreigners only on a reciprocity basis and foreigners cannot acquire certain types of land (including agricultural) from the state.

² From January 2000.

³ Refers to all taxes on international trade.

⁴ Excludes swaps with frozen foreign currency deposits.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								<i>Estimate</i>	<i>Projection</i>
Output	<i>(Percentage change in real terms)</i>								
GDP	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.3	-0.5
Industrial gross output	-28.7	-14.6	-6.0	-2.6	0.3	3.1	6.8	3.7	na
Agricultural gross output	-7.2	-13.5	4.5	-2.9	0.7	1.5	3.6	na	na
Tourism ¹	-85.2	11.7	29.2	59.4	-45.3	94.3	49.3	5.3	na
Employment	<i>(Percentage change)</i>								
Labour force (annual average)	na	na	na	-1.0	-1.3	-4.1	-0.1	1.0	na
Employment (annual average) ²	-13.7	-12.7	-2.6	-4.2	-3.3	-1.4	-1.7	-3.4	na
	<i>(In per cent of labour force)</i>								
Unemployment	13.2	13.2	14.8	14.5	14.5	16.4	17.5	17.2	na
Prices and wages	<i>(Percentage change)</i>								
Retail prices (annual average)	123	666	1,518	97.6	2.0	3.5	3.6	5.7	3.8
Retail prices (end-year)	250	938	1,149	-3.0	3.8	3.4	3.8	5.4	4.0
Producer prices (annual average)	146	825	1,512	77.6	0.7	1.4	2.3	-1.2	na
Producer prices (end-year)	412	1,079	1,076	-5.5	1.6	1.5	1.6	-2.1	na
Average monthly earnings (annual average) ³	69	309	1,477	137.1	34.0	12.3	13.1	12.6	na
Government sector ⁴	<i>(In per cent of GDP)</i>								
Government balance	na	-3.9	-0.8	1.6	-0.9	-0.4	-1.3	0.6	-3.6
Government expenditure	na	36.1	35.0	40.6	44.9	45.3	44.0	46.2	na
Monetary sector	<i>(Percentage change)</i>								
Money (M1, end-year)	na	na	na	111.9	24.6	37.9	20.9	-1.5	na
Domestic credit (end-year)	na	na	na	9.1	10.9	1.0	15.5	18.9	na
	<i>(In per cent of GDP)</i>								
Broadest money (M4, end-year)	na	na	25.8	20.0	24.9	33.9	40.3	40.7	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (daily)	na	2,182	86.9	17.8	27.2	10.4	9.4	15.8	na
Refinancing rate (3-month)	na	na	97.4	14.0	27.0	9.5	9.0	10.5	na
Deposit rate ⁵	na	434.5	27.4	5.0	6.1	4.2	4.4	4.1	na
Lending rate ⁵	na	2,333	59.0	15.4	22.3	18.5	14.1	16.1	na
	<i>(kuna per US dollar)</i>								
Exchange rate (end-year)	na	0.80	6.56	5.63	5.32	5.54	6.30	6.25	na
Exchange rate (annual average)	0.02	0.26	3.58	6.00	5.23	5.43	6.16	6.36	na
External sector ⁶	<i>(In millions of US dollars)</i>								
Current account	-589	823	600	786	-1,283	-881	-2,435	-1,554	-1,355
Trade balance	-536	-303	-960	-1,323	-3,238	-3,651	-5,224	-4,169	-3,526
Merchandise exports	3,292	3,127	3,904	4,260	4,633	4,546	4,206	4,605	4,282
Merchandise imports	3,828	3,430	4,864	5,583	7,870	8,197	9,430	8,773	7,808
Foreign direct investment, net	na	13	77	95	83	529	346	854	750
Gross reserves (end-year), excluding gold	0	167	616	1,405	1,895	2,314	2,539	2,816	na
External debt stock (end-year)	2,978	2,736	2,486	2,822	3,336	4,808	6,662	8,197	na
	<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), excluding gold	0.0	0.4	1.2	2.5	2.5	2.8	2.7	3.2	na
	<i>(In per cent of exports of goods and services)</i>								
Debt service	12.3	8.9	9.5	7.6	9.9	8.5	11.5	11.1	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	4.51	4.47	4.64	4.65	4.67	4.49	4.57	4.53	na
GDP (in billions of kuna)	0.4	2.7	39.0	87.4	98.4	108.0	124.9	138.9	140.0
GDP per capita (in US dollars)	4,028	2,291	2,349	3,137	4,029	4,422	4,436	4,820	na
Share of industry in GDP (in per cent)	29.5	29.0	30.8	27.9	28.4	26.5	26.9	25.4	na
Share of agriculture and fishing in GDP (in per cent)	10.9	14.8	13.9	11.5	10.7	10.3	9.6	8.9	na
Current account/GDP (in per cent)	-3.2	8.0	5.5	5.4	-6.8	-4.4	-12.0	-7.1	-6.8
External debt minus reserves (in US\$ millions)	na	na	1,870	1,417	1,441	2,494	4,123	5,382	na
External debt/GDP (in per cent)	16.4	26.7	22.8	19.3	17.7	24.2	32.8	37.5	na
External debt/exports (in per cent)	na	na	63.7	66.2	72.0	105.8	158.4	178.0	na

¹ Nights spent by foreign tourists.² Excludes small enterprises, self-employed people, farmers, and employees of the Ministry of Defence.³ Per employee. Until 1994 net wages, gross wages thereafter.⁴ Consolidated central government.⁵ Weighted average over all maturities.⁶ For 1991-92, data exclude trade with republics of former Yugoslavia.

Key reform challenges

- **Complete bank restructuring and privatisation to strengthen the sector and to prepare for competition arising from EU accession.**
- **Further encourage foreign direct investment into the industrial sector to spur enterprise restructuring and reduce high corporate leverage.**
- **Improve legislation on and enforcement of minority shareholder rights, creditor rights and bankruptcy to foster finance for investment.**
- **Tightly control off-budget expenditures and contingent liabilities and reform social welfare to maintain fiscal balance and public debt within the Maastricht criteria.**

Liberalisation

Regulated rents impede housing development and labour mobility.

Rent control impedes much-needed investment in the residential housing stock, since regulated rents do not generate adequate investment income, often failing to cover maintenance costs. There is a burgeoning black market in state- and municipality-owned housing. Regulated rents also constrain labour mobility and contribute to large regional differences in unemployment, ranging from about 3% in the capital region to 15-17% in the mining regions of Northern Moravia and Northern Bohemia. There have been some state initiatives to support private investment in housing, including state contributions to savings in building societies and tax incentives for mortgage holders.

Stabilisation

Controls on off-budget outlays and contingent liabilities need strengthening.

Although official central government deficits have been tightly managed until recently, the state has run substantial deficits in the Konsolidacni Banka, Ceska Inkasni, Ceska Financni and National Property Fund and through the provision of state guarantees for infrastructure projects and health care providers. These off-budget outlays and contingent liabilities must be effectively managed if macroeconomic stability is to be maintained. The pressure of claims on the budget arising from guarantees increased to almost a quarter of the state budget deficit in 1998. Accumulated off-budget and contingent liabilities are estimated at 15% of GDP at the end of 1998, doubling the officially reported government debt.

Financial fragility restricts bank lending.

The Czech National Bank (CNB) cut its headline repurchase rate by 900 basis points between June 1998 and September 1999, easing significantly the stance of monetary policy. However, weak bank balance sheets (bad loans amount to 30% of total loans), caution by banks preparing for their privatisation and the application of stricter credit criteria by the banking sector have restricted availability of loans. Domestic

credit to enterprises declined by 5.3% in 1998. However, the capital of the banking sector increased by about 15% in 1998 owing to the recapitalisation of banks with new private ownership and the restructuring of state banks in advance of their privatisation. The fragility of the banking sector, together with high leverage in the corporate sector, has contributed to the economic recession.

Privatisation

Residual state control of some companies is increased.

The state has retained significant ownership stakes in mines, steel mills, chemical companies, oil-refineries, regional energy distribution companies, and other large enterprises such as Ceske Energetické Zavody (CEZ), SPT Telecom, and the two largest banks, Komerční Banka (KB) and Česká Spořitelna (CS). While the pace of privatisation has been slow in the last 12 months, with only bank privatisation advancing (see below), private investors have gained substantial shares in the mining and energy distribution companies through consolidation of publicly traded shares and acquisition of shares held by municipalities. However, in the case of regional energy distribution companies the state's ownership share has risen above 50% following share purchases in the market by CEZ and Transgas, two state-owned enterprises.

Enterprise reform

Strong FDI inflows spur industrial restructuring.

There has been a wave of sell-offs to foreign investors by the investment funds preparing for their opening and by large over-leveraged domestic conglomerates seeking fresh equity. The recession, domestic credit crunch and decline in asset prices have also contributed to the increase in FDI. Rapid restructuring and improvement in financial performance have often followed the entry of a strategic foreign partner as, for example, in the case of the automobile manufacturer Skoda Mlada Boleslav. Foreign investors have also responded to the investment incentives introduced in 1998 and to the

Liberalisation, stabilisation, privatisation

1990

Jul First Czechoslovak Eurobond

1991

Jan Exchange rate unified
Jan Fixed exchange rate regime adopted
Jan Most prices liberalised
Jan Most foreign trade controls lifted
Jan Small-scale privatisation begins
Feb Restitution law adopted
Mar Skoda Auto sold to Volkswagen

1992

Feb T-bills market initiated
May Voucher privatisation begins
Jul EFTA membership

1993

Jan Czechoslovakia splits into Czech and Slovak Republics
Jan VAT introduced
Jan Income tax law adopted
Feb New currency (koruna) introduced
Mar First Czech Eurobond
Mar CEFTA membership

1994

Mar Second wave of voucher privatisation begins

1995

Jan WTO membership
Oct Full current account convertibility introduced
Dec OECD membership

1996

Feb Exchange rate band widened

1997

Mar Managed float exchange rate regime adopted
Apr Austerity package announced
May Currency crisis
May Second austerity package announced

creation of new business zones with enhanced infrastructure provided by municipalities.

A state restructuring agency is established.

In response to significant problems in the industrial sector (Chemapol, a holding company controlling most of the chemical industry, was declared bankrupt in early 1999 and Skoda Plzen, CKD, Vitkovice and several other large industrial conglomerates are on the verge of bankruptcy), the government set up a Restructuring Agency in May 1999. It is envisaged that the agency will target a limited number of troubled large

Enterprises, infrastructure, finance and social reforms

1990

Jan Two-tiered banking system established

1991

Mar Competition law adopted

Oct Bankruptcy law enacted

1992

Jan Commercial code adopted

Feb Banking law enacted

Mar Telecommunications act amended

Apr Investment companies law enacted

May First bank privatised

May Insurance law adopted

Nov Securities law adopted

1993

Apr Stock exchange begins trading

Apr Bankruptcy law amended

1994

Sep First pension fund obtains licence

Nov First corporate Eurobond

1995

Jan Bad loan provisioning regulation adopted

Jan Energy law enacted

Jun Telecommunications privatisation begins

Jul Mortgage banking law enacted

1996

Jan BIS capital adequacy regulation enacted

Jul Securities law amended

Oct Forced administration of largest private bank

Nov Competition agency established

1997

Oct First power generation company sold

1998

Jan Bankruptcy law amended

Apr Investment incentives adopted

Apr Independent securities regulator established

Jun Law on investment funds adopted

Jul Utility prices increased

Sep Banking law amended

1999

May Enterprise restructuring agency established

is to be sub-contracted to an international company, the potential for state influence over restructuring remains through governance of the agency.

Weak laws impede improvements in corporate governance.

The voucher privatisation method chosen by Czech authorities in the early 1990s led to initially fragmented ownership and weak corporate governance. The poor incentives within enterprises arising from this voucher privatisation have persisted because of the slow adoption and enforcement of laws regulating capital markets and bankruptcy of enterprises. Although there have been some improvements in recent years, the capital market regulations are still not in line with EU practices (see below). Preparation of the new commercial code to strengthen minority shareholder and creditor rights is lagging. The bankruptcy process needs substantial improvements, although there has been a significant increase in declared bankruptcies (by 62% to 2,022 cases) in 1998. The government is currently working on the new bankruptcy law to streamline the bankruptcy process, but it will not be implemented before late 2000. The changes to the bankruptcy law are likely to ease conditions for reorganisation under the court protection, strengthen the administrator's role, and reduce discretion of the court to declare bankruptcy.

Infrastructure

The adjustment of energy prices is postponed further.

Cross-subsidies between household and enterprise electricity prices still exist. While previous governments improved the energy pricing, the government established after June 1998 elections has not continued with energy price deregulation. Residential electricity prices will have to increase substantially before the liberalisation of the energy sector, part of the EU accession process. Additional steps needed to prepare the energy sector for the full liberalisation comprise an adoption of the energy sector strategy, establishment of an independent regulator, and full privatisation of the companies operating in the energy sector, including the dominant energy generating company, CEZ.

EU accession-related infrastructure investment is constrained by government finances.

While infrastructure requires significant upgrading as part of the EU accession process, particularly in water and waste-water, infrastructure investment has been limited by the lack of public funds. The infrastructure projects supported by the current government are targeted at the regions with high unemployment, such as a motorway constructed in Northern Bohemia. The monopoly state railway runs large losses and its productivity is declining.

There is strong trade union opposition to railway reform. Several regional railway lines operated by private companies and municipalities are profitable, but further railway privatisation is not envisaged.

Financial institutions

Three of the five largest banks were recently privatised.

In addition to sales of Investicni and Postovni Banka and Agrobanka in early 1998, the privatisation of Ceskoslovenska Obchodni Banka, the fourth-largest bank, to KBC Bank for CZK 40 billion (US\$ 1.1 billion) was completed in June 1999. The privatisation of the two remaining state-owned banks, Ceska Sporitelna and Komerční Banka, will be more difficult as the share of classified loans in their portfolios exceeds 30%. The state has increased the capital of both banks and moved some of their classified loans to the Consolidation Bank. However, investor interest in the two banks is limited, pointing to the need for further loan portfolio restructuring.

Capital market regulations remain inadequate.

Despite creation of the Securities and Exchange Commission and amendments to the investment fund laws in early 1998, there is scope for further improvements in the capital market. A persistent problem is fragmentation of the securities market, including the lack of a single clearing and settlement facility and the existence of multiple prices for the same shares listed on more than one exchange. Further, enforcement of financial disclosure requirements for issuers and investment fund managers is weak, minority shareholder rights are poor, and duties of company directors are vague.

Social reform

The pay-as-you-go pension system is under increasing pressure.

With the ageing population, expenditures on pensions remained at 10% of GDP in 1998. To sustain the existing pension system, the government has proposed to increase the already high contributions to the pay-as-you-go system. However, the parliament has rejected the proposal. An option to contribute to private pension funds already exists, with incentives provided by the state. However, total cumulative contributions to these private funds is equivalent to only 1.3% of GDP, even though the number of contributors is equivalent to 35% of the labour force.

companies to safeguard employment and industrial capacity. The proposed selection criteria include: company size above 2,000 employees, local supplies in excess of CZK 1 billion (US\$ 30 million), debt with state-owned banks exceeding CZK 3 billion (US\$ 90 million) and positive operating profit. While the management of the agency

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Share of the population in poverty – 1%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – no	Private pension funds – yes
Wage regulation – no	Tradability of land – full except foreigners	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 37.7%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system – yes	
		Secured transactions law – restricted	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent) ¹	na	27.9	18.3	17.9	18.1	17.4	17.4	13.3	13.3
Number of goods with administered prices in EBRD-15 basket	15.0	9.0	5.0	4.0	3.0	3.0	3.0	2.0	2.0
Share of exports to non-transition countries (per cent)	na	na	na	66.1	70.5	70.9	68.8	68.4	na
Share of trade in GDP (per cent)	19.3	33.6	31.4	38.3	35.2	44.8	42.5	47.3	49.0
Tariff revenues (per cent of imports)	na	na	na	3.9	4.1	2.6	2.6	1.7	na
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	1.6	2.6	2.8	3.3	na
Private sector share in GDP	10.0	15.0	30.0	45.0	65.0	70.0	75.0	75.0	75.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	3.0	2.6	2.2	2.4	na
Efficiency of tax collection for social security (per cent)	na	na	na	73.7	73.4	71.3	70.5	72.1	na
Share of industry and construction in total employment (per cent)	45.4	46.5	44.8	44.6	42.2	41.5	41.0	40.9	na
Change in labour productivity in industry (per cent)	0.6	-19.3	-0.2	-0.5	7.9	8.1	2.6	5.6	5.1
Investment rate (per cent of GDP)	26.3	23.1	28.5	26.6	29.6	32.8	33.0	30.7	na
EBRD index of enterprise reform	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of competition policy	na	na	na	na	na	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	15.8	16.6	17.7	19.0	20.9	23.2	27.3	31.8	36.4
Railway labour productivity (1989=100)	90.5	81.8	91.8	76.8	80.0	84.0	83.2	80.2	73.0
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	3.23 (95%)	3.72 (95%)	3.87 (95%)	3.69 (95%)	na
Electricity consumption/GDP (1989=100)	98.5	109.0	109.5	113.6	113.5	112.4	112.5	111.4	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.8
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	45 (12)	55 (12)	55 (12)	53 (13)	50 (14)	45 (13)
Asset share of state-owned banks (in per cent) ²	na	na	na	20.6	20.1	19.5	18.0	18.1	18.8
Bad loans (per cent of total loans) ³	na	na	na	na	35.8	32.7	28.1	26.5	26.7
Credit to private sector (per cent of GDP)	na	na	na	50.8	57.8	58.1	55.9	66.3	60.1
Stock market capitalisation (per cent of GDP)	na	na	na	na	29.9	34.7	34.3	29.5	22.9
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	3.0	3.0	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	10.1	13.2	13.8	13.3	12.6	na	na
Life expectancy at birth, total (years)	70.8	70.3	69.5	69.4	69.4	68.3	69.2	70.9	na
Basic school enrolment ratio (per cent)	98.6	98.7	99.2	99.1	99.5	99.4	99.2	99.1	na
Earnings inequality (Gini coefficient)	na	21.2	21.4	25.8	26.0	28.2	25.4	25.9	na

¹ Excludes health insurance, motor insurance, customers' fees for radio and TV and fees by local authorities; these items represent about 5% of the CPI.

² Excludes Ceska Sporitelna and Komerční Banka.

³ Excludes loans on the books of Kosolidacni Banka, banks in receivership and the loan of CSOB to Slovenska Inkasni.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								<i>Estimate</i>	<i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>								
GDP	-11.5	-3.3	0.6	3.2	6.4	3.8	0.3	-2.3	0.0
Private consumption	-28.5	15.5	2.9	5.3	6.0	6.9	2.1	-3.0	na
Public consumption	-8.7	-3.2	0.0	-2.3	-3.4	-1.1	3.4	0.8	na
Gross fixed investment	-17.5	8.8	-8.1	17.3	19.9	8.2	-4.3	-3.8	na
Exports of goods and services	na	6.7	7.5	0.4	16.9	9.2	8.1	10.7	na
Imports of goods and services	na	22.0	10.2	7.8	21.2	14.3	7.2	7.9	na
Industrial gross output	-22.3	-7.9	-5.3	2.1	8.7	2.0	4.5	1.6	na
Agricultural gross output	-8.9	-12.1	-2.3	-6.0	5.0	-1.4	-5.1	0.7	na
Employment	<i>(Percentage change)</i>								
Labour force (end-year)	na	na	2.1	-1.7	0.4	1.4	-2.3	-0.2	na
Employment (annual average)	na	-2.6	-1.6	0.8	2.6	0.6	-1.0	-2.4	na
	<i>(In per cent of labour force)</i>								
Unemployment (end-year)	4.1	2.6	3.5	3.2	2.9	3.5	5.2	7.5	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	56.6	11.1	20.8	10.0	9.1	8.8	8.5	10.7	2.5
Consumer prices (end-year)	52.0	12.7	18.2	9.7	7.9	8.6	10.0	6.8	3.5
Producer prices (annual average)	70.3	10.0	9.2	5.3	7.6	4.8	4.9	4.9	na
Producer prices (end-year)	na	9.3	11.4	5.6	7.2	4.4	5.7	2.2	na
Gross average monthly wages in industry (annual average)	16.7	19.6	23.8	15.7	17.0	17.4	13.5	10.6	8.0
Government sector ¹	<i>(In per cent of GDP)</i>								
General government balance	-1.9	-3.1	0.5	-1.1	-1.8	-1.1	-2.1	-2.6	-5.0
General government expenditure	54.2	52.8	41.9	41.9	41.5	40.7	40.6	41.1	na
Public debt	na	na	19.2	17.5	15.7	12.9	19.0	27.5	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	26.8	20.7	22.5	20.8	19.4	7.8	8.7	5.2	na
Domestic credit (end-year)	na	14.6	18.1	14.0	5.9	9.1	4.6	0.9	na
	<i>(In per cent of GDP)</i>								
Broad money	na	69.4	71.9	73.6	75.3	71.3	72.5	70.3	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (up to 30-day maturity)	na	12.7	6.7	12.6	11.0	12.6	17.5	10.3	na
Discount rate	na	9.5	8.0	8.5	9.5	10.5	13.0	7.5	na
Deposit rate ²	na	6.3	7.0	6.9	6.9	6.7	8.1	6.7	na
Lending rate ²	na	13.3	14.1	12.8	12.7	12.5	13.9	10.5	na
	<i>(Koruna per US dollar)</i>								
Exchange rate (end-year)	27.8	28.9	29.8	28.2	26.7	27.3	34.7	30.0	na
Exchange rate (annual average)	29.5	28.3	29.2	28.8	26.6	27.1	31.7	32.3	na
External sector	<i>(In billions of US dollars)</i>								
Current account	0.3	-0.3	0.1	0.0	-1.4	-4.3	-3.2	-1.0	-0.6
Trade balance ³	-0.5	-1.9	-0.3	-0.9	-3.7	-5.9	-4.5	-2.6	-2.0
Exports ³	8.3	8.4	13.0	14.0	21.5	21.7	22.8	26.4	28.0
Imports ³	8.8	10.4	13.3	14.9	25.1	27.6	27.3	28.9	30.0
Foreign direct investment, net	na	1.0	0.6	0.7	2.5	1.4	1.3	2.5	3.5
Gross reserves (end-year), excluding gold	0.7	0.8	3.9	6.2	14.0	12.4	9.8	12.6	na
External debt stock (convertible currency)	6.7	7.1	8.5	10.7	16.5	20.8	21.4	23.6	na
	<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), excluding gold	0.8	0.8	2.7	3.9	5.6	4.2	3.4	4.1	na
	<i>(In per cent of exports of goods and services)</i>								
Debt service	na	12.4	6.5	13.1	9.3	10.4	15.0	14.5	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	10.3	10.3	na
GDP (in billions of koruna)	750	847	1,002	1,183	1,381	1,572	1,680	1,821	1,866
GDP per capita (in US dollars)	2,467	2,906	3,337	3,990	5,050	5,625	5,144	5,479	na
Share of industry in GDP (in per cent)	na	40.2	34.9	33.6	34.1	33.8	35.2	36.6	na
Share of agriculture in GDP (in per cent)	6.0	6.1	6.5	3.8	5.3	5.1	4.8	5.0	na
Current account/GDP (in per cent)	1.2	-1.0	0.3	-0.1	-2.6	-7.4	-6.1	-1.9	-1.1
External debt minus reserves (in US\$ billions)	6.0	6.2	4.6	4.5	2.5	8.4	11.6	10.9	na
External debt/GDP (in per cent)	26.4	23.7	24.7	26.0	31.8	36.0	40.3	41.7	na
External debt/exports (in per cent)	80.8	83.8	65.4	76.3	77.1	96.1	93.7	89.3	na

Note:

Data in bold type refer to former Czechoslovakia.

² Weighted average over all maturities.³ Data for 1991-92 represent the Czech Republic's share of the total for Czechoslovakia. Break in series in 1995 due to a change in the reporting system.¹ General government includes the state, municipalities and extrabudgetary funds, but excludes privatisation revenues.

Key reform challenges

- While the government plans to abolish corporate income tax on reinvested profits in January 2000, it will need to strengthen other revenue sources such as VAT and reform the public sector to help contain expenditures.
- With the privatisation of most medium-sized and large industrial enterprises complete, the focus is on restructuring the electricity and oil shale sector and privatising some infrastructure areas.
- Although significant steps have been taken to reform the pension system, the planned introduction of a fully funded tier financed by mandatory contributions would provide a stronger boost to capital market development.

Liberalisation

Estonia reaches a membership agreement with the WTO.

Estonia reached a membership agreement with the WTO and signed the accession protocol in May 1999. Under the agreement, Estonia has undertaken to accept the obligations of all WTO multilateral agreements without transition periods. It has committed itself not to raise import duties on goods above maximum levels that range for most industrial products between zero and 10%, and for most agricultural products between 15% and 45%. In services, Estonia has agreed that by 2003, it will open its telecommunications market to foreign providers for long-distance and international services, in both the fixed-line and mobile sectors, and give free access to foreign providers of financial, freight, education, environment and tourism services. The Estonian parliament is expected to ratify the agreement by October 1999.

New customs duties are to be imposed to meet EU accession requirements.

Estonia, which has not applied any notable tariffs since the mid-1990s, endorsed a customs bill in July 1999 that creates a general framework for the application of customs duties in preparation for EU accession. In August 1999, the government announced that new tariff barriers on non-EU countries (excluding those with which it has free trade agreements) are likely to come into force in early 2000.

Stabilisation

The currency board remains in place, but the peg has automatically changed to the euro.

When the euro was introduced on 1 January 1999, the Estonian kroon was pegged to the euro at the Deutschmark-euro conversion rate, or EEK 15.65 to €1. The new government has reaffirmed its commitment to the currency board, which it plans to maintain until Estonia becomes an EMU member and introduces the euro without a change in parity.

A new supplementary budget is approved.

In May 1999, the government approved a supplementary budget cutting EEK 1.05 billion from the EEK 18.46 billion budget for 1999. However, this cut may not be sufficient as tax revenues remain below target due to weak growth, some existing duties have been lowered and planned increases have been delayed. In June 1999, vehicle excise duties were reduced and the government postponed an increase in tobacco excise duties due to come into effect in July. Moreover, in August 1999 the government announced plans to abolish the 26% flat-rate corporate income tax on reinvested profits as of January 2000. To offset the budgetary shortfall, the government plans to introduce tariffs as well as expand the value-added tax base (by reducing the number of items for which lower VAT rates or exemptions apply).

Privatisation

The sale of Liviko will largely complete the privatisation of industrial companies.

The privatisation of the Liviko distillery began at the end of 1998 with the sale of 49% of its shares to a group of local investors led by Uhispank. In May 1999, a company owned by Uhispank and the top managers of the distillery, won a competitive bid for a 30% holding. The final 21% share of the company is to be sold publicly through privatisation vouchers. In addition to a number of infrastructure companies, only a small number of industrial companies and one bank remain to be privatised.

Reforms help to advance land privatisation.

Following recent regulatory changes for titling, the acceleration of land registration in cadastres and the simplification of procedures to privatise unclaimed land, the amount of privatised agricultural land rose to about 25% of all agricultural land by May 1999, up from 15% in 1997. The sale of another 25% of the land is expected within the next two years. This would complete the privatisation process, since 50% is to remain in public hands.

Liberalisation, stabilisation, privatisation

1990

Sep	Law on leasing enacted
Dec	State trading monopoly abolished
Dec	Law on privatisation of state-owned services, retail and catering enterprises enacted
Dec	Government decree on transformation of SOEs passed

1991

Jun	Law on the fundamentals of ownership reform enacted
Aug	Independence from Soviet Union
Oct	Tradability of land rights enacted
Dec	Small-scale privatisation started

1992

Jun	Unified exchange rate introduced
Jun	New currency (kroon) and currency board introduced
Nov	Large-scale privatisation commenced
Dec	Most consumer prices liberalised

1993

May	Central bank independence granted
Jun	Law on compensation fund enacted
Jun	Law on property rights enacted
Jun	Privatisation act adopted
Aug	Estonian Privatisation Agency established
Nov	Remaining tariffs abolished

1994

Jan	VAT introduced
Jan	Non-tariff trade restrictions removed
Jan	Flat-rate income tax introduced
Aug	Government decree on the procedures for public offering of shares in SOEs
Aug	Full current account convertibility introduced

1996

Oct	Law on property rights amended
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Enterprise reform

A new competition law has been adopted.

The new competition law, which came into force in October 1998, requires the competition agency to investigate mergers to ascertain their impact on competition. The new act also provides for limits on enterprises that have exclusive rights or natural monopolies and establishes criteria for the granting of state aid. These changes bring Estonian competition law into line with that of the EU.

Infrastructure

The flotation of Eesti Telekom is completed.

Despite an attempt by some parliamentarians to declare Eesti Telekom a strategic enterprise that would require a 51% shareholding by the

Enterprises, infrastructure, finance and social reforms

1991

Sep	Law on foreign investment enacted
Oct	Telecommunications law adopted
Dec	Electricity law enacted

1992

Jun	Bankruptcy law enacted
Nov	First foreign bank founded

1993

Apr	Banking regulations adopted
Jun	Securities law enacted
Jun	Securities commission established
Jun	Competition law passed
Oct	Competition agency established
Dec	Law on prices and regulation approved for electricity sector

1994

Aug	Government decree on investment funds passed
Sep	BIS capital adequacy
Dec	Banking law amended

1995

Jan	Introduction of IAS
Feb	First state-owned bank privatised
Feb	Commercial code enacted

1996

May	Stock exchange established
May	Electric power pricing reformed
May	Money laundering regulations adopted
Jun	Trade in listed shares commenced
Jun	Commercial code amended
Nov	Energy law approved
Dec	Insolvency law amended

1998

Apr	Major adjustment to utility prices
Jun	Pension reform law adopted
Jul	Third pension tier introduced
Jul	Banking regulations tightened
Oct	Deposit insurance law takes effect
Oct	EU compatible competition law adopted

1999

Jan	First pension tier becomes operational
Feb	First Estonian Eurobond issue by Ühispank
Feb	Eesti Telekom floated
Feb	Telecommunications law amended
Feb	Banking law amended

state, the company was floated in February 1999 through an issue of GDRs in London and a public offering in Tallinn. The issue was 18 times oversubscribed and raised around EEK 3 billion. The sale and subsequent restructuring left its three strategic owners, Telia of Sweden, Sonera of Finland and Baltic Tele AB, with a combined stake of 49%. The

government retains a 27.3% stake, as well as a “golden share” with veto rights over certain strategic corporate decisions which is to expire at end-2002.

Railway privatisation is progressing.

The government is drawing up a plan for the sale of the largest freight rail operator, Eesti Raudtee, by the beginning of 2000. It plans to sell up to 67% through competitive tender but retain a golden share with veto rights. The sale of 100% of the largest passenger service, Edelaraudtee, is also progressing with the selection of the British GB Railways Group.

Privatisation of the power sector has been initiated.

Two power distribution companies – Laanemaa and Narva – were separated from the integrated state power company (Eesti Energia) and privatised in 1998. The intention is to unbundle the industry fully and to privatise at least some of the distribution and generation companies, while keeping ownership of the transmission company in state hands. Eesti Energy and the Estonian Government are in negotiations with NRG of the United States for the sale of the Narva and Balti oil shale-fired power plants. It is expected that these will be sold together in a package that includes the Eesti Polevkivi oil shale company. The privatisation is to take place through the expansion of share capital, after which 49% of the shares would belong to NRG and 51% to Eesti Energia. Under present proposals, the company would be guaranteed a 75% share of the generation market for 6-7 years, and a 50% share for the following 6-7 years. This approach would be consistent with market liberalisation required for EU accession.

Gas sector privatisation is completed.

In February 1999, the government sold the remaining 11.4% of shares in the single gas utility, Estonian Gaas, to Ruhrgas, making it the largest single shareholder with 32.1%. Gazprom holds 30.6%, Finland's Neste and Latvia's Itera each own 10% and portfolio investors have 17.3%.

Municipal utilities are being sold.

In July 1999, Sweden's Vattenfall energy group acquired a 95.6% holding in OU Ulejoje Soojusvork, a heating network company in Pärnu, from the municipal government. The Tallinn city council also announced the planned sale of 33% of the water utility later in 1999.

Financial institutions

Mergers and the Russian crisis contribute to bank consolidation.

There are now five licensed banks operating in Estonia (including one foreign bank), down from 11 in 1997. Over the past year, a number of banks have merged. Hansapank has joined with Hoiupank and Ühispank with Tallinna Pank. At the same time,

Swedbank has acquired a controlling stake in Hansapank (just under 50%) and Skandinaviska Enskilda Banken acquired a significant minority stake in Ühispank (holding 36%). A number of banks have closed. In late 1998, the central bank recapitalised a troubled bank (Foreksbank) and merged it with another bank (Estonian Investment Bank). In early 1999, following the Russian crisis, Eeva Pank and ERA Pank (which owned 35% of Eeva Pank) were declared bankrupt.

Deposit insurance and banking regulations are being reformed.

A new deposit insurance law took effect in October 1998 that provides compensation up to 90% of deposits or to a maximum of EEK 20,000. In addition, a new credit institutions law became effective in July 1999, which strengthens the central bank's authority in exercising its supervisory functions and enhances corporate governance of banks. In March 1999, the central bank announced plans to establish an integrated financial supervisory authority for banking, securities activities and insurance. However, it is not anticipated that this body will come into existence before January 2002.

Ühispank taps the Eurobond market.

In February 1999, Eesti Ühispank became the first Estonian private borrower and the first central or east European bank since the Russian crisis to tap the euro-denominated bond market with a 3-year €50 million floating rate note priced at 350 basis points over Euribor. It carried a put option exercisable after years one and two.

Social reform

Pension reform has progressed slowly.

In response to the build-up of contingent pension liabilities, the authorities are moving from the pay-as-you-go pension system to a three-tier partially funded scheme. The first tier became operational in January 1999 and is financed by a 33% social tax (part of which is designated for health care). The fully funded second tier (to be introduced in 2001) will offer additional pension coverage financed by mandatory individual contributions and the government is currently devising a conceptual framework for its implementation. The third tier (introduced in July 1998) consists of voluntary contributions administered by private pension funds and insurance companies. There are four insurance licence holders and one private pension fund, Hansa Asset Management, which received its licence in March 1999. Contributions to private pension funds are tax-free up to a maximum of 15% of income and the lump-sum payments from the fund at pension age are taxed at 10% (but tax free if taken out as annuity). Despite the tax-advantageous arrangement for voluntary pensions, the initial response has been slow.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – no	Share of the population in poverty – 40%
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Separation of railway accounts – yes	Private pension funds – yes
Wage regulation – no	Tradability of land – full except foreigners	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 34.4%	Competition office – yes	Capital adequacy ratio – 10%	
Exchange rate regime 1 – currency board		Deposit insurance system – yes	
		Secured transactions law – restricted	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	21.1	18.0	24.0	24.0	24.0
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	3.0	3.0	3.0	3.0	3.0
Share of exports to non-transition countries (per cent)	na	na	na	68.7	70.7	71.9	74.5	72.0	na
Share of trade in GDP (per cent)	na	na	46.9	54.1	61.6	57.2	53.3	61.6	62.5
Tariff revenues (per cent of imports) ²	na	na	na	0.9	0.9	0.2	0.1	0.1	0.0
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	16.3	50.3	69.1	78.9	88.1	94.7	99.6	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	2.2	6.9	9.4	10.6	12.9	13.7
Private sector share in GDP	10.0	10.0	25.0	40.0	55.0	65.0	70.0	70.0	70.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	3.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	0.9	0.5	0.4	0.3	na
Efficiency of tax collection for social security (per cent)	na	na	55.1	63.4	61.0	57.6	61.4	62.3	na
Share of industry and construction in total employment (per cent)	36.8	36.4	35.5	33.0	32.3	34.0	33.5	33.6	33.2
Change in labour productivity in industry (per cent)	na	-3.2	-30.3	-5.1	0.9	-5.6	7.5	22.4	4.0
Investment rate (per cent of GDP)	23.8	20.9	21.0	23.9	26.4	26.0	26.7	26.5	na
EBRD index of enterprise reform	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of competition policy	na	na	na	na	na	3.0	3.0	2.7	2.7
Infrastructure									
Main telephone lines per 100 inhabitants	20.3	21.2	21.5	23.1	24.5	27.7	29.9	32.1	34.3
Railway labour productivity (1989=100)	96.1	92.2	53.1	55.0	47.7	50.8	55.0	74.2	98.6
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	1.6 (99%)	3.0 (100%)	3.2 (98%)	3.4 (97%)	na
Electricity consumption/GDP (1989=100)	100.8	108.3	107.2	116.9	134.1	135.6	135.9	130.2	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	3.3
Financial institutions									
Number of banks (of which foreign-owned) ³	na	na	na	21 (1)	22 (1)	18 (4)	15 (3)	12 (3)	6 (2)
Asset share of state-owned banks (in per cent) ⁴	na	na	na	25.7	28.1	9.7	6.6	0.0	7.8
Bad loans (per cent of total loans) ⁵	na	na	na	na	3.5	2.4	2.0	2.1	4.0
Credit to private sector (per cent of GDP)	na	18.8	7.6	11.2	14.1	14.9	18.1	25.9	25.3
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	16.7	24.6	9.5
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	3.3	3.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	4.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	69.5	69.5	69.0	68.0	67.0	67.8	69.8	70.1	na
Basic school enrolment ratio (per cent)	94.9	93.6	92.3	91.7	91.2	92.2	92.8	93.7	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ Fixed at a rate of 8 kroon to the DM.

² Excludes differential excise taxes on imports.

³ Includes Merita-Nordbanken branch and investment banks.

⁴ Increase in 1998 is due to the renationalisation of Optiva bank, following its insolvency in late 1998.

⁵ Refers to provisions for non-collectible loans.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								<i>Estimate</i>	<i>Projection</i>
Output and expenditure									
	<i>(Percentage change in real terms)</i>								
GDP	-13.6	-14.2	-9.0	-2.0	4.3	3.9	10.6	4.0	0.0
Private consumption	na	na	na	0.9	5.3	8.0	8.9	5.6	na
Public consumption	na	na	na	2.0	18.6	0.0	1.3	7.5	na
Gross fixed investment	na	na	na	6.2	4.0	11.4	17.5	8.1	na
Exports of goods and services	na	na	na	3.8	5.5	2.2	30.4	12.1	na
Imports of goods and services	na	na	na	12.5	5.4	7.5	29.8	11.1	na
Industrial sales	-7.2	-35.6	-18.6	-3.1	2.0	2.9	15.0	1.8	na
Agricultural gross output	na	na	na	na	0.2	-6.3	-1.5	na	na
Employment ¹									
	<i>(Percentage change)</i>								
Labour force (end-year)	na	na	na	-2.2	-2.0	-1.6	-0.5	-1.5	na
Employment (annual average)	na	na	na	-2.2	-5.3	-1.6	0.4	-0.7	na
	<i>(In per cent of labour force)</i>								
Unemployment	na	na	6.5	7.6	9.7	10.0	9.7	9.6	na
Prices and wages									
	<i>(Percentage change)</i>								
Consumer prices (annual average)	210.5	1076.0	89.8	48.0	29.0	23.0	11.2	8.2	3.3
Consumer prices (end-year)	303.8	953.5	35.6	42.0	29.0	15.0	12.5	4.4	3.1
Producer prices (annual average)	na	na	75.2	36.3	25.6	14.8	8.8	3.8	na
Producer prices (end-year)	na	na	na	32.8	21.8	9.9	7.7	-0.2	na
Gross monthly earnings in manufacturing (annual average)	na	na	93.3	72.2	35.7	23.5	19.6	14.0	na
Government sector ²									
	<i>(In per cent of GDP)</i>								
General government balance	5.2	-0.3	-0.7	1.3	-1.3	-1.9	2.2	-0.3	-3.0
General government expenditure	na	34.9	40.3	39.2	41.4	40.7	37.8	38.6	na
Public debt	na	na	na	na	6.7	6.9	5.6	4.6	na
Monetary sector									
	<i>(Percentage change)</i>								
Broad money (end-year)	na	59.0	93.3	40.1	34.5	35.6	42.3	0.1	na
Domestic credit (end-year)	na	29.6	53.4	42.3	41.0	132.8	86.2	23.1	na
	<i>(In per cent of GDP)</i>								
Broad money	na	28.3	33.1	33.8	33.1	34.8	40.4	35.5	na
Interest and exchange rates									
	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (up to 30 days maturity)	na	na	na	na	6.03	5.82	14.67	18.15	na
Deposit rate (over 12 months) ³	na	na	na	8.79	8.73	10.46	10.78	8.93	na
Lending rate (over 12 months) ⁴	na	na	na	17.50	15.84	13.88	11.18	16.30	na
	<i>(Kroon per US dollar)</i>								
Exchange rate (end-year)	na	12.9	13.9	12.4	11.5	12.4	14.3	13.4	na
Exchange rate (annual average)	na	12.1	13.2	13.0	11.5	12.0	13.9	14.1	na
External sector									
	<i>(In millions of US dollars)</i>								
Current account	na	36	22	-167	-158	-398	-563	-478	-325
Trade balance	na	-90	-145	-357	-666	-1,019	-1,125	-1,115	-1,140
Exports (merchandise)	na	461	812	1,226	1,697	1,813	2,294	2,690	2,663
Imports (merchandise)	na	551	957	1,583	2,363	2,832	3,419	3,805	3,803
Foreign direct investment, net	na	na	156	212	199	111	130	575	350
Gross reserves (end-year), excluding gold	na	160	329	442	580	637	758	811	na
External debt stock (end-year)	na	na	161	187	287	1,499	2,564	2,900	na
	<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold	na	2.6	3.1	2.6	2.4	2.2	2.1	2.0	na
	<i>(In per cent of exports of goods and non-factor services)</i>								
Debt service ⁵	na	na	1.4	0.4	0.7	2.2	3.6	5.2	na
Memorandum items									
	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	1.56	1.53	1.51	1.49	1.48	1.46	1.45	1.45	na
GDP (in millions of kroons)	1,832	13,054	21,610	29,645	40,705	52,446	64,324	73,213	76,018
GDP per capita (US dollars)	na	707	1,085	1,530	2,405	2,981	3,192	3,593	na
Share of industry in GDP (in per cent)	na	27.5	22.0	21.1	20.7	19.8	19.0	18.1	na
Share of agriculture in GDP (in per cent)	na	12.6	9.8	9.0	7.1	6.8	6.0	5.6	na
Current account/GDP (in per cent)	na	3.3	1.3	-7.3	-4.4	-9.1	-12.1	-9.2	-6.3
External debt minus reserves (in US\$ millions)	na	na	-168	-255	-293	863	1,807	2,089	na
External debt/GDP (in per cent)	na	na	9.9	8.2	8.1	34.4	55.3	55.8	na
External debt/exports (in per cent)	na	na	19.8	15.3	16.9	82.7	111.8	107.8	na

¹ New series based on the ILO methodology. Figures for 1998 are based on data for the second quarter.

² General government includes the state, municipalities and extrabudgetary funds.

³ Weighted average annual interest rate of time deposits.

⁴ Weighted average annual interest on kroon loans.

⁵ There is a break in the debt series between 1995 and 1996. The data from 1996 onwards are from the Central Bank of Estonia.

Key reform challenges

- **The conflict in neighbouring Kosovo has significantly weakened the economy, mainly through reduced exports and increased social expenditure. The new government faces a considerable challenge in pushing ahead with reforms in the face of a macroeconomic slowdown and political volatility.**
- **Large-scale privatisation has been slow to take off. The government faces major challenges in selling or liquidating large, loss-making enterprises, both because of their limited viability and because of possible negative, short-term social consequences.**
- **The government is preparing key strategic sectors such as telecommunications for privatisation and is aiming to attract the interest of foreign investors.**
- **The banking sector remains relatively underdeveloped, with a high concentration, a large number of small banks and a high proportion of bad loans. Full privatisation of the largest bank, Stopanska Banka, is an urgent priority.**

Liberalisation

FYR Macedonia is a leading candidate for a new type of relationship with the EU.

The European Commission is proposing to develop Stabilisation and Association Agreements (SAAs) with several countries in the Balkan region to draw each target country into closer European union. The Commission adopted a favourable report on FYR Macedonia in June 1999, and it is likely to be the first country to begin SAA negotiations, perhaps by the end of 1999. The proposed areas for negotiations include the promotion of enhanced economic relations and free trade. Full membership of the EU, however, remains a distant prospect.

Pricing policies for agricultural products have been reformed.

The government has introduced important reforms in pricing for agricultural products, as part of an agreement with the World Bank under a Structural Adjustment Loan (December 1998). The price cap on bread has been abolished and guaranteed prices for certain products such as sugar beet and sunflower oil have been eliminated. Guaranteed prices for tobacco and wheat are now set below 70% of world prices, although procurement prices for tobacco were increased sharply in early 1999.

Stabilisation

Macroeconomic policies are broadly unchanged by the fallout from Kosovo.

The war in neighbouring Kosovo has had a severe impact on the economy, but signs of recovery are now apparent. Macroeconomic policy continues to be based on tight fiscal policy and a de facto peg of the exchange rate in relation to the Deutschmark. The latter policy has been assisted by the inflow of hard currency due to the large increase in military personnel, foreign journalists and international donors. On the fiscal side,

revenue collection procedures continues to be strong, and foreign aid and loans are absorbing most of the costs associated with the inflow of refugees. In August 1999, the IMF agreed a new loan of US\$ 19 million to help offset the recent sharp drop in exports.

VAT will be introduced in 2000.

FYR Macedonia has relatively high levels of taxation, with a heavy reliance on labour, sales and excise taxes. For several years, the authorities have been preparing to replace the sales tax with value added tax (VAT). The introduction of VAT has been delayed, but a law was passed by parliament during the summer. The tax is expected to be in place in January 2000. There will be two rates: a standard rate of 19%, and a reduced rate of 5% for certain essential commodities. Reductions in the high levels of direct taxation were envisaged, but may have to be postponed as a result of the economic downturn and increased expenditure resulting from the Kosovo crisis.

Privatisation

The government intends to sell or liquidate several large loss-making enterprises by the end of 1999.

By the end of June 1999, small-scale privatisation was largely complete with 1,458 companies privatised. Of the 250 or so small enterprises still to be sold, only 71 have not yet started the process. Attention is now focused on the remaining large state-owned companies and public monopolies. Twelve large, loss-making industrial enterprises with majority state-ownership, covering about 10,000 employees, have been identified for sale or liquidation. There have been significant delays in implementing this programme, largely due to the government's reluctance to add to already high unemployment and the difficulties of attracting potential buyers. However, several of these enterprises

Liberalisation, stabilisation, privatisation

1991

Sep Independence from Yugoslavia

1992

Apr New currency (denar) introduced

1993

Jun Privatisation law adopted

Nov First credit auction by central bank

Nov Privatisation Agency becomes operational

1994

Jan Sales taxes streamlined

Feb Greek embargo imposed

1995

Sep Greek embargo lifted

1996

Feb Major tax reforms introduced

Apr Agricultural privatisation law enacted

Jul Trade reforms enacted

Aug Import restrictions eliminated

1997

Jul Denar devalued

Jul New land law enacted

1998

Jan Partnership and cooperation agreement with EU

Jun Full current account convertibility introduced

(4 to 5) are still scheduled to be closed or sold by the end of the year. The World Bank has signed a US\$ 10 million loan to help mitigate the social consequences of resulting redundancies.

The privatisation programme is being extended to socially owned enterprises in agriculture.

Privatisation of the agricultural sector has proceeded more slowly than in manufacturing or services. However, by the end of 1998, 323 agricultural enterprises (representing about 15,000 employees) had been sold. Three large agricultural *kombinats* were privatised in late 1998 (representing 15% of all *agrikombinats*), with each being split into a number of smaller companies. Most privatisation in this sector has been through sale to existing managers and farmers. The process is proceeding gradually and full privatisation of the sector is likely by the end of 2000.

Enterprises, infrastructure, finance and social reforms

1992

Apr Two-tiered banking system established
Jun Securities and exchange commission established

1993

May BIS capital adequacy enacted

1994

Jan Bank credit ceilings introduced

1995

Mar Banking rehabilitation law adopted

1996

Mar Stock exchange begins trading
Apr Banking law adopted
Jun Telecommunications law adopted

1997

Mar TAT Savings House collapses
Jul Securities law enacted
Nov Electricity law adopted

1998

May New bankruptcy law enacted

New bankruptcy procedures are being implemented very slowly.

A new bankruptcy law, based on the 1994 German Insolvency Statute, was passed in late 1997 and became effective in May 1998. However, application of the law is proceeding very slowly, particularly with regard to large enterprises. Several cases are in process, but the courts are reluctant to declare such enterprises bankrupt, as this may lead to widespread redundancies.

Infrastructure

The government is seeking to attract a strategic investor for the national telecommunications company.

The government has been preparing for the privatisation of the state-owned Makedonski Telekomunikacii (MT), building on the pre-privatisation programme of the previous government. The Kosovo crisis has led to delays in the process and the new target date is June 2000. A strategic investor has not yet been identified. MT secured pre-privatisation financing in 1998 of US\$ 50 million from the IFC and ING, and is seeking additional financing from international investors to expand the mobile network, in order to meet the recent sharp upturn in demand. MT has a monopoly in fixed-line and other telecommunications services. It is not yet clear how long this monopoly will last after privatisation. Plans for setting up a fully independent regulator are being developed.

economic activity this year, and two banks (one domestic bank and one branch of a foreign bank) are currently under a rehabilitation programme of the central bank, supported by the government.

Activity on the stock exchange has increased rapidly but remains at a low level.

Turnover on the stock exchange, founded in 1996, increased sharply in 1998 to over DM 150 million, up from DM 36 million in 1997. Part of this increase reflected a rise in the interest of foreign investors in the country and the purchase of majority shares in certain companies by strategic investors. However, the market remains thin and most trading continues to take place on the third market, where companies are unlisted. Plans to expand the market include proposals for a law on investment funds, a clearing house and a central share registry.

Social reform

Poverty is being exacerbated by the Kosovo conflict.

A World Bank survey of poverty in 1996 indicated that 18% of the population were living below the poverty line. The likely stagnation in output this year as a result of the Kosovo conflict may increase this number by up to 2-3 percentage points, according to a new poverty assessment by the World Bank. Rural areas are likely to suffer disproportionately because of the costs of absorbing refugees and the fall in agricultural exports. In addition, unemployment remains very high, at around 35% of the labour force.

Enterprise reform

A new competition law has been drafted but not yet enacted.

The previous government prepared comprehensive anti-monopoly legislation in 1998, the first reading of which took place in the middle of that year. However, the law has not yet been passed by the new parliament and it is unclear when it will be further considered.

Perceptions of increased risk dampened foreign direct investment.

Foreign direct investment increased sharply in 1998, rising from US\$ 18 million in 1997 to well over US\$ 100 million. Significant investments, mostly from west European countries, included a cement company (Cementamica Usje) and a brewery (Privara Skopje Brewery). However, several planned deals for the first half of 1999 have been postponed because of the deterioration in the investment climate and increased investor caution in the region. FDI is now expected to pick up again on the back of renewed stability in the region, and following recent amendments to the privatisation law that facilitate foreign investment. A survey conducted last year of Greek and German foreign investors found that they were often deterred by, *inter alia*, confusion over ownership rights, lengthy and inconsistent decision-making by the government, and cumbersome procedures for tax and customs relief.

Financial institutions

Privatisation of Stopanska Banka has been delayed.

Bank privatisation has proceeded gradually, both through the privatisation of existing shareholders and the sale of new shares. In the sector as a whole, the average rate of privatisation at the end of 1998 was 77%. The late withdrawal last year of a foreign strategic investor delayed the full privatisation of the largest bank, Stopanska Banka, which accounts for about one-third of all banking assets. A new strategic investor has been identified and an agreement is expected soon, with the participation of the EBRD and the IFC.

The financial condition of some banks has weakened.

Outstanding credit from the central bank to Stopanska Banka has increased sharply in 1998 and early-1999, and doubtful loans remain a feature of the sector as a whole. At the end of 1998, about one-third of all loans were classified as bad or doubtful, although the overall trend has been improving over the past four years, largely due to the write-off of existing loans. A number of banks have reported difficulties in their loan portfolios as a result of the slow down in

Liberalisation	Privatisation	Infrastructure	Financial sector
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator – no	Capital adequacy ratio – 8%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – not available	Deposit insurance system – yes
Wage regulation – no	Tradability of land – limited de jure	Independent electricity regulator – no	Secured transactions law – yes
Stabilisation	Enterprises		Social reform
Share of general government tax revenues in GDP – 33.6%	Competition office – no		Share of the population in poverty – 20%
Exchange rate regime 1 – fixed			Private pension funds – no

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	32.8	24.8	17.7	15.0	15.5	15.0	19.6	19.6	na
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	4.0	3.0	2.0	2.0	2.0	2.0	na
Share of exports to non-transition countries (per cent)	na	na	na	na	na	na	na	na	na
Share of trade in GDP (per cent)	29.5	26.9	51.9	41.2	37.4	32.8	33.1	43.0	49.2
Tariff revenues (per cent of imports)	na	na	na	na	10.5	12.5	11.4	6.8	6.9
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	na	na	na	na	na
Private sector share in GDP	15.0	15.0	15.0	35.0	35.0	40.0	50.0	50.0	60.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	3.1	2.7	2.0	0.3	na
Efficiency of tax collection for Social Security (per cent)	na	na	na	na	na	na	na	na	na
Share of industry and construction in total employment (per cent)	na	na	na	na	na	na	35.6	33.7	na
Change in labour productivity in industry (per cent)	-7.5	-9.6	-10.0	-10.4	-4.9	3.1	9.2	8.2	6.5
Investment rate (per cent of GDP)	23.6	19.3	16.4	3.1	1.6	4.0	6.0	7.2	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	14.2	14.3	15.2	15.6	16.1	16.5	17.0	19.9	na
Railway labour productivity (1989=100)	76.9	83.4	66.6	61.0	23.7	27.1	47.2	43.6	58.7
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	2.73 (90%)	2.81 (90%)	3.1 (90%)	3.54 (90%)	na
Electricity consumption/GDP (1989=100)	93.2	103.3	106.8	125.5	134.7	146.8	157.7	162.0	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.2
Financial institutions									
Number of banks (of which foreign-owned) ²	na	na	na	na	6 (3)	6 (3)	22 (5)	22 (5)	24 (5)
Asset share of state-owned banks (in per cent) ^{2, 3}	na	na	na	na	na	na	0.0	0.0	0.7
Bad loans (per cent of total loans) ⁴	na	na	na	na	na	na	42.2	35.6	32.9
Credit to private sector (per cent of GDP)	na	na	na	59.3	48.8	25.6	29.8	30.6	20.5
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	0.3	na
EBRD index of banking sector reform	na	na	na	na	2.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	1.0	1.0	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	15.0	14.3	14.4	13.8	na	na	na
Life expectancy at birth, total (years)	72.3	na	72.5	na	na	na	na	72.5	na
Basic school enrolment ratio (per cent)	89.4	87.1	86.2	86.2	86.8	86.5	86.9	na	na
Earnings inequality (Gini coefficient)	22.3	26.7	23.5	27.2	25.3	27.0	25.0	25.9	na

¹ Peg to the DM at a rate of 30.9 denar.² Number and assets of banks exclude branches of foreign banks.³ Increase in 1998 is due to the establishment of the Macedonian Bank for Development Promotion.⁴ Includes loans of banks under forced administration.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-7.0	-8.0	-9.1	-1.8	-1.2	0.8	1.5	2.9	0.0
Industrial gross output	-17.2	-13.0	-9.0	-7.0	-6.0	3.4	1.7	4.5	na
Agricultural gross output	17.1	0.5	-23.5	7.1	4.0	1.2	5.5	3.0	na
Employment ¹	(Percentage change)								
Labour force (annual average)	1.3	1.3	-3.6	-2.4	-1.5	na	1.4	na	na
Employment (annual average)	-6.5	-5.2	-5.6	-6.0	-9.9	-4.7	-4.7	5.4	na
	(In per cent of labour force)								
Unemployment (annual average) ²	19.2	27.8	28.3	31.4	37.7	31.9	36.0	34.5	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	na	1,664.4	338.4	126.5	16.4	2.5	1.5	0.6	2.0
Consumer prices (end-year)	229.7	1,935.0	241.8	55.0	9.0	-0.6	2.6	-3.1	2.0
Producer prices in industry (annual average)	112.0	2,198.2	258.3	84.6	3.9	-0.2	4.5	4.0	na
Producer prices in industry (end-year)	281.5	2,148.6	177.8	28.5	2.2	-0.6	8.6	-0.1	na
Net average monthly wages in industry (annual average)	79.2	1,084.1	454.0	105.8	11.1	3.6	2.3	3.1	na
Government sector ³	(In per cent of GDP)								
General government balance	na	-9.6	-13.8	-2.9	-1.2	-0.5	-0.4	-1.7	-7.8
General government expenditure	na	48.2	55.3	50.5	43.1	37.0	35.3	35.3	41.9
Monetary sector	(Percentage change)								
Broad money (end-year)	na	na	na	na	6.4	0.1	17.6	14.9	na
Domestic credit (end-year)	na	na	na	na	-22.3	-11.5	6.8	na	na
	(In per cent of GDP)								
Broad money	na	na	25.6	14.2	12.3	11.9	14.1	na	na
Interest and exchange rates	(In per cent per annum, end-year)								
Refinancing rate	na	719	848	66	30	18.4	22.2	22.2	na
Discount rate	na	250	295	33	15	9.2	8.9	8.9	na
Deposit rate ⁴	na	435	322	32	9	9	9	9	na
Lending rate ⁵	na	1,100	367	87	25	20	20	17	na
	(Denar per US dollar)								
Exchange rate (end-year)	0.2	12.4	44.5	40.6	38.0	41.4	54.9	51.6	na
Exchange rate (annual average)	0.2	5.1	23.6	43.2	38.0	39.9	49.8	54.5	na
External sector	(In millions of US dollars)								
Current account	-262	-19	15	-180	-230	-288	-275	-318	-300
Trade balance	-225	-7	43	-186	-235	-317	-386	-400	-350
Exports	1,150	1,199	1,056	1,086	1,204	1,147	1,237	1,322	1,134
Imports	1,375	1,206	1,013	1,272	1,439	1,464	1,623	1,722	1,484
Foreign direct investment, net	na	0	0	24	13	12	18	175	30
Gross reserves (end-year), excluding gold	na	na	105	149	270	267	280	333	na
External debt stock	744	758	818	844	1,060	1,121	1,141	1,400	na
	(In months of current account expenditures, excluding transfers)								
Gross reserves (end-year), excluding gold	na	na	1.2	1.3	1.9	2.0	1.9	2.0	na
	(In per cent of current account revenues, excluding transfers)								
Debt service	na	na	13.1	15.8	10.1	10.8	8.5	9.5	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	2.2	2.2	2.2	2.1	2.1	2.0	2.0	2.0	na
GDP (in millions of denar)	920	11,791	59,161	136,033	169,521	176,477	185,023	193,153	197,000
GDP per capita (in US dollars)	2,134	1,053	1,141	1,500	1,917	1,971	1,663	1,548	na
Share of industry in GDP (in per cent)	na	29.4	25.1	19.3	19.2	19.5	19.0	na	na
Share of agriculture in GDP (in per cent)	na	14.4	9.8	10.4	10.7	11.0	10.8	na	na
Current account/GDP (in per cent)	-5.6	-0.8	0.6	-5.7	-5.2	-6.5	-7.4	-9.0	-8.8
External debt minus reserves (in US\$ millions)	na	na	713.0	695.0	790.0	854.0	861.0	1,067.0	na
External debt/GDP (in per cent)	15.9	32.7	32.6	26.8	23.8	25.3	30.7	39.5	na
External debt/exports (in per cent)	64.7	63.2	77.5	77.7	88.0	97.7	92.2	105.9	na

¹ Figures on employment and labour force up to 1995 are based on census data and are not comparable with later years, which are based on the ILO definition of unemployed.

² Up to 1995, figures refer to officially registered unemployment. From 1996, they are based on a labour force survey.

³ General government includes the state, municipalities and extrabudgetary funds.

⁴ Household deposit rate (3-6 months). Minimum rate offered.

⁵ Lending rate to small enterprises. Minimum rate offered.

Key reform challenges

- **The advances in privatisation must be complemented by tighter enforcement of bankruptcy legislation and improvements in the investment climate to accelerate restructuring and foster new entry.**
- **State capacity has been severely impaired by the lack of revenue collection. Improving tax compliance will be key to overcoming the budgetary crisis and providing adequate social protection.**
- **Further consolidation in the banking sector will be important in order to strengthen confidence in the financial system and increase its role in financial intermediation.**

Liberalisation

Prospects for WTO accession are promising.

Following a year of intense work to harmonise legislation with international standards in the areas of customs valuation, sanitary and phytosanitary measures, technical barriers to trade, trademarks and government procurement, Georgia may in 1999 become the fourth country of the former Soviet Union to join the WTO (after Kyrgyzstan, Latvia and Estonia). Final official negotiations, including a draft Protocol of Accession specifying the terms of entry, were concluded in July 1999. Upon approval by the General Council of the WTO, expected for October, documentation will be submitted to the Georgian parliament for ratification. Georgia has stated its readiness to undertake the obligations of the agreement immediately upon accession without recourse to transitional periods. Tariffs are low, with a base rate of 12%, a lower rate of 5% for capital goods and few exemptions.

Stabilisation

Government control over the fiscal situation remains weak.

The National Bank of Georgia (NBG) continues its freely floating exchange rate policy adopted in December 1998, so as to rebuild exchange reserves. The absence of a nominal exchange rate anchor has shifted the burden of safeguarding macroeconomic stability to interest rates and to control of fiscal imbalances. At 9% of GDP, tax revenues in Georgia are among the lowest in all transition economies and the main cause of persistent fiscal deficits. In seeking to improve revenue performance, the government in 1999 tendered out customs revenue collection to the British company ITS, and introduced excise stamps on alcohol and tobacco. After suspending its ESAF facility in November 1998 the IMF released the last tranche in August 1999, while strongly emphasising that much more must be done to enhance revenues and to reduce the stock of budgetary arrears.

Privatisation

Improvements in land registration and a new law on non-agricultural land could accelerate the development of a land market.

Economic efficiency in agriculture continues to be limited by the slow pace with which private ownership titles have been registered and the resulting lack of a functioning land market. However, in the middle of 1999, USAID offered to fund a two-year programme to improve land registration. Registration of land titles is a precondition for the right to sell land, lease it or use it as collateral. In November 1998 the law on privatisation of non-agricultural land was approved. It allows investors to acquire ownership rights over land, whereas before non-agricultural land could only be leased. This will remove considerable uncertainty over ownership rights in the enterprise sector and should also encourage the development of a market for commercial land.

Economic downturn slows large-scale privatisation.

As of June 1999, an estimated 1,292 medium-sized and large enterprises, or 80% of the initial total of state firms, were transferred to majority private ownership. Residual state shares in privatised enterprises vary considerably, but never exceed 49%. However, prospects for privatisation of the remaining large industrial enterprises have been clouded, partly by the emerging markets crisis. In the second half of 1998, sales of Chiatura Manganese and Rustavi Metallurgical, the two largest enterprises, and also of Kartli, a tobacco processing plant, were aborted because either investors pulled out of deals at a late stage or they failed to fulfil agreed investment commitments. Negotiations with new investors for the privatisation of these companies are ongoing.

Enterprise reform

The emerging private sector is still fragile despite strong growth in recent years and faces a difficult investment climate.

Georgia's economy has undergone significant structural change. The share of industry in GDP – at 30% before the transition – has

Liberalisation, stabilisation, privatisation

1991

Apr	Independence from Soviet Union
Aug	Exchange rate unified
Aug	Interest rates liberalised

1992

Jan	Introduction of personal income tax and enterprise profit tax
Feb	Majority of prices liberalised
Mar	Controls on foreign trade lifted
Mar	VAT introduced

1993

Mar	Small-scale privatisation begins
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1994

Dec	Export tax to non-CIS countries abolished
Dec	Unified import tariff structure introduced

1995

Jan	Trade regulations streamlined
Jun	State order system abolished
Jun	Voucher privatisation begins
Jun	Large-scale privatisation commenced
Oct	New currency (lari) introduced

1996

Mar	Tradability of land rights enacted
Jun	Voucher privatisation ends
Dec	Full current account convertibility introduced

1997

May	New privatisation law adopted
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1998

Dec	Exchange regime modified from managed float to free float
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1999

Apr	Council of Europe membership
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fallen to 10%. The private sector, concentrated in services and agriculture, is estimated to produce around 75% of GDP. Rapid structural change has yielded high growth rates in recent years, but this trend slowed in 1998. The fragility of the recovery is due in part to the inability of new private firms to undertake major investments. Lack of outside investment – FDI remained relatively low at US\$ 47 per capita in 1998 – and the virtual absence of financial intermediation have constrained private sector development. Yet the most serious impediment to private businesses lies in the weakness of public institutions. Predatory tax enforcement practices, lack of confidence in the competence of lower court judges, the absence of reliable property

Enterprises, infrastructure, finance and social reforms

1994

Jan First foreign-owned bank opened

1995

Jun Two-tiered banking system established

1996

Jun Competition law enacted

Jun Last bank privatised

Jul Basle capital adequacy requirement introduced

Aug Loan classification and provision requirements introduced

Sep BIS capital adequacy regulation comes into effect

Sep Anti-monopoly office established (not independent)

Dec First bank privatised

1997

Jan Bankruptcy law takes effect

Apr Securities regulator established (not independent)

Jun Independent electricity regulator (Georgian Electricity Regulatory Commission) established

Jun Electricity law established

Aug T-bills market initiated

1998

Oct Law on providing non-state pension insurance adopted

Nov Major utility privatised (energy distribution company – Telasi)

registries, corruption and onerous licensing requirements have encouraged informal business activity and discouraged investment.

Renewed efforts are under way to improve financial transparency and encourage restructuring.

In February 1999, the parliament adopted a law that requires the use of international accounting standards for all joint-stock companies in Georgia from 1 January 2000. This should help in sorting viable from non-viable enterprises among the many firms with high arrears and large idle capacity. Tacis and the World Bank continue to support restructuring of privatised enterprises, and USAID will finance a project to analyse the situation at the 26 largest industrial enterprises in Georgia in order to advise the government on restructuring, attraction of investment and possibly liquidation. Bankruptcy legislation in Georgia is relatively advanced but largely unenforced.

Infrastructure

Privatisation of power generation and distribution is well advanced.

The reorganisation and privatisation of the electricity sector in Georgia is at an advanced stage compared with most CIS countries. After completing the unbundling of the electricity sector into generation, transmission and distribution, the government consolidated the 66 distribution companies operating in Georgia into four regional units (Telasi, Ajara, East and West Georgia). Under a World Bank funded programme, privatisation of generation and distribution is to be largely completed within one year. In November 1998, a 75% stake in Telasi, Georgia's main power distribution company, was sold to the American utility operator AES Corporation. In June 1999, the government announced the tender for the East and West distribution systems to be privatised through competitive direct sales open to domestic and foreign investors. Twelve hydro and thermal power plants have also been offered through a competitive tender process.

Privatisation of telecommunications is expected to proceed quickly.

In January 1999, the Ministry of Post and Communication announced a privatisation programme for the telecommunications sector through international tenders. Georgia plans to privatise the local fixed-line operator (Sakartvelos Elektrovavshiri) as well as the long-distance operator (Sakartvelos Telekom). State-owned shares of the telecommunications companies will be either sold or transferred to new operators under 20- to 25-year management contracts. Sakartvelos Elektrovavshiri will be transformed into a joint-stock company and an international tender of 75% of the company or a management contract/lease is to be concluded by next year. A cornerstone of the programme is the completion of a new legal and regulatory framework, currently in preparation with support from the IFIs, including the establishment of an independent regulator.

Financial institutions

Following the Russian crisis, consolidation is expected in the banking sector.

Georgia's banking sector was severely hit by the devaluation of the lari. 60% of deposits are in foreign exchange, and while loans are often denominated in US dollars, many companies will have difficulty servicing these loans. Total deposits fell by 20% in the second half of 1998, with deposits in national currency declining by 30%. The NBG increased reserve requirements to 16% in September 1998, further tightening liquidity. To avoid a loss of confidence, the NBG signed a memorandum of understanding with the country's largest banks to guarantee their liquidity by means of short-term loans and remuneration of required reserves, while insisting that these banks continue

to observe all regulatory requirements. Small banks, however, may fail to meet minimum capital requirements of GEL 2 million by July 1999 and GEL 3 million by January 2000, and may have their licences revoked. Financial intermediation in Georgia remains at very low levels, with total bank assets below 5% of GDP in 1998.

The opening of the stock market should boost capital market development.

As a result of the Russian crisis and the underlying weakness of state finances, the government suspended trading in treasury bills and stopped new issues in September 1998, thereby effectively closing the rudimentary capital market. New treasury bill issues resumed in August 1999, however. The development of a corporate securities market has also recently progressed with the creation of a legislative and regulatory framework. A central share depository has been created and the shareholders list consolidated. In December 1998, parliament adopted a law providing for regulation of the market by a National Securities Commission and a stock exchange supervisory board. In February 1999, USAID announced the winner of the tender for developing a securities exchange in Georgia. According to plans, bidding at the Georgian Stock Exchange should begin by the fourth quarter of 1999 with about 50 licensed brokerages expected to participate.

Social reform

The renewed accumulation of pension arrears increases the urgency of pension reform.

Social transfers in Georgia are minimal. Pensions are flat, around US\$ 7 per month at the current exchange rate. Unemployment benefits are paid for six months and do not exceed US\$ 7 per month. In 1998, budgetary arrears for public sector wages and pensions increased significantly to GEL 110 million (1.5% of GDP). The pension system is burdened by a low ratio of actual contributors to pension recipients, partially as a result of large-scale evasion. With the assistance of the World Bank, the government plans to replace the current system with a multi-pillar system, which could encourage contribution compliance. In October 1998, parliament approved a law on private pension funds with immediate effect, but it may take some time before private pensions gain public acceptance.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Share of the population in poverty – 60%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – no	Private pension funds – no
Wage regulation – no	Tradability of land – limited de facto	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 9.0%	Competition office – yes	Capital adequacy ratio – 12%	
Exchange rate regime – floating		Deposit insurance system – no	
		Secured transactions law – restricted	
		Securities commission – no	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	13.4	13.0	13.0	8.3	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	5.0	5.0	5.0	4.0	3.0	3.0	na
Share of exports to non-transition countries (per cent)	na	na	na	na	29.0	33.7	32.2	28.4	na
Share of trade in GDP (per cent)	na	na	61.6	77.4	45.1	18.5	14.1	15.6	16.6
Tariff revenues (per cent of imports)	na	na	na	na	0.3	0.5	2.1	4.5	na
EBRD Index of price liberalisation	na	na	na	na	2.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	1.0	2.0	3.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	11.1	22.7	62.5	81.5	93.8	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	0.2	2.3	6.7	7.3	7.8	8.9
Private sector share in GDP	15.0	15.0	15.0	20.0	20.0	30.0	50.0	55.0	55.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	3.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	1.0	2.0	3.0	3.3	3.3
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	13.8	1.1	1.1	1.6	na
Efficiency of tax collection for social security (per cent)	na	na	62.5	5.6	6.6	9.3	13.2	17.4	na
Share of industry and construction in total employment (per cent)	30.4	28.7	24.7	23.9	19.5	15.0	9.8	na	na
Change in labour productivity in industry (per cent)	na	-14.9	-12.1	-5.4	-21.0	2.9	21.2	-16.2	-0.5
Investment rate (per cent of GDP)	19.3	20.9	19.9	18.9	20.1	20.0	21.4	22.1	na
EBRD index of enterprise reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	1.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.0	10.3	10.5	10.5	9.6	10.3	10.5	11.4	na
Railway labour productivity (1989=100)	95.4	71.8	37.2	17.2	23.1	18.9	18.0	31.8	37.9
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	1.6 (20%)	3.5 (35%)	2.8 (55%)	3.1 (68%)	na
Electricity consumption/GDP (1989=100)	110.3	117.5	165.5	193.8	157.1	151.9	130.5	117.6	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.4
Financial institutions									
Number of banks (of which foreign-owned)	na	na	75 (na)	179 (na)	226 (1)	101 (3)	61 (6)	53 (8)	43 (9)
Asset share of state-owned banks (in per cent)	98.4	92.5	77.6	72.7	67.9	45.8	0.0	0.0	0.0
Bad loans (per cent of total loans)	13.3	11.0	12.9	10.3	23.9	40.5	6.6	6.6	6.5
Credit to private sector (per cent of GDP)	na	na	na	na	4.0	2.4	2.7	na	na
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	2.0	2.3	2.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	1.0	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	9.0	10.3	6.7	9.7	8.3	1.7	2.1	1.1	na
Life expectancy at birth, total (years)	69.3	69.3	69.0	69.0	69.4	69.8	70.3	70.6	na
Basic school enrolment ratio (per cent)	95.3	92.4	83.3	82.4	80.7	79.8	80.7	na	na
Earnings inequality (Gini coefficient)	na	na	36.9	40.0	na	na	na	49.8	na

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-20.6	-44.8	-25.4	-11.4	2.4	10.5	11.0	2.9	3.0
Industrial gross output	-24.4	-43.3	-21.0	-39.1	-9.9	6.8	8.1	na	na
Agricultural gross output	-10.1	-34.2	-42.0	11.6	19.9	5.1	7.1	na	na
Employment ¹	(Percentage change)								
Labour force (end-year)	na	-19.5	-5.5	-5.5	9.3	5.1	12.9	-13.9	na
Employment (end-year)	na	-21.2	-9.7	-2.4	10.5	5.4	9.7	-22.5	na
	(In per cent of labour force)								
Unemployment ²	0.2	2.3	6.6	3.6	2.6	12.0	5.1	14.5	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	79.0	887.4	3,125	15,607	162.7	39.4	7.3	3.7	19.0
Consumer prices (end-year)	131.0	1,177	7,488	6,474	57.4	13.7	7.2	10.7	9.5
Average monthly wages in industry (annual average)	na	na	1,950	23,315	102.1	159.3	48.7	na	na
Government sector ³	(In per cent of GDP)								
General government balance	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	-3.8	-4.4	-3.7
General government expenditure	33.0	35.7	35.9	23.5	11.6	14.1	14.2	14.7	na
Monetary sector	(Percentage change)								
Broad money (end-year)	na	464.0	4,319	2,229	135.2	41.9	45.5	-1.2	na
Domestic credit (end-year)	na	724.0	2,048	3,448	80.7	59.6	56.1	28.9	na
	(In per cent of GDP)								
Broad money	na	40.3	20.1	5.6	4.9	4.5	5.5	5.1	na
Interest and exchange rate	(In per cent per annum, end year)								
Inter-bank credit rate (3-month) ⁴	na	na	na	na	na	47.6	32.1	36.7	na
Treasury bill rate (3-month maturity) ⁵	na	na	na	na	na	na	44.0	35.5	na
Deposit rate (3-month)	na	na	na	na	17.9	16.1	12.6	10.0	na
Lending rate (3-month)	na	na	na	na	69.8	53.2	45.0	38.0	na
	(Lari per US dollar)								
Exchange rate (end-year)	na	na	0.1	1.3	1.2	1.3	1.3	1.8	na
Exchange rate (annual average)	na	na	0.02	1.1	1.3	1.3	1.3	1.4	na
External sector	(In millions of US dollars)								
Current account	na	-248	-354	-278	-218	-278	-376	-389	-232
Current account (excluding transfers)	na	-319	-485	-448	-407	-418	-573	-599	-440
Trade balance	na	-378	-448	-365	-338	-351	-559	-685	-525
Exports	na	267	457	381	363	417	494	478	500
Imports	na	645	905	746	700	768	1,052	1,164	1,025
Foreign direct investment, net	na	na	na	8	6	54	236	221	96
Gross reserves (end-year), excluding gold	na	1	1	41	157	158	179	118	na
External debt stock	na	95	544	987	1,225	1,371	1,539	1,686	na
	(In months of current account expenditures, excluding transfers)								
Gross reserves (end-year), excluding gold	na	0.0	0.0	0.7	2.7	2.5	2.0	1.2	na
	(In per cent of current account revenues, excluding transfers)								
Debt service	na	na	na	na	7.2	9.7	8.6	14.8	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of lari)	na	na	16	1,373	3,694	5,724	6,798	7,232	8,600
GDP per capita (US dollars)	114	214	194	231	531	845	975	967	na
Share of industry in GDP (in per cent)	na	12.6	6.3	21.3	14.5	10.3	9.6	9.6	na
Share of agriculture in GDP (in per cent)	na	54.5	67.7	28.7	38.0	31.0	28.2	26.1	na
Current account/GDP (in per cent)	na	-21.4	-33.7	-22.3	-7.6	-6.1	-7.2	-7.5	-5.9
External debt minus reserves (in US\$ millions)	na	94	543	945	1,069	1,213	1,360	1,568	na
External debt/GDP (in per cent)	na	8.2	51.7	79.0	42.7	30.3	29.4	32.4	na
External debt/exports (in per cent)	na	35.6	118.9	259.2	337.9	328.8	311.9	352.7	na

¹ Figures from 1997 onwards are from the SDS Household Survey.

² Up to 1996 unemployment is calculated based on registered employment. From 1997 onwards, ILO methodology is used.

³ General government includes the state, municipalities and extrabudgetary funds.

⁴ Determined at credit auctions in which central bank and commercial banks participate.

⁵ Treasury bills were introduced in August 1997.

Key reform challenges

- With advances in the privatisation and liberalisation of infrastructure services, the regulatory framework must be enhanced, including tariff reform and open network access.
- While recent banking troubles have been effectively resolved, the provision of services must be further strengthened if the needs of the housing market and SMEs are to be met. Increased competition among financial institutions and financial innovation are central.
- The pace of social and public service reforms should be reinvigorated to improve services and to safeguard the public finances.

Liberalisation

Remaining trade restrictions are to be rolled back.

Based on current WTO and EU commitments, the global quota on consumer goods is to be eliminated by 2001, with quotas on textiles, clothing and larger cars removed in 1998. Detergent, fish products and footwear are the main goods still covered. Accession to the EU would involve adoption of the common customs policy, with the overall tariff average falling to 4% (excluding agriculture) from the 9.6% that Hungary would reach after completing its WTO commitments.

Stabilisation

The policy mix places a heavy burden on monetary control.

In the wake of the Russian crisis and weak growth in western Europe, the fiscal and external balances have weakened in the second half of 1998 and first half of 1999. However, the limited cuts in fiscal expenditure and the failure to achieve stronger tax collection performance have placed a relatively heavy burden on monetary policy. While the tightening of monetary policy through higher real interest rates has stabilised the current account deficit by dampening domestic demand, it has also contributed to the crowding out of domestic private investment. A planned tax reform aimed at reducing the tax burden on wage earnings and envisaging changes to VAT has been shelved until 2001.

Access to international finance is retained despite emerging markets turmoil.

Although yield spreads of Hungarian government bonds widened immediately after the Russian crisis, they have subsequently narrowed and are now back to pre-crisis levels. Hungary received an upgrading from all the major rating agencies in December 1998 and in January 1999 it launched successfully a 10-year Eurobond issue, as well as a domestic 10-year bond. The government has actively issued debt in both the domestic and international markets in the first half of 1999.

Privatisation

The state retains residual shares in some privatised companies, but remains a largely passive shareholder.

Under the 1997 amendments to the Privatisation Act, the State Property Agency (APV Rt) will retain a permanent stake in 98 companies. This provision includes eight companies, primarily in the energy, telecommunications and agribusiness sectors, in which the state will retain a golden share. This share provides the government with a wide range of powers, such as the right to veto changes in product lines and to approve mergers, shares conversions and divestments. The state will also retain permanently a residual ownership stake in 26 agricultural companies that account for more than a quarter of total agricultural sale revenues. So far, APV Rt has acted as a passive shareholder in those companies where it is a minority investor. A notable exception is the oil and gas company, MOL, where it initiated significant Board changes in February 1999, including the removal of the Chairman appointed prior to privatisation under the previous government. Private shareholders did not seem to oppose this move.

Divestiture of other state assets continues.

Privatisation efforts over the past 12 months have concentrated on the sale of residual state stakes, notably in telecommunications company MATAV (see below). The agency also plans to proceed with the commissioned sale of social security fund assets including a 25% share in pharmaceuticals firm Human, and a 14.1% stake in the savings banks OTP. APV is also examining the possibility of selling the fund's 9.5% holding in pharmaceuticals maker, Richter, and some of the state's prime property holdings, such as a 66% stake in Hajogyari Sziget Vagyongkezelő Kft, a property company.

Enterprise reform

Foreign-owned firms lead output and export growth ...

Foreign-owned companies produce about one-third of GDP and account for about 25% of private sector employment, reflecting

Liberalisation, stabilisation, privatisation

1990

Jan	Securities law enacted
Mar	Large-scale privatisation begins
Mar	State property agency established

1991

Jan	Most prices liberalised
Jan	Small-scale privatisation begins

1992

Jan	T-bills market introduced
Mar	EU association agreement

1993

Mar	CEFTA membership
Oct	EFTA membership

1995

Jan	WTO membership
May	Privatisation law adopted
May	State property agency and asset management company merge
Dec	Restitution law enacted

1996

Jan	Full current account convertibility introduced
Apr	Customs law enacted
May	OECD membership

1997

Jan	Currency basket changed
Jan	Corporate and personal income tax rates reduced
Jul	Import surcharge abolished

1998

Jan	Capital account liberalised
Feb	IMF programme completed

in part a privatisation programme that encouraged foreign strategic investment. In 1998, output in those sectors that have received the bulk of FDI, including machinery, computers, telecommunications equipment, electrical and electronic goods and transport equipment, increased by 41%. Their export sales rose by 54%. At the same time, the manufacturing sector as a whole recorded a 16% increase in output and a 30% rise in export sales. FDI has thus played a key role in restructuring and in increasing output and exports.

... while the performance of domestic companies lags behind.

The local corporate sector, consisting largely of SMEs, has lagged behind foreign-owned enterprises in terms of restructuring and modernisation. The main constraints affecting domestic enterprises are the lack of medium- and long-term finance, poor business

Enterprises, infrastructure, finance and social reforms

1990

Jan	Securities law enacted
Jun	Stock exchange established
Oct	Banking law adopted

1991

Jan	Competition law enacted
Jul	MATAV transformed into joint-stock company
Sep	Bankruptcy law adopted
Dec	Electricity board transformed into joint-stock company

1992

Nov	Telecommunications law adopted
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1993

Jan	BIS capital adequacy enacted
Sep	Bankruptcy law amended
Oct	Railway law enacted
Dec	First major utility partially privatised, MATAV

1994

Apr	Electricity law adopted
Apr	Independent electricity regulator established
Jul	First state bank privatised

1995

Dec	Securities and exchange commission established
Dec	MATAV is majority privately owned

1996

Jan	Restructuring of MAV (national railway) begins
Dec	Financial sector supervision law adopted
Dec	IAS introduced

1997

Jan	New banking law enacted
Jan	Competition law amended
Jul	Pension reform adopted
Oct	Land Credit and Mortgage Bank established

1998

Apr	Venture capital law enacted
Aug	Health insurance fund reformed

infrastructure, training, and bureaucratic red tape. A government-sponsored programme is being developed to address training needs and reduce bureaucratic hurdles.

Corporate tax reforms relax requirements for foreign companies.

According to previous legislation, foreigners could conduct business activities in Hungary only through a Hungarian branch or through

an incorporated Hungarian subsidiary. This was affecting foreign companies intending to carry out temporary business activities, such as in the construction sector. Since February 1999, this requirement has been abolished for certain types of activities.

Infrastructure

Electric power sector reforms are announced.

The government announced in February 1999 that up to 15% of the electric power generation market will be opened to new producers in January 2001. If this reform is successful, there will be further liberalisation during 2001. The aim is to liberalise fully the generation market in advance of EU accession. In conjunction with these liberalisation steps, a new regulatory body will be set up to oversee network access. The power sector regulator introduced a new tariff structure in July 1999. The main change from the previous tariff regime is the re-balancing of prices to reduce the cross-subsidy from large-scale users to households and other small-scale consumers.

The reform of natural gas pricing is planned.

Locally produced gas is currently priced below the price of imported gas, reflecting relative low domestic production costs. The government's pricing reform proposal, which is currently pending before the parliament, would link the price of domestically produced natural gas to gas import costs. The reform of natural gas pricing would facilitate the restructuring of the monopoly gas importer and supplier, MOL.

Privatisation of telecommunications company MATAV Rt is completed.

APV Rt sold its remaining 5.75% stake of MATAV Rt through a domestic public offering and an international private placement in June 1999. The agency, however, retains a single golden share in the company. Proceeds from this privatisation represent 73% of budgeted privatisation receipts of HUF 116 billion for 1999. MATAV currently retains a monopoly over long-distance calls within Hungary until the end of 2001. It also provides local telephone services in 70% of the country.

Financial institutions

The banking sector is largely private with significant foreign participation ...

Four institutions remain in state ownership, Postabank, Hungarian Development Bank, Konzumbank and Foldhitel es Jelzalogbank (FHB). The privatisation of FHB is scheduled for completion in November 1999. Foreign capital and management are represented in 30 out of the 41 banks in the system. The sector is generally sound following a long-lasting and extensive consolidation effort.

... but SMEs have yet to benefit significantly.

Banks often prefer to do business with larger enterprises, because loan risk assessments for SMEs are inherently more difficult and loan failure rates are higher. In 1998, small enterprises received only 4% of total bank credit to enterprises. A number of government loan and guarantee programmes exist, although these are not large enough to satisfy demand.

Restructuring of Postabank is well under way.

Postabank, the second-largest domestic bank by deposits, has been progressively re-capitalised, with the state now holding 100% of the bank. Its management has been replaced and non-performing debt and equity assets worth HUF 129 billion at book value were transferred to Reorg Apport Rt, a special purpose subsidiary of the state-owned work-out company Reorg Rt. Privatisation is not expected to take place until next year, at the earliest. Postabank's former management is now facing investigation.

Mortgage-backed securities are launched, but a poorly functioning property market constrains mortgage lending.

Two mortgage banks operate in Hungary, the state-owned FHB and Vereinsbank Hungaria Jelzalogbank (HVB) Rt (a joint venture by Bayerische Hypo and Vereinsbank AG). However, only 15% of new home construction is financed from mortgages, compared with about 75% in the EU. The main constraints on this sector are an inadequate property register and protracted foreclosure procedures. Mortgage-backed securities were recently launched by FHB, with two issues in 1999. Demand for the issues by institutional investors was strong.

Social reform

Implementation of the new pension system is temporarily slowed.

In January 1998, a new pension scheme was introduced, based on three pillars: a modified version of the existing pay-as-you-go system, a fully funded mandatory pillar, and a third, voluntary fully funded operated pillar. The fully funded components are operated by private pension funds and regulated by the Pension Funds Supervision Agency. In the long term, this reform will lead to a sharp increase in the share of national savings intermediated by the local financial sector, thus aiding its development. However, the 1999 budget law froze the increase of the contribution rate to the second pillar scheduled by the pension reform law. This measure was adopted to create short-term fiscal savings. The freeze has been extended into 2000, and the government has not announced a schedule for completing the pension reform.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – yes	Share of the population in poverty – 2%
Interest rate liberalisation – full	Secondary privatisation method – MEBOs	Separation of railway accounts – yes	Private pension funds – yes
Wage regulation – no	Tradability of land – full except foreigners	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 40.0%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime 1 – crawling peg with band		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	16.0	11.0	10.9	10.8	11.8	12.9	12.8	15.9	na
Number of goods with administered prices in EBRD-15 basket	7.0	6.0	4.0	2.0	2.0	2.0	2.0	2.0	na
Share of exports to non-transition countries (per cent)	12.2	78.7	81.3	80.9	80.7	79.6	81.7	80.7	na
Share of trade in GDP (per cent)	na	27.4	27.0	25.2	22.7	31.4	34.3	44.8	45.6
Tariff revenues (per cent of imports)	na	9.1	11.8	12.0	12.6	12.9	9.6	4.0	2.6
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.3	3.3
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
Privatisation									
Share of small firms privatised	0.1	2.0	10.6	40.4	57.8	66.0	77.2	87.7	na
Privatisation revenues (cumulative, per cent of GDP)	na	0.1	1.2	1.8	2.7	5.9	9.6	12.6	13.0
Private sector share in GDP	25.0	30.0	40.0	50.0	55.0	60.0	70.0	75.0	85.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	3.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	5.7	4.0	3.8	4.5	3.8	3.9	3.2	na
Efficiency of tax collection for social security (per cent)	na	53.4	49.9	47.0	48.4	47.0	49.5	51.0	na
Share of industry and construction in total employment (per cent)	36.4	35.7	35.1	33.8	33.0	32.6	32.6	33.1	na
Change in labour productivity in industry (per cent)	-4.0	-8.3	4.0	16.3	14.7	10.5	4.4	11.7	6.6
Investment rate (per cent of GDP)	na	na	30.4	27.9	26.1	23.1	17.2	16.3	na
EBRD index of enterprise reform	na	na	na	na	3.0	3.0	3.0	3.0	3.3
EBRD index of competition policy	na	na	na	na	na	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	9.6	10.9	12.6	14.6	16.9	18.5	26.1	30.4	na
Railway labour productivity (1989=100)	88.3	74.9	80.8	72.9	85.6	92.6	93.2	108.4	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	3.99 (90%)	5.85 (90%)	5.96 (90%)	6.75 (90%)	na
Electricity consumption/GDP (1989=100)	101.6	107.1	102.3	103.7	101.2	102.0	103.0	99.1	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	3.8
Financial institutions									
Number of banks (of which foreign-owned)	32 (11)	35 (8)	35 (12)	40 (15)	43 (17)	42 (21)	41 (25)	41 (30)	40 (27)
Asset share of state-owned banks (in per cent)	81.2	75.3	74.4	74.9	62.8	52.0	16.3	10.8	11.8
Bad loans (per cent of total loans)	na	na	na	25.6	17.6	10.3	7.2	3.6	5.9
Credit to private sector (per cent of GDP)	46.3	38.8	33.2	28.2	26.2	22.3	21.7	23.4	22.8
Stock market capitalisation (per cent of GDP)	na	1.5	1.6	2.3	4.2	5.8	34.7	35.8	29.5
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	4.0	4.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	3.0	3.0	3.3	3.3	na
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	12.2	13.0	14.0	13.5	13.9	12.4	11.4	na	na
Life expectancy at birth, total (years)	68.3	68.0	67.7	66.7	65.7	64.9	na	64.9	na
Basic school enrolment ratio (per cent)	99.2	99.2	99.2	99.1	99.1	99.1	99.2	99.2	na
Earnings inequality (Gini coefficient)	na	na	30.5	32.0	32.4	na	na	34.8	na

¹ The exchange rate is a pre-announced crawling peg to a currency basket of 70% DM and 30% US\$, with band of +/- 2.25%.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	(Percentage change in real terms)								
GDP ¹	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	5.1	3.0
Private consumption	-5.6	0.0	1.9	-0.2	-7.1	-3.4	2.0	3.8	na
Public consumption ²	-2.7	4.9	27.5	-12.7	-4.1	-5.4	2.0	3.0	na
Gross fixed investment	-10.4	-2.6	2.0	12.5	-4.3	6.3	8.8	11.4	na
Exports of goods and services	-13.9	2.1	-9.1	13.7	13.4	7.4	26.4	16.0	na
Imports of goods and services	-6.1	0.2	20.2	8.8	-0.7	5.7	25.5	22.2	na
Industrial gross output	-18.3	-9.7	4.0	9.6	4.6	3.3	11.0	10.6	na
Agricultural gross output	-6.2	-20.0	-9.7	3.2	2.6	7.0	-1.5	-1.8	na
Employment	(Percentage change)								
Labour force (end-year) ³	-3.7	-3.6	-4.4	-2.6	-1.7	-0.9	-1.6	0.8	na
Employment (end-year) ³	-9.6	-9.3	-5.7	-1.2	-1.3	-0.1	0.0	1.6	na
	(In per cent of labour force)								
Unemployment ⁴	7.4	12.3	12.1	10.4	10.4	10.5	10.4	9.1	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	9.0
Consumer prices (end-year)	32.2	21.6	21.1	21.2	28.3	19.8	18.4	10.3	8.0
Producer prices (annual average)	32.6	12.3	10.8	11.3	28.9	21.8	20.4	11.3	na
Producer prices (end-year)	23.5	18.8	10.3	19.9	30.2	20.1	19.5	7.1	na
Gross average monthly earnings in manufacturing (annual average)	25.6	25.9	24.7	23.5	21.3	21.6	22.1	14.4	na
Government sector ⁵	(In per cent of GDP)								
General government balance	-3.7	-7.6	-8.9	-8.6	-6.2	-3.1	-4.9	-4.6	-4.5
General government expenditure	52.1	53.7	54.6	52.1	48.7	47.5	48.6	46.4	na
General government gross debt	73.4	77.6	87.9	85.2	84.3	71.5	62.9	60.3	na
Monetary sector	(Percentage change)								
Broad money (end-year)	35.7	27.6	15.7	13.0	20.1	22.5	19.4	15.7	na
Domestic credit (end-year) ⁶	14.9	11.8	21.5	18.1	13.7	7.6	12.0	13.7	na
	(In per cent of GDP)								
Broad money	54.8	59.4	56.8	52.2	48.7	48.6	46.8	45.1	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate (up to 30-day maturity)	na	na	21.8	31.3	27.8	23.2	19.7	17.3	na
Treasury bill rate (3-month maturity)	33.0	14.7	24.3	31.6	30.1	21.7	19.2	17.2	na
Deposit rate (one year)	31.1	17.6	17.2	23.6	26.1	20.1	17.6	15.4	na
Lending rate (one year)	35.5	28.8	25.6	29.7	32.2	24.0	20.8	18.8	na
	(Forints per US dollar)								
Exchange rate (end-year)	75.6	84.0	100.7	110.7	139.5	164.9	203.5	219.0	na
Exchange rate (annual average)	74.8	79.0	92.0	105.1	125.7	152.6	186.8	214.5	na
External sector	(In billions of US dollars)								
Current account	0.3	0.3	-3.5	-3.9	-2.5	-1.7	-1.0	-2.3	-2.9
Trade balance	0.2	0.0	-3.2	-3.6	-2.4	-2.6	-1.7	-2.1	-2.6
Exports	9.3	10.0	8.1	7.6	12.8	14.2	19.6	20.7	24.3
Imports	9.1	10.1	11.3	11.2	15.3	16.8	21.4	22.9	26.9
Foreign direct investment, net	1.5	1.5	2.3	1.1	4.5	2.0	1.7	1.5	1.6
Gross reserves (end-year), excluding gold	3.9	4.3	6.7	6.7	12.0	9.7	8.4	9.3	na
External debt stock	22.7	21.4	24.6	28.5	31.7	27.6	23.7	26.7	na
	(In months of current account expenditures, excluding transfers)								
Gross reserves (end-year), excluding gold	3.7	3.6	5.1	5.0	6.7	5.1	3.6	3.7	na
	(In per cent of current account revenues, excluding transfers)								
Debt service ⁷	33.3	34.2	43.1	54.4	45.9	45.8	35.2	28.4	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	10.3	10.3	10.3	10.2	10.2	10.2	10.1	10.1	na
GDP (in billions of forints)	2,498	2,943	3,548	4,365	5,614	6,894	8,541	10,261	11,520
GDP per capita (in US dollars)	3,230	3,613	3,752	4,052	4,374	4,441	4,513	4,730	na
Share of industry in GDP (in per cent)	26.7	25.7	26.6	27.4	23.1	23.5	25.0	na	na
Share of agriculture in GDP (in per cent)	7.8	6.7	6.3	6.0	5.9	6.1	5.8	na	na
Current account/GDP (in per cent)	0.8	0.9	-9.0	-9.4	-5.6	-3.7	-2.1	-4.8	-6.3
External debt minus reserves (in US\$ billions)	18.7	17.1	17.9	21.8	19.7	17.8	15.3	17.4	na
External debt/GDP (in per cent)	67.8	57.6	63.7	68.7	70.9	61.0	51.9	55.9	na
External debt/exports (in per cent)	244.7	213.8	303.4	374.6	247.1	194.3	120.9	128.9	na

¹ Demand components for 1996 are estimates. There is a considerable gap between changes in final demand and GDP growth estimates for that year.

² Data for public expenditure and imports in 1993-94 include payments for Russian military equipment. Government consumption excludes social transfers, which are included in household final consumption.

³ Data on labour force and employment from 1993 onwards are from the labour force survey.

⁴ Registered unemployed. Data from the labour force survey indicate a lower rate of 8.7% in 1997.

⁵ General government includes the state, municipalities and extrabudgetary funds.

⁶ Change in domestic credit includes the forint debt arising from valuation changes on external government debt; government bonds of HUF 48.3 billion issued against outstanding rouble claims taken over by the government; and consolidation bonds with a total value of HUF 560 billion (around 12% of 1994 GDP) issued over the course of 1993-96.

⁷ Includes prepayments, of US\$ 1.687 billion in 1996 and US\$ 1.609 billion in 1997.

Key reform challenges

- **Budget revenue shortfalls have prompted confiscatory measures by tax enforcement agencies, highlighting the urgency of increasing tax compliance while improving the fairness of tax enforcement.**
- **Temporary trade barriers against selected Kyrgyz, Uzbek and Russian goods have set back liberalisation and have damaged regional trade prospects.**
- **The reform of the public service, including the judiciary, remains a major challenge in pursuit of the government's aim to reduce corruption and increase the predictability and reliability of the regulatory framework.**

Liberalisation

Backtracking in trade liberalisation creates tensions with neighbouring countries.

In early 1999, Kazakhstan imposed an import ban on selected Russian goods and 200% tariffs on similar items from Kyrgyzstan and Uzbekistan. For the former two countries, these restrictions were lifted during the second half of the year. The abolition of all selective trade barriers would be a precondition for WTO accession. The introduction of dual Russian and Kazakh language labeling requirements is also considered an implicit trade barrier by importers.

Currency surrender requirements are temporarily introduced.

As part of the April 1999 devaluation package, a 50% currency surrender requirement was introduced. Exporters can freely reconvert the obtained tenge on the forex market, which remains free of government distortions. Under the grandfathering clause of the 1994 foreign investment law, investors who entered the country after the abolition of currency surrender in August 1996 are exempt from the new restrictions. The National Bank of Kazakhstan (NBK) has indicated that they will be abolished again soon.

Stabilisation

The government faces fiscal financing shortfall despite budget reforms.

Despite increased tax collection by mid-1999 – largely due to improved liquidity in the economy following devaluation – lack of secure financing for the budget continues to raise fears of currency and price instability. The budget process was changed in January 1999 with the aim of improving fiscal management. Reforms include the consolidation of all remaining extrabudgetary funds into the republican budget, the creation of a Ministry of Revenues, changes in the delineation of republican and regional fiscal responsibilities, improvements in public procurement, and closer monitoring of large taxpayers. In September, the government raised US\$ 200 million through a new five-year Eurobond issue, with a coupon of 13.625%.

Complaints of tax harassment prompt a change in the role of the tax police.

Although the Kazakhstani tax code, introduced in July 1995, is generally regarded as adequate, revenue pressures have led to cases of tax harassment. The tax police repeatedly resorts to freezing enterprise bank accounts, penalties can exceed 100% of the due tax sum, and the legislative base for tax appeals remains weak. Proposed amendments to the tax code provide for a lowering of penalties, simplified tax registration, the subtraction of excise duties and losses due to government price controls from the VAT tax base, and a tax amnesty for selected sectors in financial difficulty. In August, the head of the tax police announced that its authority to conduct tax audits would shift to the Ministry of Revenues, leaving the tax police with enforcement functions only.

Privatisation

Privatisation revenue performance in 1998 is unlikely to be matched in 1999.

Privatisation revenues peaked at KZT 75 billion (US\$ 950 million) in 1998. This was largely due to the sale of the government's stake in the OCIOC (Offshore Caspian International Oil Consortium) to Japanese and US investors for US\$ 500 million. The planned sale of state stakes of large companies through public offerings on the stock market (Blue Chip programme) while recently revived is unlikely to raise similar sums in 1999. Privatisation revenues would receive a significant boost if the government proceeds with the recently announced sale of 10% of its 25% stake in Tengizchevroil, valued at up to US\$ 1.5 billion.

Residual state ownership remains significant among medium-sized and large enterprises.

Around 5,000 medium-sized enterprises and 1,000 large enterprises (51% and 33% of the total in their respective categories) remain in majority state ownership. A further 8% and 14% in these categories are under mixed ownership. 330 very large enterprises (accounting for a third of GDP according to the World Bank) remain fully state-owned, including the state oil-company, the domestic pipeline system, the national power grid and the railways.

Liberalisation, stabilisation, privatisation

1991

Dec Independence from Soviet Union

1993

Nov New currency (tenge) introduced

1994

Apr Beginning of mass privatisation: first voucher auction
Apr First T-bills issued
Nov Most prices liberalised
Dec Law on foreign investment enacted

1995

Jan Customs union with Russia and Belarus
Feb Directed credits eliminated
Feb Most foreign trade licences abolished
Jun State orders in agriculture abolished
Jul New tax code introduced
Jul Customs code introduced
Jul Barter trade prohibited
Aug Foreign exchange surrender abolished
Dec Edict on land enacted
Dec Privatisation law enacted

1996

Jun IMF programme
Jun Last voucher auction
Jun Cash sales to strategic investors begin
Jul Full current account convertibility introduced
Dec First sovereign Eurobond

1999

Jan Restrictions on Russian and later Kyrgyz and Uzbek imports introduced
Jan Major budgetary reforms introduced
Apr Export surrender requirement re-introduced

Enterprise reform

Economic recession highlights the urgency of accelerating restructuring ...

The increase in net arrears from KZT 626 billion in November 1997 to KZT 844.5 billion in November 1998 (47% of GDP) reveals the serious financial condition of the enterprise sector, plagued by falling demand and lack of competitiveness. In a 1998 survey, 61% of enterprises named customers' bad debts as a "serious impediment" to their operations. Bankruptcy implementation is sluggish. Only 679 of the 5,165 enterprises in the portfolio of the State Restructuring Agency (which includes firms with debt arrears more than 3 months overdue) had been liquidated by April 1999, a further 141 having entered court settlement. In over a third of enterprises in arrears a creditor committee has yet to be formed.

Enterprises, infrastructure, finance and social reforms

1991

Jun	Securities and stock exchange law adopted
Jun	Competition law adopted

1993

Apr	Law on banking adopted
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1994

Jan	Prudential regulations introduced
Jun	Competition agency established
Dec	New civil code enacted

1995

Apr	Central bank law adopted
Apr	Presidential decree on bankruptcy issued
Apr	Rehabilitation Bank and Enterprise Restructuring Agency set up
Apr	Anti-monopoly legislation introduced
Dec	Telecommunications law adopted

1996

Jan	Subsoil code enacted
Nov	New accounting standards adopted

1997

Jan	New bankruptcy law enacted
Jun	Pension reform law adopted
Jul	First ADR issue
Jul	Formation of the national power grid KEGOC
Oct	Stock exchange begins trading

1998

Jan	Pension reform launched
Apr	Privatisation of Turan-Alem Bank – largest to date
Sep	Law on natural monopolies adopted
Dec	National Programme for Support of Small Business approved

1999

Jul	First municipal bond issue
Aug	First domestic corporate bond issue

... while the entry of new SMEs provides little competitive pressure yet.

According to official data, 87,000 enterprises with fewer than 50 employees were registered at the start of 1999, of which less than half were active. The contributions of SMEs to employment and output were estimated at 17% and 8% respectively for 1997. A government support programme approved in December 1998 provides for simplified registration and taxation practices, as well as the development of financial and information support infrastructure.

The cancellation of management contracts opens the way to industrial consolidation but may damage Kazakhstan's reputation abroad.

Several major foreign investors entered Kazakhstan during 1994-96 through management contracts and the subsequent transfer of equity stakes, particularly in mining and metal processing. The track record of these foreign investors is mixed, many having failed to live up to their investment commitments. As a result, several management contracts have been cancelled and a consolidation process has started, with stakes resold to large foreign investors or bought out by state concerns. The resulting international legal disputes, however, may have contributed to the slow-down in investment activity.

Infrastructure

Kazakhstan is far advanced in infrastructure privatisation.

Following the privatisation of around 80% of the power generation capacity in 1997, Kazakhstan now plans to privatise regional power distribution companies. Kazakhtelecom, partially privatised in 1997 and currently under the trust management of Kazkommertsbank, is due to be upgraded and later sold to a strategic investor under a proposal involving a temporary 30% EBRD equity stake. The cities of Almaty and Astana are considering private investment in their water sectors. Plans for the demonopolisation of Kazakh railways and the sell-off of some commercial units are far advanced.

While regulatory reform has proceeded, regulatory practice remains weak.

The law on natural monopolies approved in September 1998 provides a general regulatory framework for the infrastructure sector. However, it does not provide for full cost-recovery tariffs, leaving this to specific sectoral legislation. Following the adoption of cost-recovery principles for the transportation of natural resources in late 1998, the draft energy law foresees similar provisions for the power sector. Regulatory practice has been imperfect due to weaknesses in secondary legislation and its implementation.

Financial institutions

A strengthened banking sector weathers tightened liquidity.

Following the revocation of six bank licences, the number of banks declined to 63 by August 1999. There is an active foreign presence, stimulating competition, although privatisation of the Savings Bank to a strategic foreign investor, originally planned for late 1998, has been delayed. Total bank capital increased by 55% since January 1998 to KZT 53 billion in April 1999. With the April devaluation, the large share of dollar-linked loans has led to revaluation gains in the major banks, but this has been matched by an increase in specific provisions related to mounting repayment difficulties.

A deposit conversion scheme is introduced to bolster confidence following devaluation.

The April devaluation package included an offer to convert all household bank deposits and 30% of enterprise deposits into dollars at the pre-devaluation exchange rate, if they were kept frozen for 9 and 6 months respectively. The Savings Bank, holding 80% of private tenge deposits, reported that less than 10% were converted, limiting fiscal costs to approximately KZT 1 billion. The net present value of a similar offer to convert holdings of state securities held by pension funds into 5-year dollar bonds, carrying a 7% coupon, is low and aimed primarily at the state pension fund.

The stock market remains illiquid despite growing capitalisation.

At the end of 1998, 36 companies traded on the stock exchange (7 A-listings, 11 B-listings and 18 non-listed securities) a threefold increase from the end of 1997. Capitalisation grew to US\$ 1.83 billion (9% of GDP) but turnover remained low at US\$ 43 million (including US\$ 39 million on the over-the-counter market). Kazakhstan's regulatory infrastructure for the issuance and trading of corporate securities is highly developed, but the market has suffered from a lack of interest by portfolio investors, including the new pension funds. A new programme foresees the transfer of assets of the largely defunct investment funds created during mass privatisation to private brokerages and the new pension funds. In August 1999, Kazkommertsbank registered the issue of a US\$ 30 million hard currency bond, the first corporate bond listing in Kazakhstan.

Social reform

Pension reforms have made a successful start.

Individual pension contributions as of June 1999 reached KZT 46.5 billion (US\$ 350 million). The share of private investment funds has been increasing progressively to around 30% by mid-1999. While the state pension fund has mainly bought domestic state securities, private pension funds have been investing three-quarters of their assets in Kazakhstani Eurobonds, providing considerably higher devaluation adjusted returns. In August 1999, the NBK relinquished its role as asset manager for the state pension fund, thereby eliminating potential conflicts of interest as both the issuer and buyer of state securities. In the wake of budgetary pressures, pension arrears re-emerged in 1999, standing at KZT 15 billion (1.2% of GDP) by mid-year. The government has pledged to settle pension arrears.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – no	Share of the population in poverty – 50%
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Separation of railway accounts – no	Private pension funds – yes
Wage regulation – yes	Tradability of land – limited de jure	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 16.1%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system – no	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	10.4	2.5	2.5	2.5	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	8.0	8.0	4.0	3.0	3.0	1.0	1.0
Share of exports to non-transition countries (per cent)	na	na	na	na	23.2	23.9	27.1	34.3	na
Share of trade in GDP (per cent)	na	na	68.8	32.3	31.8	31.7	31.1	30.9	27.6
Tariff revenues (per cent of imports) ¹	na	na	na	1.3	4.0	3.9	2.0	1.5	1.9
EBRD Index of price liberalisation	na	na	na	na	2.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	2.0	3.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised ²	na	na	na	27.3	41.7	60.0	79.5	100.0	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	2.7	3.0	3.3	5.5	8.7	12.4
Private sector share in GDP	5.0	5.0	10.0	10.0	20.0	25.0	40.0	55.0	55.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	2.0	3.0	3.3	4.0
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	3.2	3.6	2.6	1.8	0.7
Efficiency of tax collection for social security (per cent)	na	na	37.7	na	39.8	55.3	56.3	51.5	na
Share of industry and construction in total employment (per cent)	31.3	30.6	30.1	27.8	25.6	22.2	21.0	18.5	na
Change in labour productivity in industry (per cent)	0.7	-2.3	-10.5	-1.0	-21.2	0.9	2.9	17.3	1.8
Investment rate (per cent of GDP)	23.3	16.1	14.6	13.4	5.6	20.7	22.6	12.6	na
EBRD index of enterprise reform	na	na	na	na	1.0	1.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	8.0	8.5	8.8	11.7	11.7	11.8	11.6	10.8	na
Railway labour productivity (1989=100)	68.1	63.0	50.7	38.7	31.5	29.3	28.2	26.5	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	2.97 (73%)	2.60 (75%)	1.84 (70%)	4.00 (50%)	na
Electricity consumption/GDP (1989=100)	101.9	113.4	110.3	117.5	104.7	112.9	99.3	89.5	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.4
Financial institutions									
Number of banks (of which foreign-owned)	30 (na)	72 (1)	155 (1)	204 (5)	184 (8)	130 (8)	101 (9)	82 (22)	71 (20)
Asset share of state-owned banks (in per cent) ³	na	19.3	4.6	na	na	24.3	28.4	45.4	23.0
Bad loans (per cent of total loans)	na	na	na	na	na	14.9	19.9	7.7	7.3
Credit to private sector (per cent of GDP)	na	na	na	49.3	26.6	7.1	6.3	5.1	6.5
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	5.9	8.8
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	2.0	2.3	2.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	2.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	6.1	6.5	5.3	7.5	7.2	6.4	5.4
Life expectancy at birth, total (years)	68.3	68.6	68.1	67.2	66.0	65.8	66.5	66.9	na
Basic school enrolment ratio (per cent)	93.1	92.7	91.7	91.5	90.9	90.5	90.0	89.2	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ Refers to taxes on international trade.

² Data in this row give the number of privatised enterprises included in the original privatisation programme. As a share of all small enterprises, around 85% were privatised by 1996. Remaining small enterprises are largely in the social sector.

³ The state share of banking sector assets increased in 1997 following the merger of privately owned Alem bank and state-owned Turan bank into a new state-owned institution. In 1998 the merged bank was reprivatised.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-13.0	-2.9	-9.2	-12.6	-8.2	0.5	2.0	-2.5	-1.7
Industrial value added	-1.0	-14.0	-14.0	-27.5	-8.6	0.3	4.0	-2.1	na
Agricultural value added	-9.0	1.0	-6.9	-21.0	-24.4	-5.0	1.9	-18.9	na
Employment	(Percentage change)								
Labour force (end-year)	na	na	na	-3.0	-3.0	-2.0	-2.2	na	na
Employment (end-year)	-1.0	-1.9	-5.8	-3.9	-7.8	-12.3	-16.5	-15.0	na
Unemployment ¹	(In per cent of labour force)								
	0.0	0.5	0.6	0.8	1.7	3.6	4.1	3.7	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	79	1,381	1,662	1,892	176	39.1	17.4	7.3	9.0
Consumer prices (end-year)	137	2,984	2,169	1,160	60	28.6	11.3	1.9	19.6
Gross average monthly wages in industry (annual average)	na	na	na	1,538	178	34.4	14.2	3.0	na
Government sector ²	(In per cent of GDP)								
General government balance	-7.9	-7.3	-4.1	-7.5	-2.7	-4.7	-6.8	-8.0	-7.0
General government expenditure	32.9	31.8	25.2	25.9	19.9	18.6	20.4	21.9	na
Monetary sector	(Percentage change)								
Broad money (end-year)	210.7	391.0	692.0	576.0	106.1	13.8	27.6	-13.1	na
Domestic credit (end-year)	288.9	1,342.9	653.0	745.4	-23.6	-12.4	33.5	19.0	na
Broad money (end-year)	(In per cent of GDP)								
	na	45.0	20.9	13.4	11.6	9.5	10.4	8.4	na
Interest and exchange rates	(In per cent per annum, end-year)								
Refinancing rate	na	na	240.0	230.0	52.5	35.0	18.5	25.0	na
Treasury bill rate (3-month maturity)	na	na	na	354.0	58.8	32.6	16.1	25.8	na
Deposit rate ³	na	na	na	na	44.4	30.0	12.6	14.5	na
Lending rate ³	na	na	na	na	58.3	45.0	22.8	18.4	na
Exchange rate (end-year)	(Tenge per US dollar)								
	na	0.8	6.1	54.3	64.0	73.8	75.9	84.0	na
Exchange rate (annual average)	na	0.4	1.9	36.0	61.0	68.2	75.6	78.6	na
External sector	(In millions of US dollars)								
Current account	-1,300	-1,900	-400	-905	-517	-751	-909	-1,249	-724
Trade balance	-3,200	-1,100	-400	-920	-223	-326	-385	-801	-294
Exports	10,200	3,600	4,800	3,285	5,164	6,292	6,769	5,774	5,856
Imports	13,400	4,700	5,200	4,205	5,387	6,618	7,154	6,575	6,150
Foreign direct investment, net	na	na	473	635	964	1,137	1,320	1,132	800
Gross reserves (end-year), excluding gold	na	na	640	1,551	1,660	1,980	2,244	1,931	na
External debt stock	na	1,478	1,848	3,494	4,965	6,224	7,893	7,860	na
Gross reserves (end-year), excluding gold ⁴	(In months of imports of goods and services)								
	na	na	1.5	3.9	3.2	3.0	3.1	2.9	na
Debt service	(In per cent of exports of goods and services)								
	na	4.3	1.4	3.3	-2.3	-4.3	-4.0	-7.4	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	16.7	16.9	16.9	16.7	16.5	16.3	15.7	15.0	na
GDP (in billions of tenge)	na	2	29	423	1,014	1,416	1,702	1,759	1,884
GDP per capita (in US dollars)	na	357	916	704	1,008	1,274	1,434	1,493	na
Share of industry in GDP (in per cent)	38.0	34.7	28.7	29.1	23.5	21.2	21.4	22.5	na
Share of agriculture in GDP (in per cent)	29.0	30.4	16.4	14.9	12.3	12.2	11.4	8.8	na
Current account/GDP (in per cent)	na	-31.5	-2.6	-7.7	-3.1	-3.6	-4.0	-5.6	-4.7
External debt minus reserves (in US\$ millions)	na	na	1,208	1,943	3,305	4,244	5,649	5,929	na
External debt/GDP (in per cent)	na	24.5	11.9	29.7	29.9	30.0	35.1	35.1	na
External debt/exports (in per cent)	na	41.1	38.5	106.4	96.1	98.9	116.6	136.1	na

¹ Unemployed registered with the Public Employment Service.

² General government includes the state, municipalities and extrabudgetary funds. Balance includes privatisation revenues. The gross deficit of privatisation revenues (as presented by the government) was -3.8% of GDP in 1997, -3.7% in 1998 and is forecast at around -3.5% of GDP in 1999.

³ Deposit rate for time deposits of individuals. Lending rate for short-term credits. Following a change in definition, data for 1997 are not comparable to previous years.

⁴ In months of merchandise imports only until 1995.

Key reform challenges

- **Large-scale privatisation advances slowly. A successful sale of key strategic utilities with the involvement of foreign investors would alert the international business community to local investment opportunities.**
- **The investment climate has deteriorated, largely as a result of macroeconomic difficulties. The government faces major challenges in simplifying bureaucracy and combating corruption.**
- **The banking system has been debilitated by the collapse of several banks in 1999, and the capital base has shrunk considerably in hard currency terms as a result of currency depreciation. A consolidation of the sector is urgently required.**

Liberalisation

Despite external pressures, Kyrgyzstan has maintained a liberal trade regime.

In late 1998, Kyrgyzstan became the first CIS country to join the WTO and the country continues to maintain one of the most liberal trade regimes in the region. A uniform tariff rate of 10% applies to imports. Kyrgyzstan's trade regime is relatively open and transparent, and compares favourably to most other transition economies. However, the introduction of new tariff bands since WTO entry has created distortions by providing uneven levels of protection. WTO membership requires a reduction in tariff rates over the next few years. Despite a very high current account deficit, the authorities have avoided retaliating against restrictive trade measures imposed earlier this year by neighbouring Kazakhstan and Uzbekistan.

Stabilisation

Rising inflation and large fiscal deficits pose major challenges for the government.

Kyrgyzstan's stabilisation programme has been tested by a combination of factors over the past year. The country has a large trade exposure to Russia and Kazakhstan and, consequently, has been hit by the downturn in those countries. In addition, the sharp drop in the price of gold has reduced revenues from Kyrgyzstan's main export earner. Inflation has risen from an annual rate of less than 15% at the end of 1997 to 32% at the middle of 1999, while the general government deficit remains close to 10% of GDP. The authorities have recently implemented fiscal and monetary measures to combat these problems. The government has doubled excise taxes on a number of goods and cut non-essential expenditures, while the central bank has raised interest rates. Nevertheless, the government has been unable so far to cut expenditure sufficiently to offset declining tax revenues, and new revenue-enhancing measures are urgently needed.

Kyrgyzstan is a pilot country for the Comprehensive Development Framework programme.

Kyrgyzstan remains heavily indebted and highly dependent on external assistance. The steep decline in the value of the som during 1999 raised the ratio of external debt (mostly long-term and on concessional terms) to GDP to around 100%. Effective long-term management of this debt will require an acceleration of growth, which in turn depends on further advances in structural reforms. Both to mobilise external assistance and to support reforms, Kyrgyzstan joined the pilot phase of the World Bank's Comprehensive Development Framework (CDF) initiative. The CDF sets out a "holistic" framework for analysing the longer-term development challenges of its client countries and for coordinating and managing the activities of donors and other partners in development.

Privatisation

Large-scale privatisation is proceeding slowly.

Small-scale privatisation is largely complete, with nearly 97% of all SMEs placed in private hands by the beginning of 1999, mostly through cash auctions. Large-scale privatisation, based on a combination of voucher auctions and investment tenders for strategic stakes in the largest companies, has proceeded much more slowly. The tender programme was suspended in the middle of 1997 after allegations of corruption and was not resumed until the end of 1997. During 1998, parliament approved a new strategy for the privatisation of about 300 enterprises. Tenders for a number of them were held, but interest among investors was limited. As a result, total privatisation receipts for the year fell below expectations, amounting to less than US\$ 4 million (about 1% of total government revenue). Recently however, the state-owned cement producer Kant Cement was sold to part of the Siemens group. Further delays to the privatisation of strategic public monopolies have occurred in 1999, partly due to the frequent reshuffles in government and ongoing economic difficulties. The main sectors scheduled for privatisation in the remainder of 1999 and in 2000 are telecommunications, energy and the national airline.

Liberalisation, stabilisation, privatisation

1991

Aug Independence from Soviet Union
Dec Small-scale privatisation begins

1992

Jan Most prices liberalised

1993

Apr Free trade agreement with Russia
May Exchange rate unified
May New currency (som) introduced
May T-bills market initiated

1994

May Most export taxes eliminated
Jul First IMF ESAF programme introduced

1995

Mar Current account convertibility introduced

1996

Jan VAT introduced
Jul New tax code introduced

1997

Jul Customs union with Russia, Kazakhstan and Belarus

1998

Jul Abolition of all remaining foreign exchange controls
Oct Private land ownership passed in referendum
Dec WTO membership

1999

Jul Comprehensive Development Framework launched

Enterprise reform

The bankruptcy law is being applied more fully.

The bankruptcy law adopted in 1997 is progressive and draws on Western models. For example, it puts secured creditors first in line for payment when an enterprise is liquidated. Tax claims can only be made after secured and unsecured payments have been made. Nevertheless, implementation has been slow, despite the downturn in the economy; pre-tax profits in medium-sized and large enterprises outside agriculture fell by 57% in 1998. Loss-making enterprises survive in part by running up tax and payment arrears, particularly to public utilities in the energy sector. In an effort to accelerate bankruptcy implementation, the government has announced that at least 100 enterprises will face bankruptcy proceedings in 1999.

Enterprises, infrastructure, finance and social reforms

1991

Jun Banking laws adopted

1992

Dec Comprehensive central bank law adopted

1994

Jan Kyrgyz State Energy Holding Company established

Feb Telecommunications company corporatised

Apr Competition law introduced

May Enterprise restructuring agency established

1995

May Stock exchange begins trading

Jun BIS capital adequacy enacted

Oct First enterprise liquidations

1996

Sep Securities and exchange commission established

1997

Jan Electricity law adopted

May Utilities privatisation suspended

Jun Restructuring of state energy company

Jul IAS introduced

Oct New bankruptcy law enacted

Oct National Agency for Communication established

1998

Jan New central bank law becomes effective

Jun Major amendments to pension law

Dec Foreign investor advisory council established

1999

Feb Largest bank placed under conservatorship

Improvements in the tax regime and the reduction of bureaucracy are urgently required.

In common with other countries in the region, implementation of tax laws and regulations is often arbitrary and unfair to private businesses. For example, investors are required to have a substantial number of licences, many of which have to be renewed annually, in order to found a business. One company claims to have been asked to obtain over 100 licences to establish their business, half of which had to be renewed after a year. Furthermore,

a recent study suggests that, on average, investors will realise only one-fifth of their profits; the remainder will go to the government in the form of different taxes and fees. To respond to the concerns of businesses, the government established an Advisory Council on Investment Policy in December 1998, comprising local and foreign business representatives, government officials and IFIs. The first meeting of this Council took place in February 1999. As a result of investor concerns voiced at the meeting, some progress has been made recently in simplifying tax procedures and registration.

Infrastructure

Telecommunications privatisation moves ahead as the regulatory framework is strengthened.

In the past two years, Kyrgyzstan has established itself as the leading reformer in Central Asia in the area of telecommunications. A new telecommunications law was enacted in 1998 and an independent regulator established. However, tariffs remain well below cost-recovery levels. The national telecommunications operator, JSC “Kyrgyz Telecom” (KT), was awarded a general operating licence, including the right to provide exclusive long-distance and international telephone services until 2008, although a subsequent agreement with the WTO brought forward this date to 2003. An international tender for the sale of 40% of KT was announced earlier this year. Following an international competitive bidding process, the government appointed Raiffeisen Investment AG as privatisation advisers, and tenders have been invited from four pre-qualified bidders.

Opportunities exist for greater regional cooperation in infrastructure.

Economic cooperation between Kyrgyzstan and its neighbours in the area of infrastructure has increased recently in a number of ways. The road between Bishkek and Almaty is to be rehabilitated and upgraded, with the assistance of parallel loans (currently in process) by the Asian Development Bank to the governments of Kyrgyzstan and Kazakhstan. These governments are also exploring joint construction projects for the Kemin-Almaty railroad link and the road between Almaty and Lake Issyk-Kul. In the energy sector, there are ongoing discussions regarding trade electricity between Kyrgyzstan and southern Xinjiang in China. However, Kyrgyzstan relies on Kazakhstan and Uzbekistan for the import of oil and gas, and relations have been plagued with problems of non-payment and mutual debts.

Financial institutions

Devaluation and weak supervision have increased the fragility of the banking sector.

Kyrgyzstan's banking system is fragile and under-capitalised, with around 20 banks combining to a total share capital of less than US\$ 14 million. Five banks, including the largest (Mercury), were placed under conservatorship or liquidation in the first half of 1999, and two more banks have since been placed under conservatorship. Several had a large exposure to the state gas company, Kyrgyzgazmunaizat, which was affected by a large-scale fraud at the start of the year. The weak supervision capabilities of the central bank were revealed by the failure to recognise and to respond to this problem.

Financial intermediation is held back by lack of consolidation among banks.

Minimum capital requirements are very low and raising them substantially would force much-needed consolidation and mergers in the sector. The present central bank requirements for minimum paid-in capital are KGS 20 million (US\$ 0.47 million) for existing domestically owned banks, KGS 25 million (US\$ 0.58 million) for any new domestically owned banks opening after 1998, and KGS 40 million (US\$ 0.94 million) for banks with foreign participation. These minimum requirements will be increased substantially over the next two years. IFIs such as the ADB and the EBRD are exploring ways to inject more capital into the system.

Social reform

Substantial pension reform is envisaged.

Kyrgyzstan inherited a relatively generous pension system from the former Soviet Union, and the parlous fiscal position of the government has created an urgent need for reform. The government has agreed an ambitious reform programme with the World Bank, with the aim of eliminating all budgetary subsidies to the pension fund by 2001. Among other measures, the programme raises the minimum number of years of work in order to qualify for full benefits and the retirement age from 60 to 63 for men and 55 to 58 for women over many years. There are no plans at present, however, for substantial private sector pension provision, although a couple of small private pension funds are currently in operation.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – yes	Share of the population in poverty – 76%
Interest rate liberalisation – limited de facto	Secondary privatisation method – MEBOs	Separation of railway accounts – no	Private pension funds – yes
Wage regulation – no	Tradability of land – limited de facto	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 17.6%	Competition office – no	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system – no	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	90.0	60.0	40.0	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	7.0	7.0	7.0	7.0	7.0
Share of exports to non-transition countries (per cent)	na	na	na	na	50.2	35.2	18.2	28.7	na
Share of trade in GDP (per cent)	na	na	na	na	36.2	33.3	36.2	36.2	37.0
Tariff revenues (per cent of imports)	na	na	0.5	1.0	0.9	2.1	1.9	2.2	2.4
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	3.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	0.1	0.2	0.3	0.8	1.1	1.5	1.5	na
Private sector share in GDP	5.0	15.0	20.0	25.0	30.0	40.0	50.0	60.0	70.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP) ¹	na	na	na	na	na	6.9	4.7	3.5	3.3
Efficiency of tax collection for social security (per cent)	na	na	36.8	na	38.4	49.2	44.2	47.7	na
Share of industry and construction in total employment (per cent)	27.9	26.0	22.5	21.4	19.3	16.5	14.6	13.5	na
Change in labour productivity in industry (per cent) ²	-0.4	7.4	-23.7	-17.0	-14.5	-25.8	16.5	48.8	18.0
Investment rate (per cent of GDP)	23.0	6.2	11.2	13.8	14.9	15.1	18.1	19.3	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	7.2	7.5	7.5	8.0	7.3	7.7	7.5	7.6	7.7
Railway labour productivity (1993=100) ³	na	na	na	100.0	69.7	42.8	49.6	48.7	21.1
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	0.74 (65%)	1.00 (70%)	2.25 (75%)	2.00 (80%)	na
Electricity consumption/GDP (1989=100)	100.6	109.2	127.7	159.9	203.1	287.7	225.0	211.1	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.9
Financial institutions									
Number of banks (of which foreign-owned)	6 (0)	10 (0)	15 (1)	20 (1)	18 (3)	18 (3)	18 (3)	20 (3)	23 (6)
Asset share of state-owned banks (in per cent)	100.0	98.8	na	na	77.3	69.7	5.0	9.8	0.0
Bad loans (per cent of total loans)	13.5	10.0	na	na	92.3	72.0	26.1	7.5	1.6
Credit to private sector (per cent of GDP)	na	na	na	na	na	12.5	8.7	3.5	5.1
Stock market capitalisation (per cent of GDP) ⁴	na	na	na	na	na	na	0.3	3.2	23.7
EBRD index of banking sector reform	na	na	na	na	2.0	2.0	2.0	2.7	2.7
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	0.1	0.0	0.0	6.8	9.6	10.5	8.4	8.1	7.4
Life expectancy at birth, total (years)	69.3	69.2	68.9	67.6	66.7	66.8	69.3	69.2	na
Basic school enrolment ratio (per cent)	91.8	90.6	90.3	89.7	89.0	89.1	89.3	89.2	na
Earnings inequality (Gini coefficient)	na	na	30.0	44.5	44.3	39.5	42.8	43.1	na

¹ Refers to transfers and subsidies.

² The increase in industrial labour productivity in 1997 was primarily due to the rise in production at the Kumtor gold mine.

³ Data prior to 1993 was not available; the index is based on 1993=100.

⁴ The listing of the state energy company, Kyrgyzenergo, accounts for the large increase in capitalisation in 1998.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-5.0	-19.0	-16.0	-20.0	-5.4	7.1	9.9	1.8	0.0
Industrial gross output	-0.3	-26.4	-25.3	-23.5	-36.9	3.9	39.7	4.6	na
Agricultural gross output	-10.0	-5.0	-10.0	-15.0	4.0	-0.9	3.0	11.6	na
Employment	(Percentage change)								
Labour force (annual average)	na	0.4	-3.1	-1.5	2.0	0.6	na	na	na
Employment (annual average) ¹	0.4	4.7	-8.5	-2.1	-0.3	0.0	2.3	na	na
Unemployment rate ²	(In per cent of labour force)								
	0.0	0.1	0.2	0.7	3.0	4.5	3.2	na	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	85.0	855.0	772.4	208.0	40.7	31.3	25.5	12.1	45.0
Consumer prices (end-year)	170.0	1,259.0	1,363.0	95.7	31.9	35.0	14.7	18.3	40.0
Producer prices (annual average)	na	na	649.7	196.7	37.6	26.1	29.0	na	na
Producer prices (end-year)	na	na	224.6	96.7	47.4	39.4	14.8	18.0	na
Gross average monthly wages (annual average)	na	na	na	191.3	66.7	26.5	27.3	16.7	na
Government sector ³	(In per cent of GDP)								
General government balance	4.6	-17.4	-13.5	-11.6	-17.3	-9.5	-9.0	-9.9	-7.0
General government expenditure	30.3	33.9	36.6	28.6	33.2	25.3	25.1	27.5	na
Monetary sector	(Percentage change)								
Broad money (end-year)	84.0	428.0	180.0	125.0	76.7	22.9	24.7	17.0	na
Net domestic assets	na	761.0	307.0	83.5	96.8	17.7	8.2	na	na
Broad money	(In per cent of GDP)								
	na	na	13.2	12.9	17.1	14.3	14.3	15.0	na
Interest and exchange rates	(In per cent per annum, end-year)								
Refinancing rate ⁴	na	na	276.8	89.5	45.8	45.9	23.5	32.9	na
Treasury bill rate (3-month maturity)	na	na	na	73.0	44.0	52.3	23.5	32.9	na
Deposit rate ⁵	na	na	na	na	na	24.8	32.0	29.5	na
Lending rate ⁵	na	na	na	na	na	58.3	50.1	42.5	na
Exchange rate (end-year) ⁶	(Som per US dollar)								
	1.7	414.5	8.0	10.7	11.0	16.7	17.4	29.4	na
Exchange rate (annual average) ⁶	na	na	6.1	10.9	10.8	12.9	17.4	21.0	na
External sector	(In millions of US dollars)								
Current account balance	na	-61	-162	-124	-242	-425	-139	-285	-164
Trade balance	-41	-74	-166	-119	-179	-252	-15	-151	-62
Exports	na	258	335	340	409	531	631	554	623
Imports	na	332	501	459	588	783	646	705	685
Foreign direct investment, net	na	na	10	45	96	46	83	52	64
Gross reserves (end-year), including gold	na	na	46	96	123	129	200	193	na
External debt stock	na	na	290	414	585	753	935	1123	na
Gross reserves (end-year), including gold	(In months of imports of goods and services) ⁷								
	na	na	1.1	2.5	2.5	1.8	3.0	2.6	na
Debt service	(In per cent of merchandise exports)								
	na	na	0.6	5.0	19.5	12.9	8.0	8.8	na
Memorandum items	(Denominations as indicated)								
Population (in millions, beginning of year)	4.4	4.5	4.5	4.5	4.5	4.6	4.6	4.8	na
GDP (in millions of som)	92.6	741.3	5,355	12,019	16,145	23,399	30,700	35,730	51,809
GDP per capita (in US dollars)	580.4	751.7	195.1	245.0	332.2	394.3	383.6	354.8	na
Share of industry in GDP (in per cent)	27.5	32.1	25.1	20.5	12.0	11.9	15.5	na	na
Share of agriculture in GDP (in per cent)	35.3	37.3	39.0	38.3	40.6	46.6	43.4	na	na
Current account/GDP (in per cent)	na	na	-18.5	-11.3	-16.2	-23.4	-7.9	-16.7	-10.8
External debt minus reserves (in US\$ millions)	na	na	243.8	318.1	462.2	624.1	734.4	930.0	na
External debt/GDP (in per cent)	na	na	33.0	37.5	39.1	41.5	53.0	65.9	na
External debt/exports (in per cent)	na	na	86.5	121.7	143.0	141.7	148.2	202.7	na

¹ An industrial sector enterprise survey conducted by the ILO in 1995 found that employment fell by about one-third between 1991 and 1994.

² Registered unemployed. The true rate of unemployment is unofficially estimated to be around 20%.

³ General government includes the state, municipalities and extrabudgetary funds. Figures also include expenditure under the foreign-financed PIP. General government expenditure includes net lending.

⁴ Simple average of National Bank's credit auction rates. Credit auctions were discontinued at the end of January 1997 and the 3-month treasury bill rate has become the official reference rate.

⁵ Weighted average over all maturities.

⁶ Roubles per dollar until 1992; som per dollar thereafter.

⁷ Excluding Kumtor gold imports.

Key reform challenges

- **A political consensus on a consistent set of objectives is needed to complete large-scale privatisation.**
- **While recent moves to consolidate corporate ownership in holding companies may strengthen corporate governance, this consolidation should not come at the expense of competition.**
- **The recent disbanding of the independent telecommunications regulator by parliament after a rate increase (subsequently overturned) called into question the effectiveness of the regulatory regime. The independence of the regulator must be safeguarded if infrastructure reforms are to advance.**

Liberalisation

Latvia joins the WTO.

Latvia became a member of the WTO in February 1999 and has committed to bind its tariff schedule on agricultural products at a ceiling rate of 50% (effective on the date of accession) and to reduce tariffs on exceptional items. It has also committed to introduce competition in telecommunications services by 2003. However, Latvia's trade relations with Estonia and Lithuania have been strained by its imposition of duties on all imports of pork products, following pressure from local producers. Latvia has insisted that these measures do not contravene the committed tariff reduction schedule under the WTO, while its Baltic neighbours, who are not yet WTO members, have protested that the measures run counter to the Baltic Free Trade Agreement.

Stabilisation

The first sovereign Eurobond is issued.

In May 1999, Latvia issued a €150 million Eurobond for the first time. Prior to the launch, Latvia received a BBB rating from S&P and Baa2 rating from Moody's. It was priced more favourably than Lithuania's €200 million issue in March, reflecting a slightly better rating received from the credit agencies. Latvia's total public debt only amounts to around 12% of GDP.

Privatisation

Political tensions and conflicting objectives slow large-scale privatisation.

While there are only a few large-scale state-owned enterprises to be privatised, progress has been held back by the 1998 general elections and by the influence of rival industrial groups that have considerable sway in Latvian politics. Also slowing down privatisation are the multiple objectives of both attracting strategic investors with significant investment commitments, selling shares to the general public through public offerings and raising sufficient revenues. For example, the privatis-

ation of a 33% stake in Latvian Shipping Company (LASCO) failed in June 1999, more than three years after international bids were first called. None of the shortlisted companies formally applied at the government's asking price. The government has revised the plan and it is now considering selling a larger (but still less than a majority) stake to a strategic investor.

Enterprise reform

The Russian crisis provided an impetus for firms to restructure.

Companies that were most affected by the Russian crisis undertook workforce reductions and reoriented their businesses. Compared with the first quarter of 1998, employment declined by 2% in the same period of 1999. The reductions were mainly in the public sector (7% decline). During the first five months of 1999, total exports declined by more than 8% in US dollar terms compared with the same period of the previous year, reflecting a 59% drop in exports to the CIS. However, during the same period, exports to the EU increased by 13%, indicating that some firms were successful in reorienting their export markets.

Dispersed ownership is predominant in privatised entities ...

Privatisation methods adopted by the Latvian Privatisation Agency varied across different entities. In most very large enterprises, several methods were combined, including international tenders, direct sales, public auctions and public offerings on the stock exchange. Of more than 1,000 sales contracts concluded by the Agency between 1994 and 1998, controlling stakes (over 50%) were sold in only 12% of the firms. As a result, dispersed ownership structure became the prevalent form of ownership in privatised entities.

Liberalisation, stabilisation, privatisation

1990

Nov Exchange rate unified

1991

Jan Personal income tax introduced
Aug Soviet trade equalisation tax abolished
Sep Independence from Soviet Union
Nov Foreign investment law enacted
Nov Small-scale privatisation commenced

1992

Jan Most consumer prices liberalised
Jan VAT introduced
Jan Wages liberalised
Jun Privatisation law enacted
Jun Large-scale privatisation commenced
Jun Most foreign trade controls removed
Jul Interest rates liberalised

1993

Feb Tradability of land rights enacted
Mar New currency (lat) introduced
Dec T-bills market initiated

1994

Feb Privatisation law amended
Feb Privatisation agency established
Jun Full current account convertibility introduced

1996

Jun EFTA membership

1999

Feb WTO membership
May First sovereign Eurobond issued

... but ownership structures are gradually consolidating.

Cross-shareholding within company groups has developed to overcome the dispersed ownership structure resulting from the privatisation process. These groups, moreover, have recently begun to consolidate ownership within holding company structures and to unwind the cross holdings. For example, cross-shareholdings within the Ventspils Nafta Group in the oil transit business have been eliminated. Ave Lat Group, a group of agri-processing companies, is also in the process of unwinding cross-shareholdings between group companies.

Enterprises, infrastructure, finance and social reforms

1991

Dec Competition law enacted

1992

May Two-tiered banking system established

May Banking law enacted

Oct IAS accounting introduced

1993

May Company law enacted

Dec Stock exchange established

1994

Jan BIS capital adequacy requirement introduced

1995

May Banking crisis

Jul Stock exchange begins trading

Oct New banking law enacted

Oct IAS accounting for banks introduced

Oct First state-owned bank privatised

1996

Jun Energy Regulation Council established

Sep Bankruptcy law enacted

1997

Jun New competition law enacted

Aug First corporate Eurobond

Nov Major adjustments of electricity tariffs

Dec First corporate GDR issue

1998

Jan Anti-monopoly office established

Jul Private pension law enacted

Sep New energy law adopted

Sep New insurance law enacted

Nov Railway law adopted

... but the privatisation of Latvenergo has been postponed.

Latvenergo was to have been privatised by the middle of 1998. However, the lack of political consensus over its restructuring and privatisation has contributed to long delays. One approach, proposed by the industry, is to preserve the existing vertically integrated structure. A second approach, proposed in 1997 by the Privatisation Agency, was to maintain the transmission as a state-owned company and to sell off generation and distribution companies as separate entities. In spring 1999, the newly elected government proposed unbundling the sector under a holding company structure that would remain majority state-controlled. The government has now postponed the decision over the restructuring and privatisation of Latvenergo until December 1999.

The independence of the telecommunications regulator is challenged.

All members of the independent telecommunications regulator, the Telecommunications Rate Council (TRC), were dismissed by the parliament after they had approved Lattelekom's request to increase tariffs for local calls, calling into question the regulator's independence. The ministry in charge of telecommunications has appealed to the Constitutional Court the legality of the parliament's decision to disband the council. The case was reviewed by the court and the resolution was judged illegal.

A new railway law is enacted.

The November 1998 Law on Railways sets out the basic principles of railway restructuring. The law provides for the separation of accounts between infrastructure maintenance and operations, stipulates state and local government to subsidise the non-profitable passenger services, and regulates the rules of financing infrastructure investments.

Minimum capital requirements are likely to spur bank consolidation.

While the number of banks has been reduced from 30 to 25 over the past year, further consolidation of the system is driven by minimum capital requirements of €5 million by 31 December 1999, as required by the May 1998 amendment to the Law on Credit Institutions. On the basis of June 1999 non-audited financial statements, 10 of 25 banks had capital less than €5 million and smaller banks are increasingly looking for merger partners to meet this requirement. In March 1999, one of the medium-sized banks, Latvijas Investīciju banka, was bought by a Merita Nordbanken. In July, one of the smallest banks, Rīgas Naftas un ķīmijas banka, was merged with one of the top ten banks, Baltijas Transītu banka.

Insurance regulation has been strengthened and insurance markets are expanding.

The September 1998 insurance law strengthened the legal foundations of the Insurance Supervision Inspectorate (ISI), a quasi-independent regulatory body under the Ministry of Finance. In June 1999, there were eight life insurance companies and 22 non-life insurance companies. In the first half of 1999, gross premiums collected by insurance companies were LVL 5 million (US\$ 8 million) and LVL 41 million (US\$ 70 million) for life and non-life, representing 25% and 17% year-on-year increases, respectively.

Social reform

Private pension funds have been established ...

Following the enactment of a law on private voluntary pension funds in July 1998, Latvia is gradually moving away from a "pay-as-you-go" scheme. To date, two funds have been granted licences. Privately managed company pension funds are also being introduced. In August, Lattelekom has selected Estonia's Suprema Securities, to manage the company's pension fund for its employees.

... as the government begins to reduce fiscal burden of the PAYG scheme.

In August 1999, the parliament approved a phased increase in the retirement age for both women and men from 57.5 years and 60 years, respectively to 62 for both, by 2006. However, the enactment of the law has been suspended for two months and may be subject to a referendum if the opposition could gain signatures of 10% of the electorate.

Infrastructure

Regulation of the energy sector has been strengthened ...

The new energy law, adopted in September 1998, has strengthened regulation of the sector, including rules for licensing and establishing new generation capacity. The law also provides a framework for transparency of pricing and for strengthening the legal basis of the activities of the quasi-independent Energy Regulation Council (ERC). The tariff calculation method takes into account of efficiency gains in production and tariffs are differentiated according to the group of users. For 1999, the ERC approved an average electricity tariff for Latvenergo, the integrated state monopoly for electric power supply, of 6.17 US cents per kWh, unchanged from 1997 and 1998.

Financial institutions

Banking regulation is strengthened in the wake of the Russian crisis.

In response to the impact of the Russian crisis on Latvian banks, the central bank has strengthened regulatory requirements covering consolidated reporting, loan loss provisioning and maximum permissible exposures to borrowers in non-OECD countries. The authorities have also acted to resolve the insolvencies of a number of banks. Operations of two small banks were suspended immediately after the crisis. In early 1999, the central bank suspended the operations of the fifth-largest bank, Rīgas Commercial Bank (RKB), and a court declared the bank insolvent. Subsequently, the major creditors have worked out a rehabilitation plan. The agreement is pending court approval.

Liberalisation	Privatisation	Enterprises	Financial sector
Current account convertibility – full	Primary privatisation method – direct sales	Competition office – yes	Capital adequacy ratio – 10%
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Infrastructure	Deposit insurance system – yes
Wage regulation – no	Tradability of land 2 – full except foreigners	Independent telecoms regulator 3 – no	Secured transactions law – restricted
Stabilisation		Separation of railway accounts – yes	Securities commission 4 – yes
Share of general government tax revenues in GDP – 34.6%		Independent electricity regulator – no	Social reform
Exchange rate regime 1 – fixed			Share of the population in poverty – 23%
			Private pension funds – yes

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	6.1	6.1	16.6	16.6	17.8	19.6	20.4
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of exports to non-transition countries (per cent)	na	na	na	76.4	76.6	71.9	75.3	75.2	na
Share of trade in GDP (per cent)	na	na	54.6	48.4	32.1	37.3	36.7	40.1	40.3
Tariff revenues (per cent of imports)	na	na	2.8	2.9	3.2	1.8	1.5	1.4	1.1
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	1.0	10.2	40.8	70.6	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	0.3	0.8	1.1	2.3	3.3
Private sector share in GDP	10.0	10.0	25.0	30.0	40.0	55.0	60.0	60.0	65.0
EBRD index of small-scale privatisation	na	na	na	na	3.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	0.2	0.4	0.3	0.4	na
Efficiency of tax collection for social security (per cent)	na	na	65.4	63.7	50.6	53.5	49.5	55.7	na
Share of industry and construction in total employment (per cent)	40.6	38.9	34.6	31.0	28.8	28.0	26.7	26.8	na
Change in labour productivity in industry (per cent)	na	4.8	-28.0	-19.4	2.1	13.5	11.2	10.2	3.5
Investment rate (per cent of GDP)	27.6	22.4	23.0	23.1	23.1	23.0	23.0	24.4	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	3.0	2.7	2.7
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.7	2.7
Infrastructure									
Main telephone lines per 100 inhabitants	23.2	24.3	24.9	26.6	25.8	28.0	29.8	30.2	38.3
Railway labour productivity (1989=100)	93.0	82.5	58.5	54.0	48.8	50.2	65.6	75.4	72.0
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	3.2 (85%)	3.6 (85%)	5.6 (94%)	6.1 (98%)	na
Electricity consumption/GDP (1989=100)	96.8	102.0	126.0	118.1	113.8	114.1	112.1	86.3	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.9
Financial institutions									
Number of banks (of which foreign-owned)	na	14 (na)	50 (na)	62 (na)	56 (na)	42 (11)	35 (14)	32 (15)	27 (15)
Asset share of state-owned banks (in per cent)	na	na	na	na	7.2	9.9	6.9	6.8	8.5
Bad loans (per cent of total loans)	na	na	na	na	11.0	19.0	20.0	10.0	6.3
Credit to private sector (per cent of GDP)	na	na	na	na	16.4	7.8	7.2	10.5	14.1
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	0.2	3.0	6.1	6.0
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	3.0	2.7
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.3	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	8.0	7.0	7.4	10.1	10.0	10.6	9.6	9.5	10.5
Life expectancy at birth, total (years)	71.3	70.6	70.3	69.0	68.7	69.3	70.4	71.2	na
Basic school enrolment ratio (per cent)	96.4	95.2	90.9	89.4	89.0	89.5	90.3	90.7	na
Earnings inequality (Gini coefficient)	na	24.7	33.3	28.3	32.5	34.6	34.9	33.6	na

1 The exchange rate has been informally fixed to the Special Drawing Rights (SDR) since February 1994 and maintained a constant exchange rate of LVL 0.7997 per SDR.

2 Foreign entities are allowed to own land under joint venture with Latvian entities whereby Latvian entities have a majority stake.

3 The Telecommunications Rate Council (TRC) is in charge of regulating tariffs while other regulatory activities are performed by the Ministry of Transport and Communications.

4 The securities commission is part of the Ministry of Finance, but the members of the commission are independently appointed by and report to parliament.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								<i>Estimate</i>	<i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>								
GDP	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.6	1.5
Private consumption	na	na	na	na	na	10.3	5.0	5.8	na
Public consumption	na	na	na	na	na	1.8	0.3	5.3	na
Gross fixed investment	na	na	na	na	na	22.3	20.7	11.1	na
Exports of goods and services	na	na	na	na	na	20.2	13.1	6.6	na
Imports of goods and services	na	na	na	na	na	28.5	6.8	16.9	na
Industrial gross output	-0.6	-34.0	-32.0	-10.0	-4.0	5.0	14.0	3.1	na
Agricultural gross output	-4.0	-16.0	-22.0	-20.0	-7.0	-6.0	0.2	na	na
Employment	<i>(Percentage change)</i>								
Labour force (annual average)	-0.8	-4.1	-2.0	-1.5	-1.9	-1.0	-3.6	-4.1	na
Employment (annual average)	-0.8	-7.3	-6.9	-10.1	-3.5	-2.7	1.9	-2.9	na
	<i>(In per cent of labour force)</i>								
Unemployment	0.6	3.9	8.7	16.7	18.1	19.4	14.8	13.8	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	172.0	951.2	108.0	36.0	25.0	17.6	8.4	4.7	2.2
Consumer prices (end-year)	262.4	959.0	35.0	26.0	23.1	13.1	7.0	2.8	2.1
Producer prices (annual average)	na	na	na	17.0	12.0	13.7	4.1	1.9	na
Producer prices (end-year)	na	na	na	na	15.9	7.7	3.6	-1.9	na
Gross average monthly earnings in industry (annual average)	na	na	na	60.0	24.1	14.9	21.6	6.5	na
Government sector ¹	<i>(In per cent of GDP)</i>								
General government balance	na	-0.8	0.6	-4.0	-3.9	-1.7	0.1	-0.8	-3.8
General government expenditure	na	28.2	35.2	38.2	38.2	39.0	38.1	41.5	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	153.0	169.9	84.1	47.7	-23.1	19.9	38.7	5.9	na
Domestic credit (end-year)	91.0	303.8	146.0	65.7	-25.4	6.0	36.1	52.0	na
Broad money	na	na	31.5	33.6	22.3	22.4	25.6	24.5	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate	na	na	na	37.75	21.12	9.65	3.73	6.93	na
Treasury bills rate (3-month maturity)	na	na	na	21.54	33.39	10.14	3.61	7.48	na
Deposit rate (less than one year)	na	na	28.39	18.76	15.03	10.00	5.34	6.45	na
Lending rate (less than one year)	na	na	70.78	36.71	31.13	20.29	12.06	16.39	na
	<i>(Lats per US dollar)</i>								
Exchange rate (end-year)	na	0.84	0.60	0.55	0.54	0.56	0.59	0.57	na
Exchange rate (annual average)	na	0.67	0.67	0.56	0.53	0.55	0.58	0.59	na
External sector	<i>(In millions of US dollars)</i>								
Current account	na	25	314	-9	-159	-217	-345	-713	-533
Trade balance	na	-40	3	-300	-579	-798	-848	-1,130	-971
Exports	na	800	1,054	1,022	1,368	1,488	1,838	2,011	2,079
Imports	na	840	1,051	1,322	1,947	2,286	2,686	3,141	3,050
Foreign direct investment, net	na	43	51	155	244	376	515	220	150
Gross reserves excluding gold (end-year)	na	na	432	545	506	654	704	728	na
External debt stock (end-year) ²	na	na	na	na	1,440	2,044	2,775	3,043	na
	<i>(In months of current account expenditure)</i>								
Gross reserves (end-year), excluding gold ³	na	na	4.9	4.9	3.1	2.5	2.4	2.2	na
	<i>(In per cent of exports of goods and services)</i>								
Debt service ⁴	na	0.0	1.0	4.8	4.5	3.4	5.4	14.3	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	2.7	2.6	2.6	2.5	2.5	2.5	2.5	2.4	na
GDP (in millions of lats)	143	1,005	1,467	2,043	2,349	2,829	3,276	3,774	3,949
GDP per capita (in US dollars)	na	578	837	1,459	1,780	2,071	2,294	2,622	na
Share of industry in GDP (in per cent)	38.2	29.9	30.7	25.4	28.1	26.4	27.4	24.3	23.0
Share of agriculture in GDP (in per cent)	21.9	17.2	11.7	9.4	10.4	8.7	5.6	4.5	4.0
Current account/GDP (in per cent)	na	1.7	14.4	-0.2	-3.6	-4.2	-6.1	-11.1	-8.0
External debt minus reserves (in US\$ millions)	na	na	na	na	934	1,390	2,071	2,315	na
External debt/GDP (in per cent)	na	na	na	na	32.4	39.8	49.2	47.6	na
External debt/exports (in per cent) ⁴	na	na	na	na	105.3	74.0	90.0	93.0	na

¹ General government includes the state, municipalities and extrabudgetary funds. Privatisation revenues are not included in revenues.

² Includes non-resident currency and deposits and loans to foreign subsidiaries.

³ In months of imports of goods until 1995, and goods and services income thereafter.

⁴ In per cent of exports of goods until 1995, and goods and services income thereafter.

Key reform challenges

- While liberalisation and privatisation of telecommunications are well advanced, substantial reform of electric power and reorganisation of railways are required to boost performance of these sectors.
- To strengthen the banking system, initiatives to privatise the two remaining state banks should be restarted, after the sale of one was postponed due to the Russian crisis.
- A privately funded pension system has been launched, but the mandatory pay-as-you-go system still requires major reform.

Liberalisation

Protective policies have been adopted following the rouble devaluation.

Following the Russian crisis, import tariffs on refined oil, fertiliser and agricultural products were increased to protect domestic producers. Duties on petrol, diesel fuel and furnace oil were raised to 15% from 5% and on ammonium nitrate fertilisers to 6.5% from nil. Similar or larger increases in duties were levied on agricultural products, including meat, milk, grains and sugar. These measures may further delay WTO accession negotiations. In addition, while most of the bilateral negotiations under the WTO accession process have been concluded, that with the United States remains unfinished due mainly to differences regarding agricultural policies.

would help to ease the external imbalance while promoting private investment. The government plans to cut expenditures by LTL 450 million (1% of GDP) in a mid-year revision to the budget, adjusting partially to the revenue shortfall in the first half of the year.

Privatisation

Some progress has been made in large-scale privatisation ...

The privatisation law, which had required all cash privatisations to go through the tendering process, was amended in November 1997 to allow the sales of state assets through direct negotiations. In 1998, 344 entities were sold, generating revenues of US\$ 582 million. The sale of a 60% stake in Lithuanian Telecommunications alone raised US\$ 510 million. During the first five months of 1999, shares in 161 entities were sold for US\$ 85 million, including the sale in March 1999 of a 90% stake in the Klaipeda Stevedoring Company (KLASCO) to a Lithuanian-German consortium for US\$ 50 million. A 33% share in Mazeikiu Oil, the largest oil refinery complex in the Baltic region consisting of a main pipeline, a refinery and a terminal, is likely to be sold to a foreign strategic investor in the second half of 1999. The parliament adopted amendments on the law governing the status of Mazeikiu Oil in June 1999 so that a strategic investor could take a controlling stake (up to 66%).

... but the lack of transparency in the privatisation process has raised public concerns.

The privatisation procedures for both Mazeikiu Oil and KLASCO were marred by criticisms over the lack of transparency. While direct negotiations and closed tenders have provided some flexibility in the terms offered by the government and may thereby accelerate the process, this approach risks losing some public confidence. In future privatisations, including those of public utilities such as energy and transport, a transparent process is essential to earn the support of the public and the confidence of investors.

Stabilisation

A plan to change the currency peg has been postponed ...

Before the crisis in Russia, the central bank had considered changing the currency to which the litas was pegged from the US dollar to the euro, or to a basket of the euro and dollar. However, following the crisis and the recent government reshuffle, the authorities have taken a more cautious approach towards changing the exchange rate regime. The new Prime Minister announced in June 1999 that his government would not consider changing the currency peg before 2000.

... but fiscal tightening is essential to restore external balance.

The vulnerability of the fixed exchange rate regime increased in 1998 as the current account deficit reached 12% of GDP. This imbalance reflected strong domestic demand and a sharp fall in external demand following the financial crisis in Russia. In 1999, there have been added pressures to devalue the currency from industries that have lost competitiveness, owing to the devaluation of the rouble and the weakness of the euro against the US dollar. The IMF has recently recommended that the government implement budget cuts while maintaining the exchange rate regime, a policy mix that

Liberalisation, stabilisation, privatisation

1990

Feb	Central bank established
Mar	Independence from Soviet Union
May	Personal income tax introduced

1991

Feb	Privatisation law enacted
Feb	Voucher privatisation begins
Jul	Restitution law adopted

1992

Apr	Export surrender requirement abolished
Oct	Most prices liberalised

1993

Jul	Litas becomes sole legal tender
Jul	Trade regime liberalised
Nov	Free trade agreement with Russia

1994

Apr	Currency board introduced
May	VAT introduced
May	Full current account convertibility introduced
Jul	T-bills market initiated
Jul	Land law enacted
Oct	Export duties abolished

1995

Jan	EFTA membership
Jun	First phase of privatisation completed
Jul	Cash privatisation begins
Dec	First sovereign Eurobond issued

1997

Nov	Privatisation law amended
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1999

Jan	Capital gains tax introduced
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Enterprise reform

Benefits from transparency are revealed as "blue chip" companies raise fresh funds.

Companies on the "Official List" of the Lithuanian Stock Exchange must publish annual audited financial statements in conformity with international accounting standards. Although there are currently only seven firms in this category, several of these have been able to raise capital through new share issues following the Russian crisis. In January 1999, a refrigeration manufacturer, Snaige, raised nearly US\$ 2 million through new share issues and, one month later, Birzhu Milk raised around US\$ 250,000. In contrast, many other Lithuanian entities have faced considerable difficulties in raising capital.

Enterprises, infrastructure, finance and social reforms

1992

Sep	Two-tiered banking system re-established
Sep	Bankruptcy law enacted
Sep	Stock exchange established
Nov	First major readjustment of electricity prices
Nov	Competition law enacted
Nov	Competition office established

1993

Sep	Stock exchange begins trading
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1994

Jul	Company law adopted
Dec	Law on central bank enacted

1995

Jan	New law on commercial banks adopted
Mar	Energy law enacted
Dec	Banking crisis
Dec	Energy utilities and railways corporatised

1996

Feb	Independent securities regulator established
Jul	First GDR issue
Aug	Majority foreign ownership in first major bank

1997

Jan	IAS accounting for banks introduced
Feb	Independent energy regulator established
Feb	First corporate Eurobond
Jul	Corporatisation of Lithuanian Telecommunications
Oct	New bankruptcy law enacted

1998

Apr	Company law amended
Apr	Pledge law enacted
Apr	Mortgage registry established
Jun	Lithuanian Telecommunications privatised
Jun	IAS accounting standards for listed companies
Aug	New telecommunications law enacted

1999

Jun	Private pension funds law adopted
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The protection of minority shareholder rights has been strengthened.

Following amendments to the securities law in early 1998, the Securities Commission strengthened the enforcement of rules that protect minority shareholders in the event of corporate take-overs. From July 1998, a single shareholder that acquires a majority stake in a company registered with the Stock Exchange is required to submit a mandatory tender offer for all remaining

shares at the weighted average price of its share purchases. However, the rules are not applicable in the case of privatisation to a strategic investor.

Infrastructure

Private sector participation in district heating has begun ...

District heating assets were transferred from the state energy monopoly, Lithuanian Energy, to the municipalities in July 1998. The municipality of Kaunas recently decided to lease the district heating assets to a private operator. As a result of an open tender, a Swedish electricity utility was invited for further negotiations in July 1999.

... but little progress has been made in unbundling the electric power sector.

There has been no significant progress in implementation of the government's plan to unbundle Lithuanian Energy's electric power generation, transmission and generation facilities and to privatise them. Unbundling and privatisation will foster sound competition and increase operational efficiencies. Therefore, progress in this area would significantly enhance the potential for trade in electricity not only within Lithuania but also within the Baltic region and would increase the reliability of power supply, even without the operation of the Chernobyl-type Ignalina Nuclear Power Plant.

Railway reform has yet to begin.

Labour productivity in the provision of railway services remained below 40% of the 1989 level in 1998, the lowest ratio among the advanced transition countries. Minimal progress has been made in the reorganisation of the sector. The state-owned Lithuanian Railways has not yet separated infrastructure from rail freight and passenger operations. The Transport Ministry is currently working on a draft of a new railway law that would initiate the restructuring of the sector. A preliminary plan envisages that railway service operations would be separated from the railway infrastructure and that the service companies would be privatised.

Financial institutions

Further consolidation of private banks is likely ...

In view of the cross-border expansion of banks in the Baltic states, the two largest private banks in Lithuania, Vilnius Bank and Hermis Bank, reached agreement to merge in July 1999. The combined bank will hold about 41% of total bank assets in Lithuania and 44% of total loans. The merger received approval of the central bank in September 1999, although it had previously stated that mergers resulting in a market share above 40% would not be accepted. The openness of the sector to new entry by foreign banks is likely to mitigate the market power of large

banks. Currently, there are three majority foreign-owned banks and two branch offices of foreign banks operating in Lithuania. In August 1999, the central bank suspended most of the banking operations of Litimpeks Bank, the sixth-largest bank in terms of total assets, due to its illiquidity. The bank is likely to require additional capital to resume operations, which may also contribute to further bank consolidation.

... but the pace of bank privatisation has slowed.

Privatisation of the Agricultural Bank, originally planned in 1998, was delayed by the Russian crisis, as international investors became more cautious towards emerging markets and the region. The recent decision by the government to extend guarantees on some loans to the agricultural sector may increase the attractiveness of Agricultural Bank. In April 1998, the government added the Savings Bank to the privatisation list with the aim of selling the bank to a foreign strategic investor in 2000.

The state insurance company has been sold to a Danish insurer through public tender.

In May 1999, the government sold its 70% stake in the state insurance company, Lietuvos Draudimas, the largest insurer in the Baltic region, to a Danish insurance company for LTL 100 million (US\$ 25 million) through an international tender. Lietuvos Draudimas has 48% of the non-life insurance market in terms of written premiums; in the life insurance market, it has a 70% market share. Privatisation is likely to intensify competition in the insurance market, where the shares of insurers affiliated to commercial banks are growing.

Social reform

Private pension funds have been authorised, but the pay-as-you-go system requires an overhaul.

In June 1999, the parliament approved the law on pension funds, which comes into force from 1 January 2000. The law establishes the legal foundations for private voluntary pension funds and will pave the way for the eventual establishment of a multi-pillar pension system. However, the annual deficit of the Social Security Fund is increasing – and requires an overhaul. While the government has so far resisted raising the retirement age to relieve pressure on the existing pay-as-you-go system, it has considered measures to strengthen its revenues, such as increased contribution rates.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Share of the population in poverty – 46%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – yes	Private pension funds – no
Wage regulation – no	Tradability of land ² – full except foreigners	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 30.0%	Competition office – yes	Capital adequacy ratio – 10%	
Exchange rate regime ¹ – currency board		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	9.0	6.0	6.0	2.0	2.0	2.0	1.0
Share of exports to non-transition countries (per cent)	na	na	na	74.6	62.2	61.1	56.8	49.9	na
Share of trade in GDP (per cent)	na	na	na	78.8	50.2	50.7	48.9	49.7	44.2
Tariff revenues (per cent of imports) ³	na	na	na	1.1	3.2	1.4	1.2	1.3	1.1
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	0.9	1.3	1.4	1.5	1.8	na
Private sector share in GDP	10.0	10.0	20.0	35.0	60.0	65.0	70.0	70.0	70.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	1.4	1.7	1.1	1.3	0.9	na
Efficiency of tax collection for social security (per cent)	na	na	66.6	50.2	62.2	53.7	55.7	54.0	na
Share of industry and construction in total employment (per cent)	41.2	39.5	38.0	32.8	29.2	28.2	27.1	na	na
Change in labour productivity in industry (per cent)	na	na	na	-23.1	-11.1	13.9	9.5	0.8	8.1
Investment rate (per cent of GDP)	na	na	19.4	16.7	14.4	16.1	16.8	17.1	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	3.0	2.7	2.7
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	21.0	21.9	22.5	23.1	24.1	25.4	26.8	28.3	30.0
Railway labour productivity (1989=100)	90.3	75.2	51.2	50.7	35.4	32.3	35.6	37.9	36.0
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	na	3.6 (85%)	3.8 (85%)	4.0 (85%)	na
Electricity consumption/GDP (1989=100)	101.1	106.4	110.4	121.7	128.4	122.4	96.9	91.0	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.6
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	26 (0)	22 (0)	12 (0)	12 (3)	11 (4)	10 (5)
Asset share of state-owned banks (in per cent)	na	na	na	53.6	48.0	62.5	54.9	48.8	45.3
Bad loans (per cent of total loans)	na	na	na	na	27.0	16.7	32.2	28.3	12.9
Credit to private sector (per cent of GDP)	na	na	na	13.8	17.6	15.2	10.8	9.6	9.5
Stock market capitalisation (per cent of GDP)	na	na	na	0.6	2.5	6.3	15.9	22.7	27.7
EBRD index of banking sector reform	na	na	na	na	2.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	71.6	72.2	72.0	na	71.7	71.9	72.2	72.4	na
Basic school enrolment ratio (per cent)	93.0	92.6	92.8	91.9	92.2	93.2	93.6	95.8	na
Earnings inequality (Gini coefficient)	na	na	37.2	na	34.9	34.1	35.0	34.5	na

¹ Fixed at a rate of 4 litai to the US\$.³ Refers to all taxes on foreign trade.² Full for non-agricultural land but ownership of agricultural land is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-6.2	-4.3	-16.0	-9.5	3.5	4.9	7.4	5.2	0.0
Industrial gross output	na	na	-34.4	-26.5	5.3	5.0	3.3	7.0	na
Agricultural gross output	-6.0	-23.0	-6.0	-20.0	6.0	10.0	6.0	na	na
Employment	(Percentage change)								
Labour force (annual average)	2.7	-1.2	-1.1	-6.4	0.7	1.8	-0.5	-0.2	na
Employment (annual average)	2.4	-2.2	-4.2	-5.8	-1.9	0.9	0.6	-0.8	na
	(In per cent of labour force)								
Unemployment	0.3	1.3	4.4	3.8	6.2	7.0	5.9	6.4	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	224.7	1,021	410.4	72.1	39.5	24.7	8.9	5.1	1.6
Consumer prices (end-year)	345.0	1,161	188.8	45.0	35.5	13.1	8.5	2.4	2.5
Producer prices (annual average) ¹	148.2	1,517	397.7	44.7	28.3	16.5	6.0	-3.9	na
Producer prices (end-year) ¹	na	2,407	131.6	33.8	20.6	12.3	0.9	-8.3	na
Average monthly wages (whole economy)	129.1	651.7	223.8	95.9	47.2	29.7	26.5	21.5	na
Gross average monthly earnings in manufacturing (annual average)	na	na	na	64.6	46.3	34.7	23.1	20.0	na
Government sector ²	(In per cent of GDP)								
General government balance	2.7	0.5	-3.3	-5.5	-4.5	-4.5	-1.8	-5.8	-7.0
General government expenditure and net lending	38.7	31.5	35.1	38.5	36.8	34.1	34.3	39.3	na
Monetary sector	(Percentage change)								
Broad money (M2, end-year)	143.0	245.3	100.2	63.0	28.9	-3.5	34.1	14.5	na
Domestic credit (end-year)	na	na	109.4	78.1	10.7	1.8	37.6	16.8	na
	(In per cent of GDP)								
Broad money	na	39.2	23.1	25.8	23.3	17.2	19.0	19.5	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate	na	na	98.3	24.9	22.4	10.7	7.6	5.8	na
Treasury bill rate (3-month maturity)	na	na	na	na	22.4	10.8	9.4	11.4	na
Deposit rate ³	na	na	39.3	8.9	8.0	na	na	6.1	na
Lending rate ³	na	na	88.3	29.8	23.9	16.0	11.9	12.6	na
	(Litai per US dollar)								
Exchange rate (end-year) ⁴	110.0	379.0	3.9	4.0	4.0	4.0	4.0	4.0	na
Exchange rate (annual average) ⁴	38.5	177.3	4.3	4.0	4.0	4.0	4.0	4.0	na
External sector	(in millions of US dollars)								
Current account	na	203	-86	-94	-614	-723	-981	-1,298	-1,231
Trade balance	na	101	-155	-205	-698	-896	-1,147	-1,518	-1,510
Exports	na	1,142	2,026	2,029	2,706	3,413	4,192	3,962	3,367
Imports	na	1,041	2,180	2,234	3,404	4,309	5,340	5,480	4,877
Foreign direct investment (net) ⁵	na	na	30	31	72	152	328	921	400
Gross reserve (end-year), excluding gold	na	44	350	525	757	772	1,010	1,409	na
External debt stock (end-year) ⁶	na	59	325	529	845	2,340	3,194	3,726	na
	(In months of merchandise imports)								
Gross reserves (end-year), excluding gold	na	0.5	1.9	2.8	2.7	2.2	2.3	3.1	na
	(In per cent of merchandise exports)								
Debt service	na	na	0.4	2.7	4.5	8.7	18.1	21.8	na
Memorandum items	(Denominations as indicated)								
Population (in millions, mid-year)	3.74	3.74	3.73	3.72	3.71	3.71	3.70	3.70	na
GDP (in millions of litai/litai equivalent)	415	3,406	11,590	16,904	24,103	31,569	38,340	42,768	43,439
GDP (in US\$ millions)	1,079	1,921	2,668	4,249	6,026	7,892	9,585	10,692	na
GDP per capita (in US dollars)	289	514	715	1,142	1,624	2,127	2,591	2,890	na
Share of industry in GDP (in per cent)	45.3	38.8	36.0	27.0	26.1	25.8	25.2	23.6	na
Share of agriculture and forestry in GDP (in per cent)	16.7	14.3	14.9	10.6	11.7	12.2	11.7	10.1	na
Current account/GDP (in per cent)	na	10.6	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.3
External debt minus reserves (in US\$ millions)	na	15	-26	4	88	1,568	2,184	2,316	na
External debt/GDP (in per cent)	na	3.1	12.2	12.5	14.0	29.6	33.3	34.8	na
External debt/exports (in per cent)	na	5.2	16.0	26.1	31.2	68.6	76.2	94.0	na

¹ Excludes prices for electricity, gas and water until 1995.

² General government includes the state, municipalities and extrabudgetary funds. Privatisation revenues are not included in revenues.

³ Weighted average rate of commercial banks.

⁴ Roubles per US dollar for 1991; talonai per US dollar for 1992; and litai per US dollar from 1993.

⁵ Covers only investment in equity capital for 1993 and 1994; equity capital and reinvested earnings from 1995 onwards.

⁶ Includes non-resident currency and deposits and loans to foreign subsidiaries.

Key reform challenges

- **Enterprise restructuring continues to be held back by dispersed ownership, lack of effective bankruptcy and low managerial turnover. The attraction of strategic investors would help to galvanise the process.**
- **Privatisation of the energy and telecommunications sectors should be a priority over the coming year. It is expected that strategic investors would improve revenue collection and thereby directly contribute to reducing the burden of energy imports.**
- **Challenges in agricultural reform include the break-up of remaining collective farms, land privatisation and development of a land market.**

Liberalisation

Despite currency volatility, Moldova resists reintroducing exchange controls. Moldova maintains few currency restrictions, in contrast to neighbouring Russia and Ukraine, even after the Russian crisis. Exporters must transfer foreign currency receipts to accounts with an authorised bank and importers must offer currency for resale on the inter-bank market if they do not use it for the specified purpose within a fixed time limit. The inter-bank market for foreign exchange transactions has gained in importance over the past year, replacing the previous dominance of central bank auctions.

WTO accession is likely by end-1999.

While WTO accession was regarded as a remote prospect just one year ago, Moldova has since advanced considerably both in reforming its trade laws and in its negotiations with WTO members. The new budget law adopted the destination principle for VAT and, by September 1999, it is expected that new legislation will meet WTO standards for customs valuation, trade classification, technical and SPS standards, safeguards, countervailing action, and protection of intellectual property rights. It is likely that Moldova will gain WTO membership by the end of 1999.

Stabilisation

The Russian crisis delivered a severe shock to the economy ...

Moldova's record of low inflation and a stable currency in the period preceding the Russian crisis in August 1998 was built on fragile foundations, given substantial government borrowing from local and international markets and the accumulation of energy arrears to Russia (in excess of US\$ 200 million). Following the crisis in Russia, with which Moldova had previously conducted over half of its trade, the exchange rate depreciated by close to 150% in the year to August 1999. The increase in import prices translated into an initial bout of inflation at the end of 1998, which has since been contained by tight monetary policy.

... but IMF support is secured with an austere fiscal package.

IMF support, which remains key to ensure adequate financing of large budgetary and external imbalances, has been won, with fiscal targets amounting to an adjustment in the government's net borrowing requirement equivalent to 3% of GDP. The burden will fall on revenue generating measures including more fiscal posts on the frontier with Trans-Dniestria and strengthening the Large Taxpayer Unit within the State Tax Inspectorate. The government also plans a public sector recruitment freeze and will lower contributions to the social fund.

Privatisation

Ownership dispersion resulting from privatisation weakens corporate governance.

Small- and medium-scale mass privatisation was largely completed early on in the reform process. By June 1999 there had been 1,364 enterprise sales through auctions, the majority of these based on patrimonial bonds. The private sector now accounts for 60% of output in industry, 70% in retail trade, and 44% in capital construction works and transport. However, mass privatisation has led to widely dispersed ownership, even in small and medium-sized enterprises. Significant blocks of shares are held only by the state and by investment funds, which were originally only allowed to hold a maximum 25% stake in any one enterprise and only recently started to acquire majority stakes.

Trade sales of large enterprises accelerate following improvements in the tender process.

Sales of large enterprises for cash have formed part of the second wave of privatisation, which started in 1997. Initial progress was slow, due in part to problems with the organisation of tenders. Following the February 1998 parliamentary elections, the government has accelerated trade sales and adjusted tender procedures, in particular by lowering reservation prices. A large cement company with the capacity to produce one million tonnes per year was sold in October 1998 to a foreign investor for US\$ 200,000 cash and other financial obligations worth around US\$ 16 million. This was one of five

Liberalisation, stabilisation, privatisation

1991

Aug Independence from Soviet Union

1992

Jan Most prices liberalised
Jan State trading monopoly abolished
Jun New tax system introduced
Sep Exchange rate unified

1993

Mar Cash privatisation begins
Mar Privatisation with patrimonial bonds begins
Apr Most quantity controls on exports removed
Nov New currency (leu) introduced

1995

Jan VAT introduced
Mar T-bills market initiated
Jun Full current account convertibility introduced

1997

Jun First sovereign Eurobond issued
Jul New VAT law enacted
Jul New land law adopted
Sep New privatisation law adopted

1998

Feb National land cadastre introduced
Jun Credit auctions abolished in favour of open market operations
Aug Most tax and duty exemptions removed
Dec Changes to VAT and income taxes

1999

Apr All remaining trade restrictions removed

large enterprises sold in 1998. Progress has been uneven, however. Recent tenders of a carpet factory and a cardboard producer failed, the former because the purchaser was unable to raise the required financing and the latter because the authorities regarded the five bids as unsatisfactory.

Enterprise reform

Weaknesses in public and corporate governance hold back restructuring.

Dispersed ownership and the lack of governance provided by investment funds have limited restructuring in privatised companies. Competitive pressure from new private firms is limited as they are constrained by the poor investment climate, related to weak state and judicial capacity. As a result, labour productivity in industry has declined continuously since 1992 and the unofficial economy has grown – to an estimated 35-40% of GDP in 1998. A new Centre for Productivity and Competitiveness

Enterprises, infrastructure, finance and social reforms

1991

Jun Two-tiered banking system established

1992

Feb Competition law adopted

1994

Jul Securities and exchange commission established

1995

Jun Stock exchange established

Jun Trade in listed shares begins

Jun Enterprise restructuring agency established

1996

Jan New central bank law enacted

Jan New financial institutions law enacted

1997

Jul Bankruptcy law amended

Aug Independent energy regulator established

1998

Jan International Accounting Standards introduced

Oct Restrictions on holding more than one bank account abolished

Dec Law on privatisation of energy sector enacted

Dec Pension reform launched

1999

May Moldovgaz privatised

Jul Legislation on breakup of collective farms approved

was created in 1999 with World Bank support to address these problems, in particular through management training and improvements in product certification for exports.

Financial discipline and corporate insolvency procedures have been tightened.

Loss-making enterprises represent around 35% of the total number of enterprises. Weak financial discipline led to the accumulation of receivables in the enterprise sector. Two institutions promote restructuring in loss-making companies. The Agency for Enterprise Restructuring (ARIA) gave technical assistance to 79 enterprises between 1995 and March 1999 and completed the restructuring of 50 enterprises, through spinning off non-core activities, reducing staff levels, establishing trade and marketing departments, and introducing quality controls.

The Creditors' Council, set up to deal with large tax debtors, gave a 90-day moratorium to 100 firms to elaborate plans for debt restructuring. Firms failing to come up with satisfactory plans may be referred to the Economic Court in the first stage of bankruptcy proceedings, under the amended 1997 law.

Farm restructuring has progressed and a legal base for the development of a land-market has been laid.

The agricultural sector is Moldova's largest employer and produces 30% of the country's GDP. 80% of agricultural land is owned by either the state or collective farms. Although collective farms are nominally private, they continue to operate along the lines of the old state enterprises. Yields in collective and state farms are considerably below those from private plots. In July 1999, the parliament adopted a legal framework for the break-up of large collective and state farms. By that date, 480 farms had already been completely restructured; by May 2000, a further 850 farms are due to be broken up. Farm restructuring will free plots of land for sale and support the development of a land market. Indirect subsidies to agriculture, provided through cheap inputs, energy and credits, are being replaced by cash grants.

Infrastructure

Substantial progress has been made towards privatisation of the power sector ...

The September 1998 energy law covers the organisation and regulation of the sector. An independent regulator, which will be responsible for setting tariffs and enforcing licence conditions (such as those related to service quality), was established in August 1997. The parliament passed a law in December 1998 allowing the sale of the five regional distribution companies. An invitation for pre-qualification was issued in August 1999. The energy law also authorises the cutting-off of services to non-payers. Introduction of the private sector should lead to improved payments discipline, with higher effective prices encouraging greater energy efficiency.

... and telecommunications privatisation is to follow.

The government had intended to privatise the national telecommunications company in 1998. However, an initiative to sell 40% of the company failed after protracted negotiations with the Greek telecommunications company OTE broke down. Approval of the new privatisation plan that allows to sell 51% of the company to strategic investor and tariff increases in July 1999 have laid a sound financial basis that could help to attract a strategic foreign investor. Currently, the government is in the process of hiring an investment bank to advise on the deal.

Financial institutions

As emergency measures are eased, new regulations are likely to lead to sector consolidation.

Emergency regulations imposed during the economic crisis, including a 25% reserve requirement, have been gradually lifted. New regulations, introduced in July 1999, require that banks must have more than MDL 48 million (US\$ 4.3 million) regulatory capital starting 1 January 2000 to engage in foreign exchange operations. This should lead to much-needed consolidation of the banking system, presently crowded by the existence of 23 commercial banks, with a combined capital of only US\$ 70 million. Banks must have a ratio of regulatory capital to risk-weighted assets of at least 8%. Three banks have been closed by the National Bank of Moldova (NBM) since June 1998 on the grounds of non-compliance with regulations.

Non-bank financial institutions and domestic securities markets remain underdeveloped.

The government securities market suffered significantly in September 1998, as commercial banks switched funds from treasury bills to foreign currency. Demand for treasury bills has fallen short of volumes offered throughout 1999, with the exception of one-week to one-month papers. Volume traded on the stock exchange in the first four months of 1999 was half the level during the same period in 1998. In June 1999 changes to the law on insurance were made, allowing 100% foreign-owned companies to sell insurance in Moldova (previously restricted to companies with no more than 49% foreign ownership). In August 1999 the largest Moldovan insurance company ASITO was bought by Australian QBE.

Social reform

Mounting poverty culminates in an open protest.

Moldova is among the poorest countries in Europe, with severe and growing poverty and falling life expectancy. Social protection is severely under-funded and expenditures are not well targeted. This has resulted in the erosion of education, health and other public services. Of the estimated 28% unemployed, only 4% are registered and receiving benefits. A public protest against poverty in June 1999 won a government offer to pay wage and pension arrears of employees in the food and industrial sectors.

Liberalisation	Privatisation	Infrastructure	Financial sector
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Capital adequacy ratio – 8%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – no	Deposit insurance system – no
Wage regulation – yes	Tradability of land – full	Independent electricity regulator – yes	Secured transactions law – yes
Stabilisation	Enterprises		Social reform
Share of general government tax revenues in GDP – 29.0%	Competition office – no		Share of the population in poverty – 65%
Exchange rate regime – floating			Private pension funds – no

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of exports to non-transition countries (per cent)	na	na	na	na	11.3	18.3	15.0	16.7	na
Share of trade in GDP (per cent)	na	na	69.3	35.5	45.3	46.8	48.4	45.3	54.4
Tariff revenues (per cent of imports) ¹	na	na	0.8	0.8	1.1	1.4	2.0	2.4	na
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	2.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised ²	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	na	0.3	0.8	3.1	na
Private sector share in GDP	10.0	10.0	10.0	15.0	20.0	30.0	40.0	45.0	50.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	3.0	3.0	3.0	3.3
EBRD index of large-scale privatisation	na	na	na	na	2.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	na	na	na	na	na
Efficiency of tax collection for social security (per cent)	na	na	32.5	39.4	52.8	55.0	55.9	47.4	na
Share of industry and construction in total employment (per cent)	30.3	27.9	27.4	20.7	19.2	16.0	15.1	14.8	na
Change in labour productivity in industry (per cent)	0.9	-4.4	-25.5	7.3	-23.1	11.8	7.9	8.0	-9.2
Investment rate (per cent of GDP)	18.9	17.0	16.2	15.5	19.3	16.0	19.8	19.6	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.6	11.3	11.6	11.9	12.3	13.0	14.0	14.6	15.0
Railway labour productivity (1989=100)	98.1	80.0	60.4	43.0	32.2	28.3	26.5	27.6	25.2
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	4.3 (64%)	3.2 (92%)	3.1 (87%)	4.7 (92%)	na
Electricity consumption/GDP (1989=100)	109.1	129.4	165.0	117.9	194.6	184.4	191.7	104.6	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.2
Financial institutions									
Number of banks (of which foreign-owned)	na	15 (na)	16 (na)	16 (na)	21 (1)	22 (1)	21 (2)	22 (4)	23 (7)
Asset share of state-owned banks (in per cent) ³	na	na	na	na	0.0	0.0	0.0	0.0	0.0
Bad loans (per cent of total loans) ⁴	na	na	na	na	16.3	9.2	17.3	10.2	4.6
Credit to private sector (per cent of GDP)	na	5.9	5.9	4.1	3.0	5.8	6.8	6.2	13.9
Stock market capitalisation (per cent of GDP) ⁵	na	na	na	na	na	0.7	25.4	30.1	32.5
EBRD index of banking sector reform	na	na	na	na	2.0	2.0	2.0	2.0	2.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	9.4	8.5	11.0	9.4	12.2	12.6	14.9	14.3	na
Life expectancy at birth, total (years)	68.3	67.6	67.8	67.4	66.0	65.7	66.6	66.5	na
Basic school enrolment ratio (per cent)	95.6	94.4	80.3	80.0	79.3	79.8	79.3	78.8	na
Earnings inequality (Gini coefficient)	na	na	41.1	43.7	37.9	39.0	na	na	na

¹ Refers to all taxes on foreign trade.

² In 1997, 90 small enterprises were privatised through cash auctions. No data are available on the total number of small enterprises. Around 1,350 SMEs were privatised through voucher auctions during 1994-95.

³ Zero for all available years, after four state-owned banks were majority privatised in 1994 (and fully privatised by the end of 1995).

⁴ Refers to doubtful and non-performing credits.

⁵ Data from survey to Moldovan Stock Exchange, including government securities. Data from the IFC give a figure of 4.56% of GDP for listed companies in 1997.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								<i>Estimate</i>	<i>Projection</i>
Output	<i>(Percentage change in real terms)</i>								
GDP	-17.5	-29.1	-1.2	-31.2	-3.0	-8.0	1.3	-8.6	-5.0
Industrial gross output	na	na	0.3	-27.7	-3.9	-6.5	-7.0	na	na
Agricultural gross output	na	na	9.9	-24.3	3.7	-11.9	10.7	na	na
Employment	<i>(Percentage change)</i>								
Labour force (end-year)	na	na	-17.6	0.0	-0.2	-27.3	na	na	na
Employment (end-year)	na	-1.0	-17.7	-0.4	-0.5	-27.6	na	na	na
	<i>(In per cent of labour force)</i>								
Unemployment ¹	na	0.1	0.7	1.1	1.4	1.8	1.6	na	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	98.0	1,276.4	788.5	329.7	30.2	23.5	11.8	7.7	35.0
Consumer prices (end-year)	151.0	2,198.0	837.0	116.0	23.8	15.1	11.2	18.2	30.0
Producer prices (annual average)	na	na	na	205.1	255.3	31.2	15.3	na	na
Producer prices (end-year)	na	na	6,947.0	214.5	46.6	20.4	13.4	na	na
Gross monthly wages in manufacturing (annual average)	na	na	na	na	40.7	38.3	25.4	na	na
Government sector ²	<i>(In per cent of GDP)</i>								
General government balance	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	-7.5	-8.1	-4.5
General government expenditure	24.7	56.6	29.4	40.6	39.7	38.7	43.6	32.9	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	na	361.7	320.2	115.7	65.2	15.3	34.0	-8.7	na
Domestic credit (end-year)	na	550.0	333.8	116.6	55.8	18.5	27.8	42.6	na
	<i>(In per cent of GDP)</i>								
Broad money	69.5	43.3	15.8	13.0	16.5	16.2	19.2	18.1	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (up to 30 days maturity)	na	na	na	na	na	31.2	24.5	na	na
Treasury bills rate (3-month maturity)	na	na	na	na	52.9	39.0	25.5	42.0	na
Deposit rate (one year)	na	na	na	na	32.5	22.0	20.4	na	na
Lending rate (one year)	na	na	na	na	41.9	35.3	29.9	na	na
	<i>(Leu per US dollar)</i>								
Exchange rate (end-year) ³	0.0	0.4	3.6	4.3	4.5	4.7	4.7	8.32	na
Exchange rate (annual average) ³	na	0.2	1.5	4.1	4.6	4.6	4.6	5.4	na
External sector	<i>(In millions of US dollars)</i>								
Current account	na	-39	-182	-82	-149	-256	-292	-330	-250
Trade balance	na	-37	-180	-54	-70	-254	-319	-398	-350
Exports	na	868	451	618	739	802	823	650	550
Imports	na	905	631	672	809	1,056	1,142	1,048	900
Foreign direct investment, net	na	17	14	18	73	56	64	88	170
Gross reserves (end-year), excluding gold	na	na	89	179	257	315	366	140	na
External debt stock	na	16	255	503	670	795	1,205	1,347	na
	<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold	na	na	1.7	2.9	3.0	3.0	3.3	1.4	na
	<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service	na	na	na	2.3	8.2	5.7	13.9	27.6	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	4.4	4.4	4.3	4.4	4.3	4.3	4.3	4.3	na
GDP (in millions of leu)	25.9	191.9	2,210.4	5,780	7,545	8,828	9,998	10,121	12,900
GDP per capita (US dollars)	na	293.5	350.6	327.1	380.6	444.1	500.3	432.4	na
Share of industry in GDP (in per cent)	na	na	39.0	33.0	28.0	28.0	29.0	na	na
Share of agriculture in GDP (in per cent)	na	na	32.0	29.0	33.0	31.0	30.0	na	na
Current Account/GDP (in per cent)	na	-3.0	-11.9	-5.8	-6.8	-9.8	-12.2	-17.6	-20.3
External debt minus reserves (in US\$ millions)	na	na	165.5	323.6	413.4	479.9	839.0	1,042	na
External debt/GDP (in per cent)	na	1.3	16.7	35.3	40.5	41.4	55.6	71.9	na
External debt/exports (in per cent)	na	1.9	56.4	81.3	90.7	99.2	146.4	207.2	na

¹ Figures refer to registered unemployment.

² General government includes the state, municipalities and extrabudgetary funds.

³ Up to July 1993 the Russian rouble was the legal tender in Moldova. On 9 August 1993 the Moldovan rouble was introduced. On 29 November 1993 the Moldovan leu, equal to 1,000 Moldovan roubles, was introduced.

Key reform challenges

- **Recent reforms in pensions, health care and public administration have intensified fiscal pressures. Comprehensive tax reform is planned to reduce the rates and to broaden the bases of personal income and corporate profit taxes, but strong revenue performance must be maintained.**
- **While privatisation of the banking sector is well advanced, two large state banks and the dominant state insurance company still require significant restructuring. Privatisation of the remaining state-owned financial institutions should remain a priority.**
- **Restructuring and privatisation of heavy industry must accelerate significantly if the government is to meet its commitment to complete privatisation by 2001.**
- **Restructuring of the agricultural sector is needed to raise its very low productivity levels and to prepare for EU accession.**

Liberalisation

Capital account is liberalised.

When joining the OECD in November 1996, Poland committed to full liberalisation of the capital account by 1 January 2000. A significant step toward this goal was taken in January 1999, when a new foreign exchange law took effect. This law eliminated all restrictions on internal foreign exchange transactions between banks and non-banking entities. The National Bank of Poland (NBP) retains the authority to impose extraordinary restrictions in case of threats to the stability and integrity of the financial system. Some restrictions on short-term capital flows remain.

Stabilisation

Recent structural reforms intensify fiscal pressures.

The budget deficit widened sharply in early 1999 owing to the introduction of reforms in the health care and pension systems and the creation of a new layer of regional administration. Large subsidies for agricultural products have also boosted expenditures. At the same time, the government announced plans to reform the tax system comprehensively, by simplifying the personal income and corporate profits taxation, reducing marginal tax rates, broadening the tax bases, and harmonising the VAT with EU requirements.

Strategy to join the euro is specified.

The NBP shifted towards explicit inflation targeting in the autumn of 1998, and continues to move towards making the zloty a fully convertible currency in preparation for EU accession and eventual participation in ERM. Four steps are being implemented in changing the exchange rate regime. First, the crawling rate will be lowered. Second, the zloty's trading band will continue to be widened. Then, the crawl will be abolished and the zloty will be floated freely. The free float will be maintained until Poland joins ERM.

Privatisation

Privatisation of heavy industry remains slow and difficult.

The government planned to privatise 50 enterprises in 1998, but only 17 sales took place. Nevertheless, the target for privatisation receipts of PZI 6.7 billion (US\$ 1.9 billion) was exceeded, reaching PZI 7.5 billion (US\$ 2.1 billion), mainly as a result of bank and telecommunications privatisations. The authorities aim to finish privatisation of all major industries by 2001, with the exception of certain coalmines, the railways and the postal service. Privatisation of the state telecommunications company, TPSA, and steel and power sector companies are priorities for 1999. While there is as yet little interest in largely unstructured steel mills and mines, preparations for the privatisation of the two largest steel mills, Huta Katowice and Huta Sendzimir, are well under way.

Enterprise reform

New businesses are robust, but restructuring by state-owned enterprises in industry faces resistance.

The strong growth in recent years has been driven by rapid expansion of the new private sector, primarily services-oriented SMEs, and by a large inflow of foreign direct investment. However, employment in the state-owned enterprise sector remains large compared with that in the other first-wave accession countries at 33% of total employment in 1998. The coal sector in particular suffers from excess capacity and over-employment, and one-third of mines are permanent loss-makers. Reform of the sector, which requires downsizing by about 50%, faces stiff union resistance and is likely to involve sizeable subsidies and redundancy compensation. The strategy for steel sector restructuring – maintain the output at the current level and exploit lower costs of production – is complicated by the prospect of accession to the EU and by over-capacity in European steel markets.

Liberalisation, stabilisation, privatisation

1990

Jan	Most prices liberalised
Jan	Most foreign trade controls removed
Jan	Small-scale privatisation begins
Jan	Fixed exchange rate introduced
Apr	Privatisation law adopted

1991

May	T-bills market initiated
May	Crawling peg exchange rate regime introduced

1992

Jan	Corporate and personal income taxes reformed
Mar	EU Association Agreement

1993

Mar	CEFTA membership
Apr	Mass privatisation programme begins
Jul	VAT introduced
Nov	EFTA membership

1994

Oct	Major external debt restructuring
Dec	National Investment Funds (NIFs) established

1995

Jan	Wage restrictions redefined
May	Agricultural import restrictions changed
May	Managed float with fluctuation band introduced
Jun	First sovereign Eurobond
Jun	Full current account convertibility introduced
Jul	WTO membership
Jul	State enterprises allocated to NIFs

1996

Aug	New privatisation law adopted
Nov	OECD membership

1997

Jun	NIF shares listed on WSE
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1998

Feb	Independent Monetary Policy Council established
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1999

Jan	New foreign exchange law enacted
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Substantial reform of agriculture is required for EU accession.

Although agriculture accounts for 25% of total employment, its share in total output is only 6%. The average farm size is small compared with that in the EU, equipment is outdated, and privatisation of agribusiness enterprises is incomplete. Since the financial

Enterprises, infrastructure, finance and social reforms

1990

Jan	Competition law adopted
Jan	Competition agency established
Dec	Insurance law enacted

1991

Jan	Telecommunications law enacted
Mar	Securities law adopted
Apr	Stock exchange begins trading
Sep	Banking law enacted

1992

Dec	Banking law amended
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1993

Feb	Financial restructuring law adopted
Apr	First bank privatised
May	BIS capital adequacy adopted

1994

Sep	IAS introduced
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1995

May	Telecommunications law amended
Jul	Railway law adopted
Oct	Insurance law amended

1996

Apr	First corporate Eurobond
Aug	Gdansk Shipyard declared bankrupt

1997

Mar	First toll motorway concession awarded
May	Energy law adopted
Jun	Securities law amended
Dec	Electricity law adopted

1998

Jan	Banking act amended
Jan	Independent banking regulator established
Jan	Bankruptcy law amended
Feb	Investment funds law enacted
Nov	Telecommunications privatisation begins
Nov	Substantive negotiations for EU accession started
Nov	Mine restructuring law adopted

1999

Jan	Pension reforms implemented
Jan	Health care system reformed
Jan	Insurance law amended

requirements of a non-restructured agricultural sector under the Common Agricultural Policy would be substantial, the consolidation of farms, development of the agricultural land market, large investments in equipment, and removal of domestic market

protection are necessary. However, there is significant resistance by the farmers to required changes, leading to protests and blockades of roads and border crossings.

Infrastructure

Telecommunications privatisation has been launched.

Despite the emerging markets turmoil and the impact of the Russian crisis, the government pressed ahead with the partial privatisation of the state telecommunications company, TPSA, in November 1998. A combination of domestic IPO and foreign GDR issue, which together accounted for a 15% share in the company, raised US\$ 924 million. An additional 15% was distributed free to present and former employees. The completion of telecommunications privatisation would facilitate expansion of the telephone network, which has a coverage rate of 23% – well below the central European average.

Privatisation of power generators is planned.

The privatisation of power generators is planned for 1999, but experience with the privatisation of Patnow-Adamow-Konin (PAK), a group of power plants, points to possible difficulties. Negotiations with National Power of the UK, originally selected as the strategic investor for PAK, were cancelled owing to unresolved disputes over the power-purchase (off-take) agreement with the Polish Power Grid Company. The 20% stake in PAK was sold in March 1999 to Elektrim, a large domestic conglomerate.

Major investment in environmental infrastructure is required.

Strengthening environmental protection in preparation for EU accession is likely to be a lengthy and costly process. The Polish authorities estimate that meeting the EU environmental requirements in full will take up to 20 years and the total cost will amount to €30-35 billion, of which about 50% will be needed to improve water quality, 40% for air purity, and 10% for waste processing. Current governmental expenditures on the environment are equivalent to 1.7% of GDP, €2 billion. The EU will provide assistance of about €200 million annually, starting from 2000.

Financial institutions

Significant progress in bank privatisation has been made, but major challenges remain.

Significant stakes in three banks were sold within the last 12 months: 37% of Bank Przemyslovo Handlowy was sold to Bayerische Hypo and Vereinsbank AG for US\$ 600 million in October 1998; 52.1% of PEKAO (one of two state savings banks) was sold to Unicredito Italiano and Allianz

for US\$ 1.1 billion in June 1999, and 80% of Bank Zachodni was sold to Allied Irish for US\$ 581 million in June 1999. The two remaining state-owned banks, however, require significant restructuring. In particular, PEKAO SA, the second state savings bank, has problems in placing assets from its large deposit base in the corporate sector, while BGZ, the specialist agriculture bank, suffers from a high share of bad loans in its loan portfolio. There are also a large number of small cooperative banks operating in the rural agricultural sector, a significant share of them in a state recovery programme, which are connected to the banking system through BGZ.

Major insurance privatisation is planned.

Preparations for the sale of a 30% share of the dominant state-owned insurance company, Powszechny Zaklad Ubezpieczen (PZU), are well advanced and completion of the sale is likely by the end of 1999. This will facilitate EU accession, as the existence of a monopolistic state-owned insurance provider is inconsistent with EU directives. PZU is still a dominant company in the insurance sector, holding above 60% of market share. In the second stage of the PZU privatisation, 15% of shares will be distributed to employees within the next two to three years. The full privatisation of PZU is envisaged three to four years after the sale of the initial 30% share.

The stock market has been adversely affected by the Russian crisis.

In 1998, 57 new companies were listed on the Warsaw Stock Exchange, increasing the total number of listed companies to 198 at the end of the year. However, the stock exchange suffered from the large outflow of foreign capital in the second half of the year, despite privatisation of banks and the state telecommunications company; this was due to negative market sentiment following the Russian crisis and deterioration in the financial performance of listed companies.

Social reform

Pension reform has been launched.

In January 1999, Poland introduced a three-tier pension system in response to sizeable fiscal pressures from the old pay-as-you-go system. On average, 15% of GDP has been spent on pensions in recent years. The new pension system consists of a reformed pay-as-you-go system, with closer links between contributions and benefits, fully funded mandatory contributions, and voluntary contributions. The old system will be maintained for workers over 50. Workers between 30 and 50 will have an option to participate in the second tier. Lastly, workers under the age of 30 will be covered by the new system. The retirement age has been set at 60 for women and 65 for men.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – no	Share of the population in poverty – 13%
Interest rate liberalisation – full	Secondary privatisation method – MEBOs	Separation of railway accounts – yes	Private pension funds – yes
Wage regulation – yes	Tradability of land – full except foreigners	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share in general government tax revenues in GDP – 40.3%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime 1 – crawling peg with band		Deposit insurance system – yes	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	11.0	11.0	11.0	10.6	12.0	12.0	11.6	10.6	10.6
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of exports to non-transition countries (per cent)	na	79.3	81.7	86.5	85.3	81.6	79.8	77.5	na
Share of trade in GDP (per cent)	15.7	16.3	16.3	17.2	18.8	20.0	21.2	24.2	24.7
Tariff revenues (per cent of imports)	na	12.7	14.7	15.3	18.5	15.0	10.7	5.6	4.0
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.3
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
Privatisation									
Share of small firms privatised	72.0	86.0	95.0	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	0.2	0.6	1.1	1.9	2.8	3.8	5.3	6.7
Private sector share in GDP	30.0	40.0	45.0	50.0	55.0	60.0	60.0	65.0	65.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.3	3.3
Enterprises									
Budgetary subsidies (per cent of GDP)	na	5.0	3.2	2.2	3.3	2.9	2.5	na	na
Efficiency of tax collection for social security (per cent)	na	60.8	53.8	54.9	56.7	60.0	59.3	57.8	na
Share of industry and construction in total employment (per cent)	36.3	35.3	34.0	32.7	31.9	32.0	31.7	31.9	na
Change in labour productivity in industry (per cent)	-19.7	0.0	12.5	13.8	13.0	6.3	9.1	10.5	5.5
Investment rate (per cent of GDP)	21.0	19.5	16.8	15.9	16.2	16.9	19.0	20.8	na
EBRD index of enterprise reform	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of competition policy	na	na	na	na	na	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	8.6	9.3	10.3	11.5	13.1	14.8	16.9	19.4	22.8
Railway labour productivity (1989=100)	83.0	71.1	68.5	76.2	78.4	83.0	84.4	87.4	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	4.94 (90%)	6.19 (95%)	6.71 (97%)	6.24 (97%)	na
Electricity consumption/GDP (1989=100)	103.6	108.6	102.8	101.5	97.4	93.5	90.6	85.1	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	3.2
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	87 (10)	82 (11)	81 (18)	81 (25)	83 (29)	83 (31)
Asset share of state-owned banks (in per cent)	na	na	na	86.2	80.4	71.7	69.8	51.6	48.0
Bad loans (per cent of total loans)	na	na	na	36.4	34.7	23.9	14.7	11.5	11.5
Credit to private sector (per cent of GDP)	na	10.9	11.4	12.2	12.0	12.7	15.9	18.1	20.6
Stock market capitalisation (per cent of GDP)	na	0.2	0.3	3.8	3.5	3.9	6.6	9.8	13.8
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	3.0	3.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	3.0	3.0	3.3	3.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	4.3	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	10.5	10.8	10.4	10.7	9.7	na	na	na
Life expectancy at birth, total (years)	70.9	70.6	71.1	71.6	71.7	71.9	72.2	72.6	na
Basic school enrolment ratio (per cent)	97.5	97.3	97.1	97.2	97.1	97.2	97.4	98.0	na
Earnings inequality (Gini coefficient)	na	23.9	24.7	25.6	28.1	29.0	30.2	30.0	na

¹ The exchange rate is a pre-announced crawling peg to a currency basket of US\$ and DM with a fluctuation band of +/- 15% and a crawling rate of 0.3% per month.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	<i>(Percentage change in real terms)</i>								
GDP	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	3.5
Private consumption	6.3	2.3	5.2	4.3	3.6	8.7	7.0	4.9	na
Public consumption	10.2	6.4	3.8	2.8	2.9	3.4	3.4	3.0	na
Gross fixed investment	-4.4	2.3	2.9	9.2	16.9	20.6	21.9	14.5	na
Exports of goods and services	-1.7	10.8	3.2	13.1	23.6	12.5	9.9	11.0	na
Imports of goods and services	29.6	1.7	13.2	11.3	24.3	28.0	16.7	14.0	na
Industrial gross output	-8.0	2.8	6.4	12.1	9.7	8.7	10.8	5.0	na
Agricultural gross output	-1.6	-12.7	6.8	-9.3	10.7	0.7	1.0	na	na
Employment	<i>(Percentage change)</i>								
Labour force (end-year)	1.9	-0.4	0.7	0.6	-1.0	0.4	-2.7	-4.0	na
Employment (end-year)	-4.3	-2.8	-1.7	1.1	2.9	3.5	1.3	1.4	na
	<i>(In per cent of labour force)</i>								
Unemployment (end-year)	11.8	13.6	16.4	16.0	14.9	13.2	10.5	10.4	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.0
Consumer prices (end-year)	60.4	44.3	37.6	29.4	21.6	18.5	13.2	8.6	6.5
Producer prices (annual average)	40.9	34.5	31.9	25.3	25.4	12.4	12.2	7.3	na
Producer prices (end-year)	35.7	31.5	37.0	27.9	18.9	11.2	11.5	4.9	na
Gross average monthly earnings in manufacturing (annual average) ¹	63.1	38.7	35.4	36.7	32.7	26.9	25.0	16.8	na
Government sector ²	<i>(In per cent of GDP)</i>								
General government balance	-6.7	-6.7	-3.1	-3.1	-2.8	-3.3	-3.1	-3.0	-3.0
General government expenditure	49.0	49.5	50.5	48.9	47.9	47.5	48.1	45.5	na
Public debt	na	147.3	108.6	69.0	59.0	53.6	49.4	43.0	na
Monetary sector ³	<i>(Percentage change)</i>								
Broad money (end-year)	37.0	57.5	36.0	38.2	34.9	29.4	29.1	25.0	na
Domestic credit (end-year)	158.7	55.6	44.2	30.1	20.1	29.7	26.4	24.6	na
	<i>(In per cent of GDP)</i>								
Broad money	31.6	35.8	35.9	36.7	36.5	37.5	39.6	42.0	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (up to 30-day maturity)	36.7	30.8	25.2	21.1	24.7	21.2	24.8	16.0	na
Treasury bill rate (3-month maturity)	na	41.4	33.7	27.0	24.2	18.8	23.5	12.8	na
Deposit rate ⁴	36.0	32.0	25.0	26.0	22.0	18.3	19.5	na	na
Lending rate ⁵	40.0	39.0	35.0	31.0	24.0	23.3	25.8	na	na
	<i>(Zloty per US dollar)</i>								
Exchange rate (end-year)	1.10	1.58	2.13	2.44	2.47	2.88	3.52	3.49	na
Exchange rate (annual average)	1.06	1.36	1.81	2.27	2.43	2.70	3.28	3.49	na
External sector	<i>(In billions of US dollars)</i>								
Current account	-2.0	0.9	-0.6	2.3	5.5	-1.3	-4.3	-6.8	-9.0
Trade balance ⁶	0.1	0.5	-2.3	-0.8	-1.8	-8.2	-11.3	-13.6	na
Exports ⁶	12.8	14.0	13.6	17.0	22.9	24.4	27.2	30.3	na
Imports ⁶	12.7	13.5	15.9	17.8	24.7	32.6	38.5	43.9	na
Net unclassified transactions ⁷	1.3	1.8	2.2	3.2	7.8	7.2	6.1	na	na
Foreign direct investment, net ⁸	0.1	0.3	0.6	0.5	1.1	2.8	3.0	6.6	6.5
Gross reserves (end year), excluding gold	3.6	4.1	4.1	5.8	14.8	17.8	20.7	27.4	na
External debt stock	48.0	47.6	47.2	43.6	45.2	41.6	43.0	45.0	na
	<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold	2.5	2.9	2.6	3.2	6.1	5.8	5.9	6.8	na
	<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service	68.9	19.3	20.1	14.3	6.7	7.6	5.9	na	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	38.3	38.4	38.5	38.6	38.6	38.6	38.7	38.7	na
GDP (in billions of zloty)	82.5	114.9	155.8	210.4	288.7	362.8	445.1	525.0	600.0
GDP per capita (in US dollars)	2,037	2,197	2,234	2,399	3,084	3,486	3,512	3,887	na
Share of industry in GDP (in per cent) ⁹	40.2	34.0	32.9	32.2	29.2	27.1	28.1	28.1	na
Share of agriculture in GDP (in per cent)	6.8	6.7	6.6	6.2	6.4	6.0	5.7	na	na
Current account/GDP (in per cent)	-2.6	1.1	-0.7	2.5	4.6	-1.0	-3.1	-4.5	-5.5
External debt minus reserves (in US\$ billions)	44.4	43.5	43.1	37.8	30.4	23.8	22.3	17.6	na
External debt/GDP (in per cent)	61.5	56.4	54.9	47.1	38.0	30.9	31.7	29.9	na
External debt/exports (in per cent)	375.0	340.0	347.1	256.5	197.4	170.5	157.9	148.5	na

¹ Gross wages are those before deducting income taxes. Prior to 1993, the change in wages is net of income taxes.

² General government includes the state, municipalities and extrabudgetary funds. General government balance excludes privatisation receipts. Data are on a cash basis. Government expenditure includes net lending.

³ Beginning in 1992, data are based on a new system of accounts and an improved reporting system.

⁴ Beginning in 1995, weighted average of rate offered by commercial banks on household deposits. Prior to 1995, lowest rate offered on six-month time deposits.

⁵ Beginning in 1995, weighted average rate charged by commercial banks on lowest risk loans. Prior to 1995, lowest rate charged by commercial banks to prime borrowers.

⁶ Balance of payments data based on banking statistics and presented on a settlements basis. On the basis of customs questionnaires, exports are virtually the same as on a settlements basis, while imports are higher (about 20% in 1994-96).

⁷ Sales of foreign exchange from kantors (small foreign-exchange bureaux) to commercial banks. A survey by the National Bank of Poland in 1995 indicated that about 85-90% of such transactions were associated with border trade (including services).

⁸ Balance of payments data based on banking statistics and presented on a settlement basis.

⁹ Beginning in 1993, industry is classified according to the Polish version of the NACE-EKD classification system. The 1993 index includes VAT and excise taxes from 1994 onwards it excludes VAT; and from 1996 it excludes excise taxes.

Key reform challenges

- While both small-scale and large-scale privatisation have accelerated, the legislative framework for bankruptcy must be strengthened to promote the restructuring or closure of non-viable firms.
- The recent major advances in structural reforms must be complemented by sound fiscal policies, including further reductions in public expenditures and subsidies, more transparent taxes and improved revenue collection.
- The enforcement of prudential regulations, restructuring of the financial sector and further privatisation of state-owned banks remain central to macroeconomic stabilisation and a precondition for economic recovery.

Liberalisation

Trade liberalisation continues to advance.

All quantitative restrictions on exports were eliminated by 1998 and replaced with licensing requirements for monitoring purposes. However, the government introduced a temporary import surcharge of 6% at the end of 1998. This rate has subsequently been reduced to 4% and is to be eliminated by end-1999. In the context of EU-accession negotiations, Romania is expected to harmonise its trade regulations with those of the EU and, as a member of CEFTA, to reduce tariffs and import duties further. In March 1999, Romania signed a declaration with Bulgaria and Turkey to establish free trade in industrial goods by 2002.

Capital inflows are liberalised further.

While there are practically no restrictions on capital inflows, outflows by residents require prior approval of the National Bank of Romania (NBR). Repatriation of earnings on direct and portfolio investments are guaranteed. While the market in government securities for non-residents was liberalised in September 1998, foreign investors still need to act through authorised intermediaries to purchase government securities in the primary market.

Stabilisation

Sustained stabilisation depends on improved fiscal performance.

Romania experienced financial turbulence in 1998, largely because of its failure to tighten financial discipline in the public sector, including the toleration of tax arrears. A significant tightening of public finances is expected with a renewed effort to collect taxes, control public sector wages and reduce subsidies. Measures include confiscation of bank balances and the closure of large loss-making enterprises. To boost fiscal revenues in the 1999 budget, the government also increased social security contributions and excise taxes (on petroleum and other goods) following the rapid depreciation of the leu in the first half of 1999.

The tax system requires a major overhaul to broaden the tax base.

The tax system depends heavily on direct taxation, reflecting in part the lack of a

personal income tax. The government intends to submit to parliament drafts of a new personal income tax law and new corporate profit tax regulations. These measures would help to shift the burden of taxation from direct to indirect taxes.

Privatisation

Both small-scale and large-scale privatisations accelerate.

In 1998, 1,015 small and medium-sized enterprises were privatised, bringing the cumulative total to 4,889 by the end of that year. Allowing the local branches of the State Ownership Fund to handle small-scale privatisations directly helped speed up the process. Large-scale privatisation also gained pace in the last quarter of 1998 with the sales of Romtelecom, the dominant telecommunications provider, and of Romanian Development Bank, the first state-owned bank to be privatised in the country. These two landmark sales were followed in early 1999 by the sales of car-maker Automobile Dacia, and a 45% stake in the state savings bank, Bank Post. Revenues from these sales, including investment commitments, total US\$ 1.2 billion.

Investment banks are set to play a key role in upcoming strategic sales.

The new privatisation law, approved by parliament in June 1999, provides for the use of investment banks as sales agents, eliminates minimum sale prices linked to book value (thereby allowing sale at market value) and contains provisions for debt work-outs. These amendments are intended to attract strategic investors and to address the criticism of lack of transparency in previous sales. Major strategic sales to be carried out with the help of investment banks include the sales of shares in the national oil company Petrom, the metallurgical company Sidex Galati, the tractor-maker Tractorul Brasov, the national tobacco company, and the national airline Tarom.

Enterprise reform

Restructuring has begun in the coal-mining sector.

The coalmining sector typifies the need for restructuring in Romania's industry. In 1998,

Liberalisation, stabilisation, privatisation

1991

Aug Privatisation law enacted
Sep Mass voucher privatisation begins

1992

Jan Small-scale privatisation begins
May State trading monopoly abolished

1993

May EFTA member
Jul VAT introduced

1994

Mar T-bills market initiated

1995

Jan WTO membership
Mar New privatisation law adopted
Jun Restitution law adopted
Jul Most prices liberalised
Aug Second voucher privatisation begins

1997

Mar Exchange rate unified
Mar Large-scale privatisation commenced
Jun First sovereign Eurobond
Jul CEFTA membership

1998

Mar Full currency convertibility
Nov Public property and concession laws enacted

1999

Jan Temporary import surcharge introduced
Jan Local public finance law enacted
May New privatisation law enacted

state-owned coalmines were responsible for about one-third of the total losses of the state-enterprise sector. Reform measures taken so far, such as the closure of 113 mines, the layoff of 81,500 employees and the corporatisation of four regional mining companies, have been insufficient to contain further losses. Government targets for the sector in 1999 include an annual 25% loss reduction in real terms and the closure of 10 additional mines. The agreement ending the Jiu Valley miners' strike in January 1999 provides for reductions in losses and increases in labour productivity, but further industrial action cannot be ruled out.

Legal reforms improve the basis for corporate governance and bankruptcy enforcement.

The new privatisation law approved in June 1999 contains provisions giving minority shareholders the right to more information and control. These provisions aim to reduce the power of enterprise insiders, who have

Enterprises, infrastructure, finance and social reforms

1990

Dec Two-tiered banking system established

1991

Mar Company law enacted

Apr Banking legislation adopted

1994

Jan BIS capital adequacy enacted

Dec Securities and exchange commission established

1995

Jun Bankruptcy law enacted

Nov Stock exchange begins trading

1996

Jan Bank deposit insurance scheme enacted

Oct OTC market established

1997

Jan Competition law enacted

Feb First corporate Eurobond

Feb Enterprise liquidation programme begins

Mar Major adjustments of utility prices

Dec Law on reorganisation of utilities into commercial companies enacted

1998

Mar New banking legislation enacted

Jun First corporate GDR issue

Jul Restructuring of railway begins

Dec Energy law enacted

Dec Privatisation of telecommunications company

1999

Jan Mine restructuring agreement signed

Mar Privatisation of the first state bank

May Second-largest state bank placed under administration

May Bankruptcy law amended

Jun Liquidation of the first large farm started

gained effective control of privatised enterprises in the majority of cases. The bankruptcy law has also been amended by simplifying procedures and allowing quicker debt recovery. Leasing and secured transactions will be facilitated under these amendments.

Restructuring in the agricultural sector remains sluggish.

Agriculture is an important sector of the Romanian economy, accounting for 20% of GDP and around 35% of total employment. Extensive price liberalisation and the reduction of import tariffs have created competitive pressures for the sector, which remains largely unreformed. Average yields of major crops such as wheat, barley and

sugar beet have declined and productivity of livestock lags well behind that in west European farms. Productivity increases are constrained by the small size of many farms, as well as inefficient supply and processing facilities, which remain largely state-owned. The government has agreed to the restructuring and possible liquidation of large loss-making agribusinesses, such as the livestock breeder Comtim, and plans to introduce farm loans based on grain receipts to reduce dependency on subsidised credits. However, the absence of secure property rights for land and a functioning land register limit the use of land as collateral for finance.

Infrastructure

Major reforms of the power sector are under way.

The new energy law enacted at the end of 1998 covers the basic principles for restructuring and regulating the power market and for introducing private ownership and competition. The first stage of power sector restructuring consisted of the unbundling of RENEL, the former vertically integrated energy utility, into CONEL and a company in charge of the Cernavoda nuclear power complex. CONEL is structured as a holding company with four subsidiaries: two power-generating companies (thermal and hydro), a distribution company, and a transmission and system operator. The second stage of the restructuring is to allow the privatisation of power generation and distribution by unbundling further the related companies into independent corporate units. As part of this restructuring, CONEL is expected to lay off about 25% of its estimated 82,000 employees. Regulations for granting licences to power-generating and distribution companies were approved in July 1999. An interim energy regulator for heat and power was established in October 1998, to be transformed into an independent regulatory agency.

Railway commercialisation started with the unbundling of the state railways.

The first stage in the commercialisation of the Romanian railways (SNCFR) was completed in late 1998 with its unbundling into several joint-stock companies. The new structure consists of five companies dedicated to infrastructure, passenger transport, freight transport, rolling stock and storage and a parent company. Under the reform plan, and in line with EU regulations, 18 smaller firms focused on repair and maintenance will be spun off the original railways to service the newly created railway businesses. However, subsidies for passenger services remain high.

Financial institutions

The legal base for bank restructuring has been established ...

The legal framework for the banking sector was significantly strengthened in 1998 with the adoption of three laws: on banking

activity, on the statute of the National Bank of Romania and on bank bankruptcy. A law on money laundering was also adopted in October 1998. Enforcement of these new laws is expected to hasten the closure of several troubled banks.

... and bank restructuring has begun.

Bancorex, the country's second-largest state-owned bank, was put under administration of the NBR in May 1999. More than 70% of Bancorex' loans are classified as non-performing. An Asset Recovery Agency was created to manage the bank's non-performing loan portfolio and to implement a comprehensive recovery plan. The transfer of bad loans to the agency was completed by July 1999, when Bancorex's licence was withdrawn. The remainder of the bank was merged with Banca Comerciala Romana. The Agency will also administer the non-performing loan portfolio in Banca Agricola, another state-owned bank with large exposure to loss-making enterprises in the agro-sector. In the first half of 1999, the NBR removed the licence of Banca Albina and placed Bankcoop under administration. The cost of bank restructuring is budgeted at 2% of GDP for 1999 alone.

Social reform

Measures are planned to mitigate the large social costs of enterprise restructuring.

Large-scale layoffs, estimated in the range of 150,000-200,000 workers, are expected from the restructuring and privatisation of state enterprises in industry, banking and infrastructure. Severance payments differ across workers according to the political influence of their unions, but most redundant workers currently face inadequate social protection. Unemployment benefits are low, coverage is limited and matching of unemployed to vacancies is poor. A newly established Agency for Employment and Professional Training is expected to undertake government programmes of retraining.

A move towards a three-pillar pension system is planned.

The current pay-as-you-go pension system is faced with growing difficulties owing to declining employment, accumulated debts to the social security budget and failure to pay contributions. The ratio of retirees to employees will increase over time and payroll contributions are already high. The system is to be transformed into a three-pillar system administered by the social security fund. The second, fully funded pillar will be mandatory for all employees under 45. Pension assets will be managed by private pension funds, licensed by a planned new regulatory authority, with a minimum capital requirement in the US\$ 10-20 million range.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator – yes	Share of the population in poverty – 22%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – yes	Private pension funds – no
Wage regulation – yes	Tradability of land – limited de facto	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 34.4%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – floating		Deposit insurance system – yes	
		Secured transactions law – restricted	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	85.0	47.0	29.0	20.0	18.0	18.0	18.0	7.0	na
Number of goods with administered prices in EBRD-15 basket	14.0	15.0	13.0	7.0	5.0	5.0	5.0	2.0	na
Share of exports to non-transition countries (per cent)	61.4	68.0	77.2	84.6	89.3	89.4	88.6	88.2	na
Share of trade in GDP (per cent)	na	14.6	25.4	20.7	21.0	24.3	26.2	27.1	25.2
Tariff revenues (per cent of imports)	na	6.7	5.0	6.6	6.0	6.2	5.1	4.5	4.9
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	3.0	4.0	4.0
Privatisation									
Share of small firms privatised	na	na	na	na	21.7	32.1	63.6	94.0	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	0.1	0.4	1.2	2.2	4.1	6.1
Private sector share in GDP	15.0	25.0	25.0	30.0	35.0	40.0	60.0	60.0	60.0
EBRD index of small-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.0	3.3
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	3.0	2.7	2.7
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	3.8	4.1	4.3	2.6	na
Efficiency of tax collection for social security (per cent)	na	82.4	77.5	81.6	77.2	69.5	65.9	61.9	na
Share of industry and construction in total employment (per cent)	1.5	38.1	35.4	34.2	32.9	31.0	31.5	30.5	na
Change in labour productivity in industry (per cent)	-21.1	-18.7	-10.0	10.4	8.6	16.1	5.3	3.8	3.2
Investment rate (per cent of GDP)	19.8	14.4	19.2	17.9	20.3	21.4	23.1	19.2	na
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	1.0	1.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.5	10.8	11.3	11.4	12.3	13.1	14.0	16.7	na
Railway labour productivity (1989=100)	60.9	55.0	47.5	42.8	44.2	53.2	52.0	51.5	54.2
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	4.25 (88%)	4.24 (94%)	4.24 (96%)	6.00 (96%)	na
Electricity consumption/GDP (1989=100)	93.9	90.4	92.9	89.6	83.9	83.7	83.2	88.5	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	3.1
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	na	20 (3)	24 (6)	31 (8)	33 (11)	36 (16)
Asset share of state-owned banks (in per cent)	na	na	na	na	80.4	84.3	80.9	80.2	74.6
Bad loans (per cent of total loans) ¹	na	na	na	na	18.5	37.9	48.0	57.0	34.2
Credit to private sector (per cent of GDP)	na	na	na	na	na	na	11.4	8.5	12.8
Stock market capitalisation (per cent of GDP) ²	na	na	na	na	na	0.4	0.2	2.0	1.2
EBRD index of banking sector reform	na	na	na	na	2.0	3.0	3.0	2.7	2.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	4.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	69.7	69.8	69.8	69.6	69.5	69.5	69.1	69.0	na
Basic school enrolment ratio (per cent)	89.5	89.4	89.6	90.3	91.4	92.6	93.9	95.0	na
Earnings inequality (Gini coefficient)	na	20.4	na	22.6	27.6	27.8	30.3	42.2	na

¹ Includes overdue loans and interest classified as doubtful and loss-making; data for bad loans for Credit Bank between 1994 and 1996 and Dacia Felix Bank in 1997 are not included.

² Includes listings on the Bucharest Stock Exchange and RASDAQ over-the-counter market.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	<i>(Percentage change in real terms)</i>								
GDP	-12.9	-8.8	1.5	3.9	7.1	4.1	-6.9	-7.3	-4.0
Private consumption	na	-7.5	0.9	2.4	12.9	11.1	-5.6	-6	na
Public consumption	na	2.2	2.7	11.7	0.7	7	-2.3	na	na
Gross fixed investment	na	11	8.3	20.7	6.9	3.7	-15.9	-18	na
Exports of goods and services	na	2.9	11.1	19	17	0.2	2.1	na	na
Imports of goods and services	na	7.5	4.4	28	16.3	5.2	-4.7	na	na
Industrial gross output	-22.8	-21.9	1.2	3.3	9.4	9.9	-5.9	-17.3	na
Agricultural gross output	-8.6	-12.2	13.4	3.2	4.5	1.8	3.1	na	na
Employment	<i>(Percentage change)</i>								
Labour force (end-year)	1.8	-1.8	-3.0	0.0	-7.1	-4.9	-0.7	na	na
Employment (end-year)	-0.5	-3.0	-3.8	-0.5	-5.2	-1.2	-3.1	na	na
	<i>(In per cent of labour force)</i>								
Unemployment ¹	3.0	8.2	10.4	10.9	9.5	6.6	8.9	10.3	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	161.1	210.4	256.1	136.7	32.3	38.8	154.8	59.2	45.0
Consumer prices (end-year)	222.8	199.2	295.5	61.7	27.8	56.9	151.4	40.6	40.0
Producer prices (annual average)	11.5	6.1	9.6	4.8	2.3	4.1	8.1	34.6	na
Producer prices (end-year)	250.5	104.0	195.4	73.4	32.0	60.4	154.3	18.4	na
Net average monthly earnings in manufacturing (annual average)	123.0	166.0	189.0	142.2	57.6	55.3	95.3	56.2	na
Government sector ²	<i>(In per cent of GDP)</i>								
General government balance	3.3	-4.6	-0.4	-1.9	-2.6	-4.0	-3.6	-3.3	-2.7
General government expenditure	38.7	42.0	34.2	33.9	34.5	34.1	34.3	38.3	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	101.2	79.6	141.0	138.1	71.6	66.0	75.9	48.9	na
Domestic credit (end-year)	116.5	34.6	139.7	115.4	89.5	80.8	50.8	71.5	na
	<i>(In per cent of GDP)</i>								
Broad money	46.9	30.8	22.3	21.4	25.2	27.7	24.9	18.9	na
Interest and exchange rates	<i>(In per cent per annum, end year)</i>								
Inter-bank interest rate (up to 30-day maturity)	19.5	43.6	61.4	64.3	45.2	55.3	90.3	136.4	na
Treasury bills rate (3-month maturity)	na	na	na	na	45.0	55.0	98.0	60.0	na
Deposit rate (one year)	na	28.3	42.5	49.5	32.4	38.9	34.1	41.1	na
Lending rate (one year)	na	49.5	86.4	61.8	47.5	53.6	55.6	56.8	na
	<i>(Lei per US dollar)</i>								
Exchange rate (end-year)	189	460	1,276	1,767	2,578	4,035	8,023	10,951	na
Exchange rate (annual average)	76	308	760	1,655	2,033	3,084	7,195	8,881	na
External sector	<i>(In millions of US dollars)</i>								
Current account	-1,290	-1,518	-1,239	-516	-1,732	-2,600	-2,159	-3,019	-2,195
Trade balance	-1,345	-1,373	-1,130	-483	-1,605	-2,494	-1,980	-2,611	-1,984
Exports	3,538	4,286	4,882	6,067	7,882	8,061	8,431	8,300	8,561
Imports	4,883	5,659	6,012	6,550	9,487	10,555	10,411	10,911	10,545
Foreign direct investment, net	37	73	97	341	417	263	1,224	2,040	1,345
Gross reserves (end-year), excluding gold	695	826	995	592	334	551	2,194	1,375	na
External debt stock	2,131	3,240	4,249	5,563	6,861	8,597	9,467	9,611	na
	<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold	1.5	1.5	1.7	0.9	0.4	0.5	2.2	1.7	na
	<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service	2.3	8.9	6.2	8.7	10.6	13.4	19.2	23.7	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	23.2	22.8	22.7	22.6	22.6	22.6	22.5	22.5	22.3
GDP (in billions of lei)	2,204	6,029	20,036	49,768	72,560	109,515	249,750	338,600	472,313
GDP per capita (in US dollars)	1,245	859	1,161	1,331	1,579	1,571	1,543	1,695	na
Share of industry in GDP (in per cent)	37.9	38.3	33.8	35.6	34.6	36.0	35.6	31.7	na
Share of agriculture in GDP (in per cent)	18.9	19.0	21.0	19.8	19.9	19.1	18.8	16.0	na
Current account/GDP (in per cent)	-4.5	-7.8	-4.7	-1.7	-4.9	-7.3	-6.2	-7.9	-7.0
External debt minus reserves (in US\$ millions)	1,436	2,414	3,254	4,971	6,527	8,046	7,273	8,236	na
External debt/GDP (in per cent)	7.4	16.6	16.1	18.5	19.2	24.2	27.3	25.2	na
External debt/exports (in per cent)	60.2	75.6	87.0	91.7	87.0	106.6	112.3	115.8	na

¹ Registered unemployment.

² General government includes the state, municipalities and extrabudgetary funds.

Russian Federation

Key reform challenges

- The parliamentary and presidential elections, scheduled for December 1999 and June 2000, respectively, will be milestones in Russia's political and economic transition. Before the presidential election, new constitutional arrangements on power sharing will be needed.
- While a comprehensive stabilisation and reform programme is not likely to be adopted before the question of power is solved, the authorities should aim to minimise disruptions caused by the election campaigns and to ensure progress in at least some critical structural reforms.
- Restructuring the banking system, fiscal reforms, and reducing non-payments and non-monetary forms of payments are priorities in the government's policy programme for 1999 and recent agreements with the IMF and the World Bank.

Liberalisation

Temporary price and trade controls have been imposed over the last year.

Many regions introduced price controls following the August 1998 crisis, although in most cases these measures were maintained for only a few months. Driven in part by budget revenue considerations, export tariffs were reintroduced for oil, gas, metals, petrochemicals and some other goods. In the middle of 1999, special price agreements were reached between state authorities and large producers of key commodities, to limit price increases to 50% of the rate of producer price inflation until the end of the year. In the energy sector, obligatory deliveries to the domestic market or to selected customers have been reinstated. In some cases, such as fuel, oil and petrol, where the differentials between domestic and world market prices have been very high, significant shortages developed.

Foreign exchange liberalisation is reversed.

In the wake of the collapse of the currency corridor regime in August 1998, the rouble was allowed to float. To support the currency and curb capital flight, a range of currency restrictions were introduced, leading to a reversal in the degree of convertibility of the rouble. The currency market became segmented with a de facto multiple exchange rate regime. The surrender requirement for exporters was raised from 50% to 75%, access of foreign banks to the foreign exchange market was limited, and a deposit/advance payment system was introduced for import transactions, among other measures. Some of these restrictions were removed in the middle of 1999 as a prior condition of the new IMF programme. The exchange rate has been reunified and the ban on foreign banks from using rouble-correspondent account balances to buy foreign exchange was lifted. The import deposit/advance payment mechanism is to be phased out by October 1999.

Stabilisation

1999 saw a major fiscal adjustment ...

The year brought a sharp turnaround in both revenue and expenditure developments. The federal budget recorded a primary surplus of 0.7% of GDP in the first half of 1999 against a deficit of 1.3% of GDP in 1998. Revenues were boosted by increases in world market prices for oil and gas and by higher inflation and a lower exchange rate than those assumed in the original budget. Federal tax offsets, still widespread in late 1998, have ceased this year. The brunt of the fiscal adjustment, however, was borne on the expenditure side. This was mainly a result of the non-payment of government creditors (both domestic and foreign) and across-the-board erosion of real budgetary expenditures due to the lack of full indexation to higher than expected inflation.

... but structural reforms of the fiscal system are still slow and partial.

While Part I of the long-awaited tax code was introduced in early 1999, Part II is still under debate in the Duma. Only limited advances were made in improving tax administration, phasing out privileges and strengthening tax compliance. While tax compliance of some key large enterprises improved, total tax arrears continued to rise in the first half of 1999. In the context of the new IMF agreement, new policy commitments were made to improve fiscal management. The measures include linking pipeline access to tax compliance by oil companies, transferring all budgetary entities to the Treasury, and reforming central/regional fiscal relations.

Debt rescheduling negotiations continue.

Faced with a scheduled external debt service obligation of over US\$ 17 billion in 1999, Russia continued to accumulate arrears primarily on its Soviet-era debt. However, official default has been prevented with the IMF stand-by agreed in July. Subsequently, a rescheduling arrangement was reached with the Paris Club on Russia's debt service obligations due in 1999-2000 of US\$ 8.1 billion. Negotiations with the London Club continue.

Liberalisation, stabilisation, privatisation

1990

Jun Sovereignty proclaimed

1991

Oct Reform programme adopted
Dec Dissolution of Soviet Union

1992

Jan VAT introduced
Jan Most prices liberalised
Jan State trading monopoly abolished
Jun Mass privatisation programme adopted
Jul Exchange rate unified
Oct Voucher privatisation begins

1993

May T-bills market initiated
Jul New currency (rouble) introduced
Nov Rouble zone collapses

1994

Jul Voucher privatisation completed
Jul Cash-based privatisation begins
Oct Currency crisis

1995

Jul Currency corridor introduced
Nov First shares-for-loans auctions conducted

1996

Mar IMF three-year programme agreed
Apr Foreign trade liberalisation completed
Jun Full current account convertibility introduced
Nov First sovereign Eurobond

1997

May First regional Eurobond
Sep Admission to Paris Club
Dec London Club deal completed

1998

Jun Western financing package
Aug Financial crisis, including default on GKO's, partial foreign debt moratorium, exchange rate devaluation, IMF programme off track, and dismissal of government

1999

Jan New tax code (Part I) enacted
Jan Dual exchange rate regime introduced
Jun Exchange rate re-unified
Jul New IMF programme approved

Privatisation

Privatisation has virtually stalled over the last year.

The August crisis had a range of adverse implications for the privatisation process. The sharply devalued rouble and steep falls

Enterprises, infrastructure, finance and social reforms

1990

- Dec Banking law enacted
- Dec Law on central bank enacted

1991

- Mar Law on competition enacted
- Mar Anti-monopoly committee established

1992

- Feb Law on subsoil resources enacted
- Nov RAO UES and Gazprom transformed into joint-stock companies
- Nov Federal energy commission established

1993

- Mar Bankruptcy law enacted

1994

- Jan 60% of Gazprom shares sold to the public
- Oct New civil code adopted

1995

- Feb First issue of ADR
- Aug Inter-bank market crisis
- Aug Law on natural monopolies
- Dec Law on joint-stock companies
- Dec Securities law adopted

1996

- Jan Federal telecommunications regulator established
- Feb Federal transport regulator established
- Jul Federal securities and exchanges committee established

1997

- Jul First corporate Eurobond

1998

- Mar New bankruptcy law enacted
- Aug Banking crisis
- Oct Bank restructuring agency established

1999

- Feb Law on insolvency of financial institutions enacted
- Mar Law on protection of securities market investors enacted
- Jul Law on restructuring of credit organisations enacted
- Jul Law on foreign investment
- Jul Mortgage law enacted

in share prices made new privatisation deals financially unattractive. In addition, the widely held perception that market reforms had failed, particularly privatisation, made the process politically even less palatable than before. The only major privatisation deal in late 1998 was the auction of a 2.5% stake in Gazprom, which was sold in a prearranged

deal to German gas consortium Ruhrgas. In the first half of 1999, privatisation revenues amounted to RUR 4.3 billion (of which only RUR 1.2 billion came from actual sales, with the rest consisting mostly of income from rent and dividends), against a target of RUR 15 billion for the year as a whole. The Russian Federal Property Fund currently envisages selling off significant share packages in a range of oil and gas companies, including Gazprom, Lukoil, Slavneft, Rosneft and Tyumen Oil by end-1999.

Enterprise reform

Corporate governance scandals flare up.

Given the still strongly entrenched management control of most of Russia's corporations and the associated weaknesses in the protection of shareholders' and creditors' rights, the last year saw a series of high-profile corporate governance scandals. With the economic and political crisis, including a series of defaults by large corporations and banks, asset-stripping became widespread. Mechanisms included transfer prices, share dilution, manipulation of debt-offsets, and diversion of cash flow and assets to related companies. The resource extraction sectors and the banking system have been the most exposed to these practices. It is encouraging, however, that in a number of cases the authorities, especially the Federal Securities and Exchange Commission, have intervened and prevented illegal actions.

Incentives and pressures for enterprise restructuring are still inadequate.

Despite the enactment of a much-improved bankruptcy law in March 1998 and increases in the number of bankruptcy proceedings, a credible bankruptcy threat still does not exist. The bankruptcy process itself is often used as another channel for asset-stripping, with the appointment of lenient administrators. Moreover, in early 1999, a number of legislative acts were passed to protect specific groups of enterprises (firms of strategic significance, regional energy distribution companies, agricultural firms) from bankruptcies and to stop the initiation of bankruptcies against tax debtors. Budgetary constraints for the enterprise sector remain soft.

Infrastructure

Financial controls on natural monopolies have been tightened.

Infrastructure monopolies have traditionally been at the centre of non-payment chains and a key source of indirect subsidisation of the enterprise sector. Improving the transparency and accountability of these monopolies, as well as strengthening their tax discipline, has been a recurring task for the government. Tax collection from these enterprises has substantially improved in 1999. The policy focus is now on cash collection, more active management of state shareholding and better financial reporting. Cash collection as a share of total sales

is to be raised by end-1999 for electric power, district heating and natural gas from 25% in mid-1999 to 40%, and for freight service by the railways from 52% to 65%.

Financial institutions

The systemic banking crisis has not yet been defused.

The number of banks declined to 1,390 by August 1999 from close to 1,600 a year earlier. Share capital of the banking system had fallen to RUR 75.8 billion (approximately US\$ 3 billion), or half of its pre-crisis level, by mid-1999. Most previous large banks are insolvent (15 of 18 of the largest banks reviewed by the World Bank) and their reputations – partly as a result of their behaviour in the wake of the crisis – are beyond repair. While the Agency for Restructuring Credit Organisations (ARCO) was created in late 1998 and legislation on bank bankruptcies and bank restructuring was adopted in February and July 1999, the restructuring of the banking system has been slow, uncoordinated and inefficient. The key stumbling blocks include the reluctance of the central bank to protect the rights of bank creditors and to ensure that bank shareholders absorb losses. This approach has seriously impaired the efficacy of the regulatory and supervisory system.

The rules of the game for restructuring are to be further refined.

According to the law on restructuring banking organisations, ARCO is empowered to (i) accept or refuse banks for restructuring referred to it by the central bank; (ii) assume full control over banks, disenfranchise current shareholders, initiate write-down of shareholder capital and impose write-down on creditors; (iii) restructure in the interest of depositors and creditors, including transfers of assets and household deposits to a newly created institution or to other banks; (iv) reverse previous asset-stripping. The initiation of bankruptcy proceedings remains primarily with the central bank. To increase transparency, strengthen creditor rights and specify responsibilities during the bank liquidation process, amendments are planned to banking legislation, the civil code and the law on pledge by October 1999.

Social reform

The crisis has led to further social strains but little social reforms.

As a result of the 36% drop in average real income from its pre-crisis level, the social situation has substantially deteriorated. The share of population living below the poverty line was 35% in the first half of 1999. However, public wages and pensions have been paid on time since late 1998 and the stock of arrears has also been falling. Given the budgetary constraints, reforms are targeted at increasing the transparency and efficiency of the main social funds and eliminating unproductive social programmes.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – yes	Share of the population in poverty – 38%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – no	Private pension funds – yes
Wage regulation – no	Tradability of land – limited de jure	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP ¹ – 31.7%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system ² – no	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	7.0	7.0	6.0	5.0	5.0	5.0	5.0
Share of exports to non-transition countries (per cent)	na	na	na	na	66.2	64.1	61.9	61.9	na
Share of trade in GDP (per cent)	na	na	57.5	30.9	21.3	20.4	18.3	18.0	24.2
Tariff revenues (per cent of imports) ³	na	na	3.8	12.0	15.0	11.0	7.8	7.1	7.3
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	2.7
EBRD Index of forex and trade liberalisation	na	na	na	na	3.0	3.0	4.0	4.0	2.3
Privatisation									
Share of small firms privatised ⁴	na	na	na	na	84.0	84.0	89.0	90.0	90.0
Privatisation revenues (cumulative, per cent of GDP)	na	na	0.8	1.1	1.3	1.5	1.7	1.7	2.3
Private sector share in GDP	5.0	5.0	25.0	40.0	50.0	55.0	60.0	70.0	70.0
EBRD index of small-scale privatisation	na	na	na	na	3.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.3	3.3
Enterprises									
Budgetary subsidies (per cent of GDP) ⁵	na	na	na	na	na	na	7.9	8.2	5.9
Efficiency of tax collection for social security (per cent)	na	na	75.0	43.3	40.6	40.1	44.5	46.1	na
Share of industry and construction in total employment (per cent)	42.3	41.8	40.5	39.4	37.0	35.2	33.7	31.8	na
Change in labour productivity in industry (per cent)	2.1	-5.5	-14.6	-11.2	-11.5	4.6	1.3	7.9	-0.3
Investment rate (per cent of GDP)	28.7	23.3	23.9	20.4	21.8	20.3	20.5	19.4	17.4
EBRD index of enterprise reform	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	14.2	15.2	15.5	15.8	16.2	17.0	17.5	18.3	na
Railway labour productivity (1989=100)	99.5	105.6	89.8	75.4	57.7	56.8	54.6	58.6	60.9
Electricity tariffs, Ucc/kWh (collection rate in per cent) ⁶	na	na	na	na	2.20 (50%)	2.33 (50%)	3.00 (50%)	3.20 (50%)	na
Electricity consumption/GDP (1989=100)	103.8	103.6	113.3	117.1	124.5	128.0	127.3	123.3	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.4
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	na	na	2,295 (19)	2,029 (23)	1,697 (26)	1,476 (29)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	na	40.9	42.2
Bad loans (per cent of total loans)	na	na	na	na	na	5.9	5.1	3.5	4.6
Credit to private sector (per cent of GDP)	na	na	na	11.8	12.1	8.5	7.2	8.7	12.7
Stock market capitalisation (per cent of GDP) ⁷	na	na	na	na	5.0	2.7	5.3	15.8	4.4
EBRD index of banking sector reform	na	na	na	na	2.0	2.0	2.0	2.3	2.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	3.0	3.0	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.3	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	6.0	7.2	7.7	6.1	6.5	7.0	6.0
Life expectancy at birth, total (years)	68.9	68.8	67.8	65.2	64.0	64.8	66.0	66.9	na
Basic school enrolment ratio (per cent)	93.6	94.4	93.3	91.9	90.7	91.3	91.4	90.8	na
Earnings inequality (Gini coefficient)	26.9	32.5	37.1	46.1	44.6	47.1	48.3	na	na

¹ Revenue of the federal and regional budgets. Federal budgets revenues alone were 10.7% of GDP in 1998.

² Although there is no general deposit insurance, depositors of Sberbank, the state-owned savings bank, are covered by a formal deposit insurance scheme.

³ Refers to all taxes on international trade.

⁴ In total number of small enterprises.

⁵ Expenditures on national economy of the consolidated budget (including industry, agriculture, the energy sector and housing subsidies of regional budgets).

⁶ Figures are averages of the Siberian, Northern, Southern, Volga, Far East and Ural regions and the Federation; collection ratios are estimated.

⁷ Survey data from the Russian Trading System. IFC data show somewhat higher figures for capitalisation, reaching 16.5% in 1998.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure									
(Percentage change in real terms)									
GDP	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	0.0
Private consumption	na	na	-5.5	-9.2	-5.5	-5.6	2.0	-14.4	na
Public consumption	na	na	-7.2	-2.7	1.2	-1.5	-2.0	-39.0	na
Gross fixed investment	na	na	-25.8	-26.0	-7.5	-18.5	-5.0	-6.7	na
Exports of goods and services	na	na	-2.1	4.9	7.3	-6.0	4.0	-16.5	na
Imports of goods and services	na	na	-9.6	9.2	8.4	-14.7	7.0	-19.1	na
Industrial gross output	-8.0	-18.0	-14.1	-20.9	-3.3	-4.0	1.9	-5.2	na
Agricultural gross output	-3.7	-9.0	-4.4	-12.0	-7.6	-5.1	0.1	-12.3	na
Employment									
(Percentage change)									
Labour force (annual average)	na	na	-1.1	-1.6	-1.8	0.4	-0.7	-0.5	na
Employment (annual average)	-2.0	-2.3	-1.7	-3.3	-3.0	-0.7	-2.0	-1.5	na
(In per cent of labour force)									
Unemployment (annual average)	0.0	4.8	5.3	7.1	8.3	9.2	10.9	12.4	na
Prices and wages									
(Percentage change)									
Consumer prices (annual average)	92.7	1,526.0	875.0	311.4	197.7	47.8	14.7	27.8	87.0
Consumer prices (end-year)	161.0	2,506.1	840.0	204.4	128.6	21.8	10.9	84.5	45.0
Producer prices (annual average)	na	1,767.9	941.9	337.4	236.5	50.8	19.7	7.0	na
Producer prices (end-year)	345.0	3,279.1	895.0	233.0	175.0	25.6	7.4	23.0	na
Gross average wages (large & medium-sized companies)	80.1	994.0	878.5	272.7	123.6	70.8	19.7	8.8	na
Government sector ¹									
(In per cent of GDP)									
General consolidated government balance	na	-42.6	-15.9	-9.7	-5.9	-9.1	-8.1	-5.4	-6.0
General consolidated government expenditure	na	71.1	44.7	45.9	37.3	40.4	40.7	37.0	na
Monetary sector									
(Percentage change)									
Broad money (end-year)	125.9	642.6	416.1	166.4	125.8	30.6	28.4	19.9	na
Net domestic assets (end-year)	na	na	770.0	359.8	70.7	80.6	14.8	75.0	na
(Percentage change)									
Broad money	68.4	37.4	21.4	16.0	13.9	13.1	14.2	16.9	na
Interest and exchange rates									
(In per cent per annum, end-year)									
Treasury bill rate (all maturities) ²	na	na	103.2	136.8	100.8	38.7	36.6	48.1	na
Central bank refinancing rate (uncompounded)	na	na	210.0	180.0	160.0	48.0	28.0	60.0	na
Lending rate	na	na	na	na	224.9	66.9	35.3	41.7	na
Deposit rate	na	na	na	na	69.6	34.5	7.4	25.7	na
(Roubles per US dollar)									
Exchange rate (end-year) ³	0.134	0.511	1.247	3.550	4.640	5.570	5.974	20.650	na
Exchange rate (annual average) ³	0.034	0.226	1.018	2.205	4.562	5.126	5.785	9.800	na
External sector									
(In billions of US dollars)									
Current account ⁴	na	na	na	9.3	7.9	12.1	3.3	2.4	11.1
Trade balance ⁴	na	na	na	21.1	17.5	16.3	16.6	17.3	21.0
Exports ⁴	na	na	na	69.6	81.5	90.2	88.8	74.8	73.0
Imports ⁴	na	na	na	48.5	64.0	73.9	72.2	57.4	52.0
Foreign direct investment, net	na	na	na	0.5	1.7	1.7	3.8	1.2	3.5
Gross reserves (end-year), including gold	na	4.5	8.9	6.5	17.2	15.3	17.8	12.2	na
External debt stock ⁵	67.0	107.7	112.7	119.9	120.4	125.0	123.5	150.9	na
(In months of current account expenditures, excluding transfers)									
Gross reserves (end-year), including gold	na	na	na	1.1	2.3	1.9	2.1	1.7	na
(In per cent of current account revenues, excluding transfers)									
Public debt service due ⁶	na	na	na	25.4	20.8	17.4	12.8	10.5	na
Public debt service paid ⁶	na	na	na	7.0	7.3	7.2	7.1	4.8	na
Memorandum items									
(Denominations as indicated)									
Population (in millions, end-year) ⁷	148.7	148.7	148.4	148.3	148.0	147.5	147.2	146.7	na
GDP (in billions of roubles)	1.4	19.0	171.5	610.7	1,585	2,200	2,602	2,685	4,948
GDP per capita (in US dollars)	280	565	1,135	1,868	2,348	2,910	3,056	1,867	na
Share of industry in GDP (in per cent)	na	46.0	43.9	43.6	41.5	41.8	42.5	42.7	na
Share of agriculture in GDP (in per cent)	na	13.4	8.5	6.8	9.6	9.8	7.1	6.5	na
Current account/GDP (in per cent)	na	na	na	3.4	2.3	2.8	0.7	0.9	5.5
External debt minus reserves (in US\$ billions)	na	103.2	103.8	113.4	103.2	109.7	105.7	138.7	na
External debt/GDP (in per cent)	161.2	128.2	66.9	43.3	34.7	29.1	27.5	55.1	na
External debt/exports (in per cent)	na	na	na	172.3	147.7	138.6	139.1	201.9	na

¹ General consolidated government includes the federal, regional and local budgets and extrabudgetary funds and excludes transfers.

² The 1998 figure is the yield on obligations of the central bank of Russia.

³ Data in new (denominated) roubles per US dollar. One new rouble = 1,000 old roubles.

⁴ Data from the consolidated balance of payments, including CIS and non-CIS countries.

⁵ Data include public debt only. From 1992 debt to former COMECON countries is included.

⁶ Difference between due and paid arises from debt rescheduling and accumulation of arrears.

⁷ Data as of 1 January of the following year.

Key reform challenges

- **Recent austerity measures aim to reduce high fiscal and current account deficits, but the government has rightly stressed the importance and urgency of renewed structural reforms.**
- **Improving creditor and minority shareholder rights, the effectiveness of bankruptcy and corporate transparency are crucial to strengthen market and financial discipline and encourage FDI.**
- **Long-overdue infrastructure reforms have begun with price adjustments. The next step should be to enhance the role of the private sector and to establish strong independent regulatory institutions.**
- **The banking sector is weakened by the poor financial state of the three large state banks. Their restructuring and privatisation is crucial to improve the efficiency of financial intermediation.**

Liberalisation

Price and wage liberalisation progresses ...

The new government has substantially raised a number of regulated prices, kick-starting long-overdue price reforms and reductions of cross-subsidies (see also infrastructure section below). Rents were raised by 70% in October, bringing them closer to market levels. The government has also annulled the wage regulation introduced in 1997 that limited wage growth of public and private firms.

... while the import surcharge is re-introduced.

In response to persistent large current account deficits (in excess of 10% of GDP for the last three years) and low tax revenue collection in 1999, the government has re-introduced a 7% import surcharge, applicable to about three-quarters of imports. The surcharge is seen as a short-term stabilisation measure and is to be gradually phased out by January 2001.

Stabilisation

Austerity package reduces the fiscal deficit ...

The new government's policy of high public infrastructure investment, extra-budgetary spending and borrowing contributed to an overheated economy, with "twin deficits" of the fiscal and current accounts. The new government has introduced a wide range of measures to contain public spending and to raise revenues, including a public sector wage freeze, infrastructure tariff rises, an increase in the lower rate of VAT and increases in excise taxes on cigarettes and petrol. The measures are likely to reduce the general fiscal deficit from over 5% of GDP in 1998 to about 3% in 1999, while the current account deficit is set to fall from over 10% of GDP to about 5%. Contingent liabilities, such as loan guarantees worth over US\$ 2 billion and anticipated costs of bank rehabilitation, remain a risk factor to fiscal stability.

... and bolsters investor confidence.

The fiscal austerity and structural reform packages put forward in 1999 have helped to rebuild investor confidence. After the flotation of the Slovak koruna in October 1998, which coincided with the arrival of the new government, the currency has gradually depreciated, but far less than initially feared. In June and July 1999, the government issued €500 million 5-year Eurobonds at around 400 basis points spread above German bonds, indicating that some access to international finance has been retained despite the economic downturn.

Privatisation

The law on strategic enterprises has been cancelled.

The 1995 law excluding certain "strategic" enterprises (mostly infrastructure companies and major financial institutions) from the privatisation process was cancelled in June 1999 and replaced by a new law on large-scale privatisation. A number of these companies, including banks and Slovak Telecoms, are expected to be partially privatised in the near future, most likely through international tender (see sections below). Apart from the former strategic enterprises, residual state ownership is now insignificant, with a book value of about US\$ 300 million and a market value far below that.

Past privatisations are being reviewed.

Past privatisations are being reviewed by the National Property Fund, targeting companies whose initial privatisation involved illegalities or whose owners have not paid their instalments to the Fund in full. These reviews can lead to significant ownership changes and the government hopes to involve foreign strategic investors in the re-privatisation process. An early case was the oil and gas storage company, Nafta Gbely, which had been privatised for a fraction of its market price in 1996. The new government has now declared the privatisation invalid and a 46% stake is to return to state hands. The details of its re-privatisation are not yet known, however.

Liberalisation, stabilisation, privatisation

1991

Jan	Exchange rate unified
Jan	Most foreign trade controls lifted
Jan	Most prices liberalised
Jan	Small-scale privatisation begins
Feb	Restitution law adopted

1992

Feb	T-bills market initiated
May	Voucher privatisation begins
Jul	EFTA membership

1993

Jan	Czechoslovakia splits into Czech and Slovak Republics
Feb	New currency (koruna) introduced
Mar	CEFTA membership

1994

Jul	First sovereign Eurobond
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1995

Jan	WTO membership
Sep	Second wave of voucher privatisation cancelled
Sep	Strategic enterprises excluded from privatisation
Oct	Full current account convertibility introduced

1997

Sep	New wage regulation enacted
-----	-----------------------------

1998

Oct	Koruna floated
Dec	New wage regulation cancelled

Enterprise reform

A credible strategy for tackling enterprise insolvency is sought.

The new government is developing plans to improve the effectiveness of bankruptcy. It is currently difficult for creditors to coordinate a workout, to find a capable receiver, or to take immediate control of the company in order to avoid asset-stripping. Reform initiatives are likely to focus on improving creditor rights and the institutional capacity of courts and receivers, while providing for voluntary debt-for-equity swaps and out-of-court settlement procedures.

Enterprise profits plummet, but productivity rises.

Aggregate reported profits of non-financial enterprises fell by over 50% in 1998 compared with a year earlier. The trend was most pronounced for medium-sized and large companies. The large steel producer VSŽ Košice made record losses of US\$ 300 million in 1998 and defaulted on its external

Enterprises, infrastructure, finance and social reforms

1990

Jan Two-tiered banking system established
Aug Competition office established

1991

Aug Bankruptcy law adopted

1992

Jan Commercial code adopted
Feb Banking law adopted

1993

Apr Stock exchange begins trading
Jun New bankruptcy law enacted

1994

Jan First corporate Eurobond
Feb New banking law becomes effective
Aug New competition law enacted

1995

Dec First municipal Eurobond

1996

Dec BIS capital adequacy requirements adopted

1997

Aug Enterprise revitalisation law enacted
Dec IRB (third-largest bank) collapsed

1998

Feb Bankruptcy law amended
Nov Enterprise revitalisation law cancelled
Nov Steel producer VSŽ defaults on foreign debt

debts. Aggregate profits in manufacturing were negative, with about 1,000 out of 2,300 firms above 20 employees reporting losses. Financial distress has also led to an increase of arrears, reaching close to 20% of GDP at the end of 1998, up from 18% at the end of 1997. Despite the gloomy financial indicators, labour productivity in manufacturing soared by over 11% and value-added increased by 5%. However, these developments are largely driven by the rapid expansion of car production at Volkswagen's subsidiary in Bratislava, rather than by general progress in enterprise restructuring.

FDI is to be attracted by tax incentives and improvements in the investment climate.

The new government seeks to encourage FDI into greenfield projects as well as for take-overs, especially of those firms in need of restructuring such as VSŽ. According to tax legislation effective from April 1999, greenfield FDI above €5 million, exporting at least 60% of output, is eligible for a 5-year

corporate income tax holiday, duty-free imports of capital goods, and VAT and property tax exemptions. Longer-term reforms aimed at improving the investment climate include legal and institutional changes to improve minority shareholder rights, contractual security and corporate transparency.

Infrastructure

Slovak Telecoms is to be privatised.

The government is preparing the partial privatisation of Slovak Telecoms, the monopoly fixed-line service provider. Some 25% to 49% is to be acquired by a foreign strategic investor in the first half of 2000. Under WTO rules, the sector must be opened for competition by January 2003. In the mobile sector, a GSM 1800 licence was issued to the two incumbent operators (one private, one state-owned).

Price reforms kick-start long-overdue infrastructure reforms ...

Utility and transport tariffs were raised drastically in 1999, bringing them closer to cost recovery levels and reducing cross-subsidies. Water prices were raised by US\$ 1 per month per household in January 1999 and heating prices were raised by 40% in July. Tariffs for rail and bus services were increased by 35% and 20% respectively in February and rail freight tariffs were raised by 15% in July. The largest increase (50% in July and another 30% planned for January 2000) applies to household gas prices, which at the end of 1998 stood at 5.5 US cents per cubic metre, compared with 16-25 US cents in the Czech Republic, Hungary and Poland. Household electricity tariffs have also been increased drastically (by 30% in January and 35% in June) from an average of 2.7 US cents per kWh at the end of 1998, compared with 6-8 US cents in the other three countries and an average of 11 US cents in OECD countries. Next steps in infrastructure reform include the introduction of the private sector, as in the telecommunications sector, and the unbundling of the vertically integrated power sector, as well as strengthening of regulation.

... alleviating the precarious financial situation of infrastructure companies.

The long-overdue price reforms will help reduce losses of major infrastructure companies that have become a significant strain on the budget. Apart from direct transfers, the state has guaranteed loans to Slovak Electricity, Slovak Water and Slovak Rail. The precarious financial position of these companies has forced the state to take on much of their debt service, adding US\$ 150 million to government expenditure in 1999 alone.

Financial institutions

Foreign investors are sought for the privatisation of the three large ailing banks.

The new government plans to move swiftly on the restructuring and privatisation of the three troubled large state banks (VUB, SLSP, IRB) which account for half of the banking sector's assets and two-thirds of bad loans. The financial position of these banks deteriorated significantly in 1998, when each made losses of around US\$ 100 million. They accounted for much of the banking sector's sharp increase in the share of bad loans in total loans from 33% to 44%. The first privatisation is likely to involve IRB, which collapsed in late 1997 and has been under central bank administrative control. The banks are expected to be sold to foreign strategic investors, although the state may retain majority ownership in the Savings Bank (SLSP) for the foreseeable future.

Progress in capital market reform is modest.

The stock market has suffered from emerging market crises, exchange rate worries and the continued decline of enterprise profitability. The local share index (SAX) lost about 50% during 1998 and another 10% in the first seven months of 1999. Apart from cyclical factors, the development of the stock market remains affected by institutional shortcomings, in particular weak minority shareholder rights and the absence of an independent securities regulator. In a first step to enhance transparency and corporate governance, the government has made registration of bearer shares with the securities registry mandatory with effect from January 2000. Further reform plans include the strengthening of reporting requirements for companies listed on the stock exchange and the creation of a new financial sector supervisory institution.

Social reform

First steps are taken to reform the crisis-ridden health care sector.

The Slovak Republic's relatively generous social welfare system is financed by a 50% payroll tax, with 27.5% of gross wages going to pensions and 18.5% to health insurance. Despite this high payroll contribution, the healthcare sector, with expenditures of 6% of GDP, is facing an increasing funding gap that rose from 0.8% of GDP in 1997 to 1.6% in 1998. Overdue payables and receivables of the public health insurers have risen rapidly. In June 1999, the government initiated reforms in the sector, reducing benefits and amending the health insurance law to facilitate the liquidation of some public health insurers and the settling of their debts.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – no	Share of the population in poverty – 1%
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Separation of railway accounts – no	Private pension funds – no
Wage regulation – no	Tradability of land – full except foreigners	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 36.4%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – floating		Deposit insurance system – yes	
		Secured transactions law – restricted	
		Securities commission – no	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	21.8	21.8	21.8	21.8	14.9	14.9
Number of goods with administered prices in EBRD-15 basket ¹	15.0	9.0	5.0	5.0	5.0	5.0	5.0	5.0	4.0
Share of exports to non-transition countries (per cent)	na	na	na	39.3	48.7	49.9	50.5	49.3	na
Share of trade in GDP (per cent)	na	na	na	49.3	48.5	50.0	53.1	54.9	58.0
Tariff revenues (per cent of imports) ²	na	na	na	2.3	3.4	3.3	2.9	3.3	2.6
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.3	4.0	4.3
Privatisation									
Share of small firms privatised	na	61.6	94.0	96.5	98.0	98.3	98.3	98.5	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	3.7	4.8	6.9	9.4	11.4	11.9	12.3
Private sector share in GDP	10.0	15.0	30.0	45.0	55.0	60.0	70.0	75.0	75.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	3.0	3.0	3.0	4.0	4.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	4.0	3.9	3.2	2.8	2.4	na	na
Efficiency of tax collection for social security (per cent)	na	na	na	48.1	50.0	50.0	56.5	52.9	na
Share of industry and construction in total employment (per cent)	44.9	44.1	39.3	37.8	36.9	37.0	37.6	37.3	na
Change in labour productivity in industry (per cent)	-4.0	-15.7	7.3	-1.1	9.0	4.0	2.5	4.8	9.1
Investment rate (per cent of GDP)	31.3	28.3	32.9	32.7	29.4	27.4	36.9	38.6	na
EBRD index of enterprise reform	na	na	na	na	3.0	3.0	3.0	2.7	2.7
EBRD index of competition policy	na	na	na	na	na	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	13.5	14.4	15.5	16.7	18.7	20.8	23.2	25.9	28.6
Railway labour productivity (1989=100)	93.8	78.4	74.4	65.4	60.7	68.2	60.8	63.1	60.4
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	2.9 (95%)	3.1 (95%)	3.2 (95%)	2.9 (95%)	na
Electricity consumption/GDP (1989=100)	99.2	108.5	107.9	113.1	109.7	104.8	108.2	88.8	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.1
Financial institutions									
Number of banks (of which foreign-owned)	na	na	na	18 (3)	19 (4)	25 (9)	24 (9)	25 (9)	24 (8)
Asset share of state-owned banks (in per cent)	na	na	na	70.7	66.9	61.2	54.2	48.7	50.0
Bad loans (per cent of total loans)	na	na	na	12.2	30.3	41.3	31.8	33.4	44.3
Credit to private sector (per cent of GDP)	na	na	na	32.1	24.3	27.8	32.0	44.2	na
Stock market capitalisation (per cent of GDP) ³	na	na	na	na	22.1	30.6	32.0	28.2	21.2
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	2.7	2.7
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	3.0	3.0	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	9.6	9.0	9.4	11.7	11.2	10.7
Life expectancy at birth, total (years)	70.9	70.9	71.8	72.4	72.3	72.3	72.7	72.7	na
Basic school enrolment ratio (per cent)	97.2	98.0	99.8	99.5	97.0	96.5	96.3	na	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ Information on price control in the Czech Republic between 1989 and 1992 was used.

² Refers to import tariffs, customs duties and import surcharge.

³ Data from survey of Bratislava Stock Exchange. IFC data show much lower capitalisation, reaching a peak of 12% in 1996 and declining to 5% in 1998.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	(Percentage change in real terms)								
GDP	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.8
Private consumption	-28.4	-6.4	-1.5	0.0	3.4	6.9	6.3	4.9	na
Public consumption	-17.8	9.9	-2.2	-11.6	2.1	21.9	0.0	0.2	na
Gross fixed investment	-25.2	-4.5	-5.4	-4.6	5.3	39.8	14.5	11.0	na
Exports of goods and services	na	na	-0.5	14.2	3.1	-0.3	14.2	10.8	na
Imports of goods and services	na	na	-0.8	-3.6	9.6	20.3	9.1	9.6	na
Industrial gross output	-22.3	-9.6	-5.4	6.8	8.3	2.5	2.7	4.6	na
Agricultural gross output	-9.0	-21.7	-8.1	4.8	2.3	2.0	-1.0	na	na
Employment ¹	(Percentage change)								
Labour force (annual average)	na	na	na	-2.6	1.4	1.0	-0.6	0.5	na
Employment (annual average)	-14.4	0.3	-0.1	-4.2	2.1	3.3	-1.1	-1.2	na
	(In per cent of labour force)								
Unemployment	na	na	12.2	13.7	13.1	11.1	11.6	11.9	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	61.2	10.1	23.2	13.4	9.9	5.8	6.1	6.7	10.6
Consumer prices (end-year)	58.3	9.1	25.1	11.7	7.2	5.4	6.4	5.6	14.5
Producer prices (annual average)	68.8	5.3	17.2	10.0	9.0	4.1	4.5	3.3	na
Producer prices (end-year)	50.6	6.1	18.8	9.4	7.1	4.7	4.4	1.6	na
Gross average monthly earnings in manufacturing (annual average) ²	16.3	18.2	21.2	18.3	15.9	14.7	11.9	9.4	na
Government sector ³	(In per cent of GDP)								
General government balance	na	na	-7.0	-1.3	0.2	-1.9	-4.4	-5.8	-3.2
General government expenditure	na	na	51.3	47.8	46.7	49.3	46.2	44.5	na
Monetary sector	(Percentage change)								
Broad money (M2, end-year)	na	na	16.8	20.1	19.2	16.5	9.1	2.6	na
Domestic credit (end-year)	na	na	na	9.2	7.8	14.4	3.2	11.1	na
	(In per cent of GDP)								
Broad money (M2, end-year)	na	64.3	67.6	68.0	69.1	72.3	69.4	64.9	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate (30-day maturity)	na	na	16.2	5.9	9.7	16.1	24.4	16.1	na
Discount rate	9.5	9.5	12.0	12.0	9.8	8.8	8.8	8.8	na
Lending rate ⁴	na	na	14.1	14.4	14.8	13.2	16.2	16.2	na
Deposit rate ⁴	na	na	8.7	9.2	8.2	6.2	8.7	10.4	na
	(Koruna per US dollar)								
Exchange rate (end-year)	27.8	28.9	33.2	31.3	29.6	31.9	34.8	36.2	na
Exchange rate (annual average)	29.5	28.3	30.8	32.0	29.7	30.7	33.6	35.2	na
External sector	(In millions of US dollars)								
Current account	na	na	-601	665	391	-2,098	-1,952	-2,059	-1,003
Trade balance	na	na	-932	59	-228	-2,293	-2,081	-2,293	-1,118
Exports	na	na	5,447	6,691	8,579	8,831	9,639	10,667	10,027
Imports	na	na	6,379	6,633	8,807	11,124	11,720	12,959	11,145
Foreign direct investment, net	82	100	168	250	202	251	177	508	500
Gross reserves (end-year), excluding gold	na	na	450	1,745	3,418	3,473	3,285	2,923	na
External debt stock	na	na	3,380	4,660	5,678	7,670	9,896	11,902	na
	(In months of imports of goods and services)								
Gross reserves (end-year), excluding gold	na	na	0.7	2.5	3.9	3.2	2.9	2.3	na
	(In per cent of exports of goods and services)								
Debt service	na	na	8.6	8.8	9.3	10.8	12.7	11.6	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	5.3	5.3	5.3	5.3	5.4	5.4	5.4	5.4	na
GDP (in billions of koruna)	320	332	369	441	517	576	654	717	820
GDP per capita (in US dollars)	2,052	2,213	2,253	2,571	3,240	3,495	3,624	3,793	na
Share of industry in GDP (in per cent)	na	37.9	35.4	30.6	32.2	30.0	28.2	26.7	na
Share of agriculture in GDP (in per cent)	na	6.2	6.6	7.4	5.6	5.2	4.8	4.4	na
Current account/GDP (in per cent)	na	na	-5.0	4.8	2.3	-11.2	-10.0	-10.1	-5.2
External debt minus reserves (in US\$ millions)	na	na	2,931	2,915	2,260	4,196	6,611	8,979	na
External debt/GDP (in per cent)	na	na	28.2	33.9	32.7	40.8	50.9	58.5	na
External debt/exports (in per cent)	na	na	62.0	69.6	66.2	86.8	102.7	111.6	na

¹ Based on labour force surveys, except 1991-93 employment series.

² Refers to industrial wages from 1991-93.

³ General government includes the state, municipalities and extrabudgetary funds.

⁴ Lending and deposit rates; weighted average over all maturities. Lending rate excludes loans at zero interest rate since 1995.

Key reform challenges

- While small-scale privatisation is now complete, the pace of large-scale privatisation has been slow. Priorities include the steel, banking, energy, transport, telecommunications and insurance sectors.
- Fostering inflows of foreign direct investment and eliminating legal and regulatory obstacles to effective corporate governance would promote enterprise restructuring.
- The local capital market could be deepened by encouraging greater financial transparency by corporations and accelerating pension reform.
- Priorities for EU accession include legal and regulatory reforms in the financial sector and restructuring of large loss-making enterprises. Substantial investments are also needed to bring local environmental standards in line with EU norms, particularly in waste water.

Liberalisation

Capital account restrictions have been substantially reduced.

The foreign exchange operations law passed in March 1999 and the implementing regulations adopted in July and September are significant steps towards full liberalisation of capital flows. The main achievements of the legislation are the complete liberalisation of inward and outward direct investments and the significant liberalisation of credit operations and securities transactions. The law and its implementation so far leave restrictions for the most part only on the inflow of short-term capital. The transitional provisions of the law set a timeframe for complete liberalisation of the capital account, with the final deadline being the time of accession to the European Union.

The officially sanctioned bank agreement on deposit rates is ended.

An agreement among domestic banks was initiated in 1995, with the backing of the central bank, in an attempt to lower deposit interest rates and to curb aggressive rate-setting for market share. This temporary agreement was renewed in subsequent years. However, in early 1999, the banks abandoned this practice.

Stabilisation

Value-added and excise taxes have been adopted.

A new VAT law and law on excise duties were adopted in December 1998 and implemented in July 1999. The general rate of VAT for all goods, services and imports, except for those exempt or subject to a reduced rate, is 19%. The reduced rate is 8% and applies to food products, medicines and medical equipment, building, reconstruction and maintenance of flats and houses, public passenger transport and accommodation in holiday facilities. Activities of public interest (postal services, health, social security, education, sports, religious, cultural and other activities) are exempt from VAT. The introduction of VAT and excise taxes is a requirement for EU accession.

The government retains access to international capital markets.

The government has been able to borrow on international markets despite the emerging markets turmoil. Slovenia tapped the international capital markets in March 1999 with a €400 million 10-year bond issue, tightly priced at 86 basis points over German government bonds. This issue continued a positive trend of Euromarket issuance characterised by progressively lower coupons and longer tenors. Slovenia is rated as investment grade by the major rating agencies.

Privatisation

The pace of large-scale privatisation remains slow.

While privatisation of "socially owned" enterprises (mostly SMEs) is now complete, there has been little progress in the area of large-scale privatisation. A number of large-scale enterprises in the aluminium, steel and oil sectors are still in the rehabilitation process led by the state-owned Slovene Development Corporation and other state agencies. A programme for steel sector privatisation, which aimed both at providing significant concession to employees and at attracting strategic investors, was initiated in 1998. Although by law employees had an option to acquire up to 20% of the shares, this option was used only up to 11%. With the capital increase provided by institutional investors this share has been further diminished. So far, only one steel company has been privatised (Jeklo Store in May 1999). Under the June 1999 law on the First Pension Fund, unused vouchers issued for the privatisation of socially owned enterprises and held by the Privatisation Investment Funds (PIDs) can be exchanged for shares in remaining state-owned enterprises and banks. The holders of shares in the PIDs also have the option to exchange their shares for pension vouchers, which in turn can be sold or exchanged for pension policy provided by the newly established First Pension Fund.

Liberalisation, stabilisation, privatisation

1991

Jun	Independence from Yugoslavia
Jun	Central bank established
Oct	New currency (tolar) introduced
Dec	Law on restitution enacted

1992

Nov	Law on privatisation of socially owned enterprises adopted
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1993

Mar	Foreign trade law enacted
Jun	Paris Club agreement
Jun	Law on privatisation of socially owned enterprises amended

1994

Apr	Wage guidelines introduced
Jun	Most prices liberalised
Oct	GATT membership
Nov	New law on privatisation adopted

1995

Feb	Capital account restrictions tightened
Apr	Inter-bank cartel on deposit rates established
Jun	EU Association Agreement
Jun	EFTA agreement
Sep	Full current account convertibility introduced

1996

Jan	CEFTA membership
Jan	London Club agreement
Jul	First sovereign Eurobond
Jul	Capital account restrictions tightened

1997

Feb	Capital account restrictions tightened
Jun	Minimum wage law adopted
Jun	Capital account restrictions eased

1998

Jan	Minimum wage law amended
Apr	Law on privatisation of state-owned enterprises adopted
Apr	Law on privatisation of socially owned enterprises amended
Dec	Excise tax law adopted
Dec	VAT law adopted

1999

Jan	Capital account restrictions eased
Mar	Foreign exchange law adopted
Sep	Capital account restrictions eased

Enterprises, infrastructure, finance and social reforms

1990

Apr Enterprise restructuring agency established

1991

Oct Bank restructuring agency established

1992

Sep Restructuring of socially owned enterprises begins

1993

Jan Bank rehabilitation begins
Apr Competition law adopted
Jun Company law enacted
Jul Electric power sector law adopted
Dec Railway law adopted

1994

Jan IAS introduced
Jan Bankruptcy law enacted
Jan Investment company law adopted
Mar Securities law enacted
Aug BIS capital adequacy adopted
Sep Insurance law adopted

1995

Jan Telecommunications and postal services separated
Sep Competition agency established

1996

Jan First privatised company listed on stock exchange
Jul First bank liquidation initiated

1997

Feb First GDR issue
May Telecommunications law adopted
Jul Bank rehabilitation concluded
Jul Takeover law enacted

1999

Jan Banking law amended
Apr Securities dematerialisation law adopted
Jul Securities market law enacted

The ban on foreign ownership of property has been partly lifted.

Under the February 1999 reciprocity law, EU nationals who have held permanent residence in Slovenia for at least three years may now purchase Slovene property. Further liberalisation is scheduled to take place four years after the Europe Agreement will be in effect, when citizens of all EU member states will be granted the right to buy property in Slovenia, providing the conditions of reciprocity and non-discrimination are met.

Enterprise reform

While privatisation has favoured management-employee buy-outs (MEBOs) and transfers to state funds, ownership structures are changing slowly.

Privatisation through MEBOs and state funds has effectively perpetuated the Yugoslav system of “social management” of enterprises. This form of ownership has resulted in high labour representation on supervisory boards and disproportionate control by managers and employees. However, existing ownership structures are changing slowly, with some consolidation of ownership through takeovers and mergers. The ban on selling shares in privatised enterprises on the secondary market for at least two years after privatisation is in most cases no longer in effect. Under the takeover law, share purchases of more than 25% are subject to supervision (approval in the case of privatised companies) by the Securities Market Agency.

Infrastructure

The unbundling of the electric power sector has been completed, and the privatisation of generation and distribution is planned.

The electric power sector has been unbundled into eight generating companies, five distribution companies and one transmission and dispatch company. According to the September 1999 energy law, the privatisation of up to 45% of the generation and distribution companies is permitted with the aim of attracting strategic investors. While electricity tariffs approach cost recovery levels, some cross-subsidisation between commercial and household users remains.

Financial institutions

A new banking law permits the entry of foreign bank branches in Slovenia ...

The banking law adopted in January 1999 authorises foreign banks to establish branches in Slovenia, subject to issuance of a licence by the central bank. However, these branches must meet minimum capital requirements and are subject to supervision by the Bank of Slovenia. These requirements would be lifted for EU banks at the time of accession. In June 1999, the Bank of Slovenia approved entry of the first foreign bank branch, Kaerntner Sparkasse of Austria.

... but the pace of bank privatisation remains slow.

The government has approved a privatisation plan for the largest state bank. Under the plan, an initial share in this bank (10%) would be privatised via an asset transfer to state-owned funds and an exchange for unused privatisation vouchers held by private investment funds. A further minority share would be sold on the open market.

Banks consolidate into banking and insurance groups.

At the end of 1998, the banking system consisted of 24 banks, with the top seven banks controlling a 73% market share. A tendency toward consolidation in the sector has been evidenced by the establishment of four banking groups and strategic alliances between banks and insurance companies during 1997 and 1998, and by a liquidation and three mergers in late 1998 which reduced the number of banking groups to two. In May 1999, SKB requested central bank permission to merge with Abanka, the sixth-largest bank.

New securities market legislation aims to promote listings and transparency.

New securities laws, which came into effect in 1999, allow all branches and subsidiaries of foreign securities firms to enter the market. They also require all companies that have publicly sold their shares to register them in a central registry and to list the shares on the OTC market. However, no corporate securities have been issued since the laws took effect. Despite the rapid growth experienced by the securities market during 1994-97 and the advanced level of institutional and technical development of the Ljubljana Stock Exchange, the Slovenian capital market remains shallow. Market capitalisation stood at 19% of GDP and total turnover was low at 6% of market capitalisation in 1998.

Social reform

Legislation on pension reform advances slowly.

A two-pillar pension reform law passed its first reading in parliament in April 1999. The reform calls for a combination of a financially balanced pay-as-you-go system (principal pillar) and a voluntary fully funded system. The proposed reforms would raise retirement age, reduce the degree of indexation, increase contributions by the self-employed and raise the cost of buying pension rights for time spent in education and military service. Moreover, a law on the First Pension Fund and the reorganisation of PIDs took effect in July 1999. The law enables shareholders of PIDs (which still hold unused privatisation vouchers) to exchange these shares for pension vouchers, which in turn can be sold or invested in the First Pension Fund.

Liberalisation	Privatisation	Infrastructure	Financial sector
Current account convertibility – full	Primary privatisation method – MEBOs	Independent telecoms regulator – no	Capital adequacy ratio – 8%
Interest rate liberalisation – full	Secondary privatisation method – vouchers	Separation of railway accounts – yes	Deposit insurance system – yes
Wage regulation – yes	Tradability of land – full except foreigners	Independent electricity regulator – no	Secured transactions law – restricted
Stabilisation	Enterprises		Securities commission – yes
Share in general government tax revenues in GDP – 41.0%	Competition office – yes		Social reform
Exchange rate regime – managed float			Share of the population in poverty – 1%
			Private pension funds – no

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	23.7	19.8	18.4	22.5	22.4	20.4	17.0
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	5.0	6.0	5.0	5.0	5.0	4.0	2.0
Share of exports to non-transition countries (per cent)	na	na	na	76.0	83.1	80.2	76.8	76.7	na
Share of trade in GDP (per cent)	25.4	31.6	50.2	48.6	48.6	47.1	46.7	48.3	48.5
Tariff revenues (per cent of imports)	na	na	6.8	7.3	7.0	7.1	6.1	4.0	3.2
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	na	0.4	0.8	1.3	1.8
Private sector share in GDP	15.0	15.0	20.0	25.0	30.0	45.0	45.0	50.0	50.0
EBRD index of small-scale privatisation	na	na	na	na	4.0	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	na	na	na	na	2.0	3.0	3.0	3.3	3.3
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	2.5	2.1	1.6	1.6	1.2	1.3	na
Efficiency of tax collection for social security (per cent)	na	na	69.5	75.8	71.2	71.8	73.0	77.6	na
Share of industry and construction in total employment (per cent)	49.2	47.6	45.8	44.0	42.2	43.1	42.1	40.6	na
Change in labour productivity in industry (per cent)	-7.9	-2.0	-3.0	6.7	11.4	7.2	6.6	5.2	5.2
Investment rate (per cent of GDP)	na	20.6	18.4	18.8	19.8	21.2	22.5	23.7	na
EBRD index of enterprise reform	na	na	na	na	3.0	3.0	3.0	2.7	2.7
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	22.0	22.9	24.8	25.9	28.7	30.9	33.3	36.4	na
Railway labour productivity (1989=100)	120.0	92.1	79.0	76.2	94.2	119.2	103.4	na	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	6.75 (92%)	7.36 (95%)	7.40 (95%)	9.37 (97%)	na
Electricity consumption/GDP (1989=100)	100.3	105.0	104.4	102.2	122.7	98.9	97.8	111.1	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	na
Financial institutions									
Number of banks (of which foreign-owned)	na	40 (1)	45 (2)	45 (5)	44 (6)	41 (6)	36 (4)	34 (4)	34 (3)
Asset share of state-owned banks (in per cent)	na	na	na	47.8	39.8	41.7	40.7	40.1	41.3
Bad loans (per cent of total loans)	na	na	na	na	22.0	13.2	14.3	12.5	11.5
Credit to private sector (per cent of GDP)	na	34.9	23.3	22.1	22.5	27.5	28.8	28.6	32.5
Stock market capitalisation (per cent of GDP)	na	na	0.2	1.3	1.2	1.8	4.9	10.9	14.9
EBRD index of banking sector reform	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	3.0	3.0	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	3.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	4.0	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	73.3	73.4	73.3	73.3	73.4	73.5	74.5	74.7	na
Basic school enrolment ratio (per cent)	97.1	96.8	97.6	97.8	96.7	97.3	99.8	99.8	na
Earnings inequality (Gini coefficient)	23.2	27.3	26.0	27.6	27.5	35.8	29.8	30.7	na

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output and expenditure	(Percentage change in real terms)								
GDP	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.9	3.5
Private consumption	-11.0	-3.6	13.9	3.8	9.2	2.4	3.3	2.4	na
Public consumption	0.3	-1.7	5.3	2.1	2.5	3.6	4.3	4.8	na
Gross fixed investment	-11.5	-12.9	10.7	12.5	17.1	9.2	11.3	11.3	na
Exports of goods and services	-20.1	-23.5	0.6	10.5	1.0	3.3	11.3	6.8	na
Imports of goods and services	-22.4	-22.9	17.6	10.7	11.6	2.4	12.2	9.7	na
Industrial gross output	-11.6	-12.6	-2.5	6.4	2.0	3.1	6.4	4.6	na
Agricultural gross output	-2.5	-6.7	-4.2	4.2	1.6	1.1	-2.9	2.2	na
Employment	(Percentage change)								
Labour force (end-year)	na	na	0.3	-1.7	-0.9	-0.8	0.5	0.3	na
Employment (annual average)	-5.1	-4.1	-3.6	-1.3	-0.1	-0.4	0.2	-0.2	na
	(In per cent of labour force)								
Unemployment ¹	7.3	8.3	9.1	9.0	7.4	7.3	7.4	7.9	na
Prices and wages	(Percentage change)								
Consumer prices (annual average) ²	117.7	207.3	32.9	21.0	13.4	9.9	8.4	8.0	7.5
Consumer prices (end-year) ²	247.1	92.9	22.8	19.5	9.0	9.0	8.8	6.5	6.5
Producer prices (annual average)	124.1	215.7	21.6	17.7	12.8	6.8	6.1	6.0	na
Producer prices (end-year)	311.8	76.2	18.6	18.2	7.9	5.8	6.8	3.6	na
Net average monthly wages (annual average) ³	82.5	198.5	52.0	28.3	19.4	14.8	11.5	9.6	na
Government sector ⁴	(In per cent of GDP)								
General government balance	2.6	0.2	0.1	-0.3	-0.5	-0.2	-1.7	-1.4	-1.0
General government expenditure	41.1	45.6	46.7	46.1	45.7	44.9	45.7	46.2	na
Government debt	na	na	21.1	18.6	18.8	23.2	23.5	24.0	na
Monetary sector	(Percentage change)								
Broad money (end-year)	na	131.6	64.2	50.8	32.2	19.4	23.8	20.9	na
Domestic credit (end-year)	na	90.1	101.4	27.2	35.1	13.2	13.5	21.6	na
	(In per cent of GDP)								
Broad money	na	28.1	32.8	38.3	42.2	43.8	47.7	51.6	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate (average)	na	60.5	34.7	24.7	15.9	10.2	9.8	5.6	na
Treasury bill rate (on tolar part of twin bills)	na	50.9	30.2	26.3	19.4	10.3	14.5	8.7	na
Deposit rate ⁵	na	48.7	30.2	27.9	20.8	11.2	13.9	7.0	na
Lending rate ⁵	na	72.2	42.6	38.5	28.0	18.3	20.3	12.3	na
	(Tolar per US dollar)								
Exchange rate (end-year)	56.7	98.7	131.8	126.5	126.0	141.5	169.2	161.2	na
Exchange rate (annual average)	27.6	81.3	113.2	128.8	118.5	135.4	159.7	166.1	na
External sector ⁶	(In millions of US dollars)								
Current account	131	926	192	600	-23	39	37	-4	-150
Trade balance	-262	791	-154	-339	-954	-882	-772	-775	-936
Exports	3,869	6,683	6,083	6,829	8,350	8,370	8,407	9,095	9,596
Imports	4,131	5,892	6,237	7,168	9,305	9,252	9,179	9,870	10,532
Foreign direct investment, net ⁷	41	113	111	131	170	178	295	154	na
Gross reserves (end-year), excluding gold	112	716	770	1,480	1,802	2,279	3,297	3,573	na
External debt stock	1,866	1,741	1,873	2,258	2,970	4,010	4,176	4,959	na
	(In months of current account expenditures, excluding transfers)								
Gross reserves (end-year), excluding gold	0.4	1.2	1.2	2.1	2.0	2.5	3.6	3.7	na
	(In per cent of current account revenues, excluding transfers)								
Debt service	7.0	5.2	5.5	5.4	6.9	8.6	8.5	13.2	na
Memorandum items	(Denominations as indicated)								
Population (in millions, annual average)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of tolar)	349	1,018	1,435	1,853	2,221	2,555	2,907	3,249	3,615
GDP per capita (in US dollars)	6,333	6,280	6,370	7,231	9,418	9,439	9,103	9,779	na
Share of industry in GDP (in per cent)	36.0	32.1	29.3	30.3	28.4	27.9	28.0	27.5	na
Share of agriculture in GDP (in per cent)	5.2	5.2	4.5	4.0	3.9	3.8	3.7	3.8	na
Current account/GDP (in per cent)	1.0	7.4	1.5	4.2	-0.1	0.2	0.2	0.0	-0.7
External debt minus reserves (in US\$ millions)	1,754	1,026	1,103	778	1,168	1,731	879	1,386	na
External debt/GDP (in per cent)	14.7	13.9	14.8	15.7	15.8	21.2	22.9	25.4	na
External debt/exports (in per cent)	48.2	26.1	30.8	33.1	35.6	47.9	49.7	54.5	na

¹ Officially registered unemployment has been consistently higher and was 14.5% in 1998.

² Consumer price index since 1998, retail price index before that date.

³ Data for 1991 cover only the social (public) sector. Data for subsequent years take into account private enterprises employing three or more persons.

⁴ General government includes the state, municipalities and extrabudgetary funds. Privatisation revenues from state and socially owned enterprises are placed below the line. 1999 balances are based upon the new budget classifications.

⁵ Deposit rate refers to deposits of 31 to 90 days. Lending rate refers to short-term working capital.

⁶ Data for 1991 exclude transactions with former Yugoslav republics.

⁷ FDI definition changed in 1999 from at least 50 per cent participation in a company to at least 10 per cent.

Key reform challenges

- The maintenance of political stability is paramount to further reform progress and to sustain recent stabilisation successes.
- Progress in land privatisation has created incentives for efficiency improvements but needs to be complemented with privatisation of agribusinesses and improvements in marketing and finance for farmers.
- Industrial restructuring and entrepreneurial activity is being held back by weaknesses in the financial sector and in physical infrastructure. The reform of these sectors remains a priority, including their restructuring and commercialisation as well as more extensive and effective regulation.

Liberalisation

Liberalisation of the foreign trade and exchange rate regime progresses under the IMF programme.

Tajikistan has a liberal foreign trade and exchange regime, with a uniform import tariff of 5% as of 1998 (albeit with some exemptions for alumina, electricity and gas) and almost full current account convertibility, with acceptance of the IMF's Article VIII planned in the near future. Regular foreign exchange auctions have taken place since April 1998 without official restrictions. However, informal restrictions applied during late 1998 led to an increase in the parallel market spread to 20%. By June 1999, the spread was back down to 7% as informal restrictions were no longer applied. Tajikistan is preparing its application for WTO membership and in January 1998 joined the customs union with Russia, Kyrgyzstan, Kazakhstan and Belarus.

Stabilisation

A new tax code is set to lay the basis for improved revenue performance.

The main fiscal challenge lies in increasing revenues, which now stand at 12% of GDP. There is little room for further spending cuts, because of the need for basic rehabilitation investments and social expenditures following years of civil war. The new tax code effective from 1 January 1999 shifts the tax base from production (sales tax) toward consumption (excise tax). The change is expected to increase tax revenue by 1 percentage point of GDP. In addition, government will assign tax identification numbers to all enterprises by the end of 1999 and they will be taxed at source. The stock of tax arrears stood at 3% of GDP by end-1998.

Privatisation

Following rapid small-scale privatisation, attention has shifted to medium-sized and large enterprises.

The revision of the privatisation law in May 1997 restarted the privatisation process, which had been stalled by the civil conflict. By May 1999, 80% of small enterprises had been placed into private hands. The government is now focusing on the privatisation of medium-sized and large enterprises. By the end of 1998, 16% of enterprises in this category had passed to private ownership. The government plans to increase this share to 40% by September 1999. Twenty-two cotton ginneries, for which international tenders were issued in January 1999, were sold in three rounds of bidding. The third tender for 12 ginneries was concluded in June 1999 and raised US\$ 17 million (2% of GDP). Moreover, the domestic cotton trading company was auctioned off to a Swiss investor. However, major sectors of the economy – including heavy industry, wholesale trade and transport – remain largely in state ownership. Plans to sell minority stakes in power generation plants and in the large state-owned aluminium production plant are unlikely to materialise in the short run.

Progress continues in shifting land ownership to private hands.

In December 1996, the authorities passed a decree allowing farmers to be granted lifetime leases to farmland. Presidential and government decrees in June and July 1998 further extended private ownership rights over farmland to include the right to freely trade land leases. As a result, the share of privately farmed agricultural land is expected to increase from 24% in 1997 to more than 50% at the end of 1999. The Land Reform Committee is preparing for the break-up of large collective farms, still comprising slightly less than 50% of all farmed land. Despite progress in creating private land ownership, efficiency improvements in agriculture remain hampered by lack of access to finance and shortages of key inputs. A US\$ 50 million pre-financing arrangement with CSFB con-

Liberalisation, stabilisation, privatisation

1992

Jan Most prices liberalised
Jul Start of civil war

1993

Dec Wage indexation introduced

1994

Sep Interim cease-fire arranged

1995

May New currency (Tajik rouble) introduced
May Exchange rate unified
May State trading monopoly abolished
Aug Licences for agricultural trade eliminated
Dec Interest rates fully liberalised

1996

Mar Price controls on grain and bread lifted
May IMF programme adopted
Jul Tariffs of electricity reduced below the average cost
Dec Land privatisation started

1997

May Privatisation law revised
Jun Peace agreement concluded

1998

Jul Free tradability of land rights
Nov Regular credit auctions introduced

1999

Feb Membership in customs union with Russia, Belarus, Kazakhstan and Kyrgyzstan
Jun Tender for cotton ginneries completed
Jun Cotton trading company sold

cluded for 1998 was not renewed for 1999 as a result of low cotton prices and the government's refusal to grant new guarantees, contributing to a disappointing 1999 harvest.

Enterprise reform

Privatisation and liberalisation have set off divergent growth dynamics in the state and private sectors.

Private economic activity has displayed remarkable dynamism in recent years. Service sector growth, particularly in private catering and retail trade establishments, has outstripped average growth. This rather than privatisation *per se* lies behind a very rapid increase in the private sector share in GDP to more than 50% of GDP in 1999, up from 15% in 1994. Restructuring of state-owned companies by contrast has been slow. For instance, the country's only aluminium producer, which employs 12,000 people, has not yet been corporatised and retains

Enterprises, infrastructure, finance and social reforms

1991

Dec Central bank law adopted
Dec Joint-stock companies law adopted

1992

Jan VAT introduced
Mar Bankruptcy law enacted

1993

Dec Competition law adopted

1994

Jun Law on mortgages adopted

1995

Aug Banking regulations adopted

1997

Sep Reform of treasury system

1998

Apr Banking regulations amended
May New banking law adopted

1999

Jan New tax code effective
Apr Major bank liquidated

numerous non-core assets. Lack of restructuring has limited the interest of strategic outside investors, without which the necessary modernisation investments are unlikely to be financed. Foreign direct investment in Tajikistan amounts to just US\$ 159 million since 1991, or US\$ 25.6 per person.

Reform efforts focus on hardening budget constraints and the establishment of basic pillars of corporate law.

Financial discipline has been tightened significantly during the past 15 months. Directed credits from the National Bank of Tajikistan (NBT) to priority sectors have been reduced sharply to TJR 404 million (US\$ 0.51 million) in 1998, the majority of which goes to the cotton sector. Credit auctions have been held regularly since November 1998. State enterprises have been instructed to insist on payment before delivery and utilities to cut off non-paying customers. A new bankruptcy law and a new law on joint-stock companies are in the process of being revised, with the aim of completion by December 1999. They would introduce the basic features of a Western corporate law system. Beyond the adoption of new laws, however, their limited enforceability in a country still characterised by substantial political violence and very weak state capacity presents a serious obstacle to private investment.

Infrastructure

Transportation remains a serious bottleneck to economic development and national integration.

Tajikistan's mountainous geography creates substantial transportation problems. A key bottleneck is the lack of a railway linking the northern to the southern part of the country. Tajikistan's landlocked position and the limited access to international trade routes lie behind recent efforts to establish new trade routes and connections. Work is under way to build a 32-km, US\$ 55 million road from Murgab in the far east of Tajikistan to the Chinese border. When completed, this will be the first modern road between Tajikistan and China, and will give Tajikistan access to the subcontinent and the Indian Ocean via the Karakoram highway.

Power generation remains far below potential due to lack of investment and an inadequate tariff system.

Tajikistan's electricity production has fallen by around 30% since 1994. The power generation and transmission equipment is outdated and power cuts are frequent. The tariff structure creates few incentives for improvements in operational efficiency. The weighted average tariff is estimated at 0.45 US cents per kWh, which is much lower than long-run marginal cost of 3 US cents per kWh. In April 1999, tariffs were raised to 0.75 US cents and the state power company was entitled to cut off non-paying customers. The government is committed to a tariff review to move towards cost recovery by 2001.

Financial institutions

Banking sector consolidation begins, as prudential regulations are tightened.

The majority of Tajikistan's 19 banks are small and financially weak. The supervisory authority of the NBT has been strengthened with the May 1998 law on its independence. Following the revision of prudential regulations in April 1998, the NBT raised minimum capital requirements to US\$ 500,000 in January 1999 and US\$ 1 million by 2000. During 1998 seven banks had their licences revoked. However, in general the NBT's enforcement capacity remains weak due to lack of qualified staff.

The restructuring of five largest banks has begun under IMF/World Bank guidance.

The banking sector is dominated by five banks, the successor institutions to the Soviet Union's monobank system, and all controlled either directly or indirectly by the state or state enterprises. These banks accounted for about 90% of deposits and 85% of the total stock of commercial bank credit at the end of 1998. Under an IFI-led restructuring programme, the banks are being audited and are to progress towards meeting all prudential standards by the end of 2000 or they will have their licences revoked. Some progress was achieved during 1998, as four of the five banks reached positive net worth on average and the September 1998 target for loan-loss provisions of 25% of non-performing credits was reached. Also in accordance with IMF guidance, proposals for the establishment of a treasury bill market have been drawn up and amendments to the law on collateral are to be presented to parliament by end-1999.

Social reform

Stabilisation improves real incomes, but poverty remains severe.

Annual per capita income is less than US\$ 200 – by far the lowest of all transition economies. The governments limited social transfers are poorly targeted and arrears remain high. In an economy with an estimated 85% of the population earning insufficient income to buy a basic food basket, social transfers in 1998 totalled only TJR 4,785 million (US\$ 6.1 million). However, as inflation subsided, real incomes in 1998 rose for the first time since independence – by 19%. The minimum monthly wage was raised to TJR 1,000 from TJR 322 in 1998. With around 70% of the population living in rural areas, a revival of the agricultural sector is perhaps most crucial to the alleviation of poverty.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – direct sales	Independent telecoms regulator – no	Share of the population in poverty – 85%
Interest rate liberalisation – limited de facto	Secondary privatisation method – vouchers	Separation of railway accounts – no	Private pension funds – no
Wage regulation – yes	Tradability of land – limited de facto	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 13.3%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system – no	
		Secured transactions law – yes	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	4.0	2.0	2.0	1.0	1.0	1.0	1.0
Share of exports to non-transition countries (per cent)	na	na	na	na	56.1	32.2	33.7	25.6	na
Share of trade in GDP (per cent)	na	na	na	77.1	75.2	165.5	74.0	68.3	53.9
Tariff revenues (per cent of imports)	na	na	na	1.0	4.2	0.9	0.6	2.7	5.8
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	2.7	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	1.0	2.0	2.0	2.0	2.7
Privatisation									
Share of small firms privatised	na	1.0	13.0	16.0	22.0	28.0	36.0	50.0	70.0
Privatisation revenues (cumulative, per cent of GDP)	na	0.0	0.7	0.9	1.2	1.5	1.7	2.2	2.8
Private sector share in GDP	10.0	10.0	10.0	10.0	15.0	15.0	20.0	20.0	30.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	2.0	2.0	2.0	2.3
EBRD index of large-scale privatisation	na	na	na	na	2.0	2.0	2.0	2.0	2.0
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	10.9	8.0	12.3	6.9	0.7	0.6	na
Efficiency of tax collection for social security (per cent)	na	na	40.0	48.6	78.4	na	na	21.4	na
Share of industry and construction in total employment (per cent)	21.7	20.5	20.0	18.1	17.0	14.3	14.4	12.0	na
Change in labour productivity in industry (per cent)	-1.5	-1.7	-22.5	8.2	-22.5	-3.2	-23.1	16.6	na
Investment rate (per cent of GDP)	na	na	na	23.1	22.3	17.4	na	na	na
EBRD index of enterprise reform	na	na	na	na	1.0	1.0	1.0	1.0	1.7
EBRD index of competition policy	na	na	na	na	na	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	4.5	4.7	4.8	4.6	4.5	4.5	4.2	3.8	3.7
Railway labour productivity (1989=100)	na	na	na	na	na	na	na	na	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	na	na	na	na	na
Electricity consumption/GDP (1989=100)	102.6	100.7	134.6	140.8	169.4	186.9	193.7	154.9	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.1
Financial institutions									
Number of banks (of which foreign-owned)	na	1 (na)	10 (na)	15 (na)	17 (na)	18 (na)	23 (na)	28 (5)	20 (5)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	5.5	30.3	21.9
Bad loans (per cent of total loans)	na	na	na	na	na	na	2.9	3.0	3.2
Credit to private sector (per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	0.0	0.0
EBRD index of banking sector reform	na	na	na	na	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	1.0	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	na	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	na	3.0
Social sector									
Expenditures on health and education (per cent of GDP)	20.3	17.4	11.7	8.5	14.5	3.9	3.5	3.4	3.3
Life expectancy at birth, total (years)	69.3	70.3	68.2	62.2	66.0	68.3	na	68.3	na
Basic school enrolment ratio (per cent)	94.0	94.2	89.6	85.1	86.4	86.6	85.0	85.5	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

	1991	1992	1993	1994	1995	1996	1997	1998 <i>Estimate</i>	1999 <i>Projection</i>
Output	<i>(Percentage change in real terms)</i>								
GDP	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	5.0
Industrial gross output	-3.6	-24.3	-7.8	-25.4	-13.5	-24.0	-2.1	8.0	na
Agricultural gross output	-4.4	-34.8	-7.1	-6.5	-25.9	2.0	3.6	6.5	na
Employment	<i>(Percentage change)</i>								
Labour force (annual average)	2.3	5.9	-2.5	0.6	7.2	1.0	2.4	na	na
Employment (annual average)	1.7	-3.2	-3.3	-0.1	0.5	-6.6	3.4	na	na
	<i>(In per cent of labour force)</i>								
Unemployment (annual average) ¹	na	0.3	0.8	1.2	1.3	1.6	1.8	3.1	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	112	1,157	2,195	350	609	418	87.8	43.2	30
Consumer prices (end-year)	204	1,364	7,344	1.1	2,133	40.5	163.6	2.7	55
Producer prices (annual average)	163	1,320	1,080	328	1,080	449	96	27.8	na
Producer prices (end-year)	184	5,926	5,996	302	628	78	122	8.6	na
Gross average monthly wages (annual average)	64.3	461.5	746.3	116.1	109.4	283.7	77.4	65.0	na
Government sector ²	<i>(In per cent of GDP)</i>								
Central government balance	-16.4	-30.5	-23.4	-5.4	-11.9	-5.8	-3.3	-3.8	-3.0
Central government expenditure	49.6	65.7	60.7	61.4	29.4	17.9	17.0	15.8	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	68	579	1,429	159	471	93.2	110.7	9.5	na
Domestic credit (end-year)	na	na	na	125	393	146	171	16.7	na
	<i>(In per cent of GDP)</i>								
Broad money	na	na	81.0	83.1	20.5	8.3	8.0	5.9	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Inter-bank interest rate (up to 30-day maturity)	na	na	na	na	153	72	81	33	na
Deposit rate (up to 3-months maturity) ³	30	30	30	30	100	85	89	80	na
Lending rate (up to 3-months maturity) ³	30	30	30	30	500	124	74	73	na
	<i>(Tajik roubles per US dollar)</i>								
Exchange rate (end-year) ⁴	134	511	1,247	3,550	285	328	747	977	na
Exchange rate (annual average) ⁴	33.7	226.2	1,018	2,205	135	298	564	788	na
External sector	<i>(In millions of US dollars)</i>								
Current account	na	53	-208	-170	-90	-76	-60	-140	-50
Trade balance	na	-55	-159	-100	-32	9	-39	-129	-57
Exports	na	na	456	559	779	770	746	637	681
Imports	na	na	615	659	811	761	785	766	738
Foreign direct investment, net	na	na	9	12	20	25	30	34	29
Gross reserves (end-year), excluding gold	na	na	2	1	4	14	30	65	na
External debt stock	na	na	509	760	817	868	1,180	1,319	na
	<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), excluding gold ⁵	na	na	0.0	0.0	0.1	0.3	0.6	1.3	na
	<i>(In per cent of exports of goods and services)</i>								
Debt service (due) ⁶	na	na	5.7	9.7	28.9	32.8	13.9	13.3	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	5.6	5.6	5.7	5.8	5.9	5.9	6.0	6.1	na
GDP (in billions of roubles until 1994, billions of Tajik roubles thereafter)	10.5	64.8	707.1	1,786	64.8	308.5	676.0	1,025	1,350
GDP per capita (in US dollars)	56	52	122	141	82	174	198	213	na
Share of industry in GDP (in per cent) ⁷	31.6	36.4	32.8	22.1	35.3	20.5	19.7	45.7	na
Share of agriculture in GDP (in per cent) ⁷	26.1	27.1	21.0	19.0	15.3	27.7	27.1	8.8	na
Current account/GDP (in per cent)	na	18.4	-29.9	-21.0	-18.7	-7.3	-5.0	-10.8	-4.2
External debt minus reserves (in US\$ millions)	na	na	507	759	813	854	1,150	1,254	na
External debt/GDP (in per cent)	na	na	73.3	93.8	170.1	83.9	98.4	101.4	na
External debt/exports (in per cent)	na	na	111.6	136.0	104.9	112.7	158.2	207.0	na

¹ Officially registered unemployed. The World Bank estimates the true unemployment rate in 1998 at about 30% of the labour force.

² Excludes transfers from the state budget to the pension fund and employment funds.

³ Interest rates were set by parliament until June 1995.

⁴ Roubles per US dollar until 1994; Tajik roubles per US dollar thereafter.

⁵ Imports of goods, excluding alumina and electricity.

⁶ In per cent of exports of goods and services less alumina imports and electricity exports.

⁷ Figures are based on current prices.

Key reform challenges

- **State interference in economic activity needs to be scaled back through the completion of price liberalisation and the implementation of a privatisation programme.**
- **The hardening of budget constraints for state enterprises is necessary to accelerate restructuring, while redressing serious fiscal and quasi-fiscal imbalances.**
- **Unification of the exchange rate by allowing the official rate to depreciate to the market rate would stimulate exports and stabilise foreign currency reserves.**

Liberalisation

Selective price subsidies and state procurement in key agricultural commodities are maintained.

Turkmenistan is one of the few transition economies where price controls remain in effect outside of public utilities and rents. The domestic prices of flour, bread, petrol and building materials are subject to control and are substantially below world market levels. The price of petrol was increased early in 1998, but this was quickly reversed. State procurement remains in place for raw cotton and wheat, at prices representing less than half of their value on world markets.

Restrictions in access to foreign exchange persist.

While Turkmenistan has few tariff and non-tariff barriers, foreign trade remains tightly constrained through restrictions on access to foreign exchange. The official exchange rate is overvalued, having been fixed since the unification of the official and commercial bank rates in April 1998. Enterprises may apply for foreign exchange through the banking system to purchase capital equipment or to repay foreign currency loans. Eligibility does not guarantee the allocation of foreign exchange, however, leaving considerable scope for government discretion. Consequently, there is a large parallel foreign exchange market, with a parallel rate premium over the official rate of around 200% in June 1999.

Stabilisation

Renewed disruption of gas exports undermines stabilisation.

Turkmenistan has successfully reduced inflation since early 1997 through tightening monetary policy and sales of foreign exchange to absorb excess liquidity. This policy has recently come under severe strain due to lack of confidence in the manat following the Russian crisis and increasing shortages of hard currency revenues. In December 1998 Turkmenistan agreed to renew exports of gas to Ukraine, planning deliveries of 20 billion cubic metres (bcm) in 1999 (for a value of US\$ 720 million, paid half in cash and half in barter). However, deliveries of 3.5 bcm during the first quarter remain unpaid and

gas sales were stopped in April at the request of the Ukrainian government. The resulting foreign exchange shortfall is likely to put further pressure on the manat, as well as complicate significant foreign debt repayments, estimated at US\$ 600 million in 1999. Central bank reserves stood only at around US\$ 20 million in June 1999. Additional reserves of US\$ 1.3 billion, half of which are pledged against foreign loans, are directly under the president's control and not available for monetary policy.

Persistent government imbalances lead to mounting foreign debt.

The budget operates increasingly on a non-cash basis, with mutual offsets, barter and payments in-kind clouding the government's underlying net position. Cash revenues accounted for only 41% of the total in 1998. The central budget deficit on a commitment basis was around 4% of GDP in 1998. This figure excludes deficits of the state funds (agriculture, cotton, oil and gas). The quasi-fiscal deficit – central budget deficit plus deficits of the state funds – was around 15% in 1998, financed mainly through foreign borrowing, which stood at US\$ 1.8 billion (around 120% of GDP) at the middle of 1999. The government has also extended substantial subsidised directed credits to the agricultural sector. The latter are rarely paid back, effectively resulting in money creation by the central bank.

Privatisation

The sale of medium-sized enterprises has been initiated ...

Twenty-three medium-sized enterprises were privatised in the first half of 1999, ten of these in textiles, seven in food, and one in electric appliances. Sale prices ranged from TMM 20 million to TMM 1 billion (US\$ 4,000 to US\$ 200,000) and all buyers were local. By the middle of 1999, there were around 24,000 privately owned companies – 80% of all registered companies – mostly in the small business sector.

Liberalisation, stabilisation, privatisation

1991

Oct Independence from Soviet Union

1993

Oct Gas exports to Europe interrupted
Oct VAT introduced
Nov New currency (manat) introduced
Nov Foreign exchange law adopted

1994

May Small-scale privatisation begins
Aug State trading monopoly reinforced
Sep National privatisation programme adopted

1995

Jan State treasury system introduced
Jul Flat rate income tax introduced

1996

Jan Legal unification of exchange rate
Jan Most prices liberalised
May Barter trade in cotton, oil, wool banned
Aug First T-bill issued
Dec Land reform decreed

1997

Mar Gas deliveries halted to non-paying CIS customers
Apr Large-scale privatisation law adopted

1998

Apr Exchange rate unified
Sep Large forex premium on parallel market re-emerges

1999

Jan Gas exports to Ukraine resumed
Apr Gas exports to Ukraine again interrupted

... but progress remains very limited and state control over the enterprise sector is pervasive.

The private sector outside of agriculture accounts for less than 10% of GDP. All the large enterprises – including cotton ginneries, building material plants and food processing – remain in the public sector. 280 medium-sized and large enterprises await privatisation. Implementation is likely to be difficult, particularly due to the practice of setting unrealistically high reservation prices, limited ownership rights regarding the land under enterprises, and social obligations placed upon firms to be transferred to the private sector. The government has yet to adopt a coherent privatisation programme that would set the stage for rapid divestment of the state from economic activity.

Enterprises, infrastructure, finance and social reforms

1992

Jun Bankruptcy law adopted

1993

Oct Company legislation enacted

Nov Two-tiered banking system established

1995

Dec Inter-bank market established

1996

Apr BIS capital adequacy enacted

1997

Mar Hydrocarbon resources law enacted

Dec Gas pipeline to Iran opened

1998

Dec Directed credits officially abolished

Dec Merger of private and state bank decreed by government

Dec New civil code adopted

1999

Mar Framework gas sale agreement signed with Turkey

Jul Agreement for construction of trans-Caspian gas pipeline signed

Enterprise reform

The enterprise sector is largely unstructured due to soft budget constraints.

The government continues to use the natural resource sector and its foreign exchange earnings to subsidise a largely outmoded domestic enterprise sector. As foreign currency revenues have fallen, liquidity has tightened and inter-enterprise arrears have grown 25% in 1999 so far, to around 30% of GDP. Combined losses in the enterprise sector were around TMM 420 billion (3% of GDP) in 1998.

State interference in private companies remains pervasive.

There is frequent interference in the running of private companies. For example, the chairman of a private pharmaceutical company was recently removed from office by order of the state. Company registration remains problematic and government regulation unpredictable. After abolishing tax exemptions on corporate income taxes for SMEs in early 1998, this decision was later revoked when the costs to small business had become apparent.

The oil and gas sector is being restructured.

The oil and gas sector is advancing with the introduction of international accounting standards and the drafting of unified rules for the development of oilfields. Both measures are in line with the law on hydrocarbon resources adopted in 1997. The Turkmen authorities and Tacis-financed consultants are close to finalising a model for the reorganisation of the oil and gas sector. Restructuring will involve spinning off non-core activities and setting up separate oil and gas companies (Turkmenneft and Turkmengas). A joint venture recently agreed between Turkmenistan, Mobil (US) and Monument (UK) will allow the development of a new oilfield containing reserves estimated at 4.5 billion tonnes; associated investment commitments are valued at around US\$ 450 million.

Infrastructure

Reform of public utilities remains negligible.

There has been no commercialisation of infrastructure: utilities remain to be corporatised, tariffs rebalanced, and there seems little prospect of private involvement and industry liberalisation. Price subsidies are substantial: households have free access to water and pay nominal sums for electricity and gas. For example, the household rate for electricity is a fixed charge of TMM 30,000 per month (US\$ 6 at the official exchange rate). Enterprises pay slightly more, but still well below cost-recovery levels.

Plans to build a new gas pipeline to Turkey have progressed.

Turkmenistan is at present dependent on the Russian pipeline system for exports of gas, with the exception of a small pipeline to Iran. Following the conclusion of a long-term delivery agreement for 20 bcm annual gas shipments to Turkey, preparations for the construction of a trans-Caspian pipeline via Azerbaijan and Georgia into Turkey (and ultimately to the markets of southern and western Europe) have gathered momentum. A pipeline consortium led by Bechtel Enterprises and General Electric Capital has been formed, a partnership with Shell Exploration entered into, and a financial adviser, CFSB, named. Consortium shareholders will together contribute between US\$ 500 million and US\$ 1 billion for development and construction of the pipeline. However, there may be problems raising the additional US\$ 2 billion finance required, as it is not clear who will provide the necessary political risk guarantee. The US government supports the pipeline proposal, raising the possibility that a guarantee could be issued by US EXIM Bank. The trans-Caspian pipeline faces competition from a project to reach the

Turkish market from Russia with a pipeline under the Black Sea. A further potential obstacle to the project is the recent discovery of large gas reserves in Azerbaijan.

Financial institutions

The banking system remains prone to government intervention.

The banking system is dominated by five state banks, controlling over 85% of total assets, whose lending decisions remain under government influence. Repeated government announcements that directed credits to the agricultural sector would be phased out have not been followed through, as particularly the agricultural sector has no commercial sources of working capital finance. A recent example of state interference in the banking sector was in December 1998, when a proposal by the President to merge a state and a private bank received parliamentary approval. The chairman of the private bank was subsequently removed.

Banks are undercapitalised and lending to the private sector is small.

The banking system does not meet international standards for capital adequacy. Banks continue to extend credit predominantly to state companies. Repayment is poor, with 40% of outstanding loans non-performing by June 1999. Only 15.8% of short-term loans, totalling around TMM 160 billion, were extended to the private sector. Longer-term loans backed by foreign currency from the EBRD and the Central Asia Enterprise Fund amount to less than US\$ 5 million. Banks do not use IAS, though the central bank intends to introduce this requirement by 2001.

Social reform

Social protection is likely to suffer from the fiscal crisis.

There have been no recent changes to the social safety net. While there is no officially recorded unemployment and no unemployment benefit, the actual level of unemployment is likely to be about 20%. The minimum wage and pension remain at TMM 36,000 per week (US\$ 7 at the official exchange rate). Wage and pension arrears are reportedly increasing, although hard evidence is unavailable. Though water is free, there are frequent shortages due to under-investment. Benefits are paid for maternity, child-care and disability.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – limited	Primary privatisation method – MEBOs	Independent telecoms regulator – no	Share of the population in poverty – 48%
Interest rate liberalisation – full	Secondary privatisation method – direct sales	Separation of railway accounts – no	Private pension funds – no
Wage regulation – yes	Tradability of land – limited de jure	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 26.3%	Competition office – no	Capital adequacy ratio 1 – 10%	
Exchange rate regime – fixed		Deposit insurance system – no	
		Secured transactions law – restricted	
		Securities commission – no	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Share of exports to non-transition countries (per cent)	na	na	na	na	34.3	38.8	31.4	26.8	na
Share of trade in GDP (per cent)	na	na	na	39.1	86.6	74.1	83.1	48.0	46.5
Tariff revenues (per cent of imports) ²	na	na	na	na	na	0.1	0.2	0.4	na
EBRD Index of price liberalisation	na	na	na	na	2.0	2.0	2.0	2.0	2.0
EBRD Index of forex and trade liberalisation	na	na	na	na	1.0	1.0	1.0	1.0	1.0
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	0.1	0.1	0.1	0.1	0.2
Private sector share in GDP	10.0	10.0	10.0	10.0	15.0	15.0	20.0	25.0	25.0
EBRD index of small-scale privatisation	na	na	na	na	1.0	1.0	1.0	2.0	2.0
EBRD index of large-scale privatisation	na	na	na	na	1.0	1.0	1.0	2.0	1.7
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	na	na	1.0	1.1	0.8	0.7	na
Efficiency of tax collection for social security (per cent)	na	na	na	na	na	na	na	na	na
Share of industry and construction in total employment (per cent)	20.8	20.8	20.2	20.7	20.1	19.3	18.5	18.0	na
Change in labour productivity in industry (per cent)	-0.5	9.4	-12.3	-5.9	-22.9	-6.3	19.6	-29.8	na
Investment rate (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of enterprise reform	na	na	na	na	1.0	1.0	1.0	1.7	1.7
EBRD index of competition policy	na	na	na	na	na	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	6.0	6.3	6.5	6.8	7.6	7.1	7.4	8.2	na
Railway labour productivity (1991=100) ³	na	100.0	74.8	60.4	42.2	26.3	28.7	27.9	na
Electricity tariffs, Ucc/kWh (collection rate in per cent) ⁴	na	na	na	na	na	na	na	na	na
Electricity consumption/GDP (1989=100)	102.3	106.4	74.3	76.0	78.0	84.5	84.6	127.8	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.1
Financial institutions									
Number of banks (of which foreign-owned) ⁵	na	na	na	na	na	67 (3)	68 (4)	67 (4)	13 (4)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	26.1	64.1	68.3	77.8
Bad loans (per cent of total loans)	na	na	na	na	na	11.2	11.4	13.9	2.2
Credit to private sector (per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	1.0	1.0	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	na	na
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	na	na
Social sector									
Expenditures on health and education (per cent of GDP)	9.5	9.4	6.2	6.3	3.3	3.1	4.5	9.2	na
Life expectancy at birth, total (years)	66.2	65.7	na	na	na	na	na	65.7	na
Basic school enrolment ratio (per cent)	94.9	92.5	91.7	92.0	91.8	83.9	83.2	83.1	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ Calculated with a risk weight of zero for all loans to state-owned enterprises which are thus implicitly assumed to be fully guaranteed by the state.

² Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.

³ Data for 1989 and 1990 were unattainable. The index starts in 1991.

⁴ Households are entitled to a free electricity allowance of 45 kWh per family member per month; excess usage is charged at just under 1 US cent per kWh.

⁵ The number of banks until 1997 includes all branches of agricultural bank. In 1998 these were unified into one agricultural bank.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-4.7	-5.3	-10.0	-18.8	-8.2	-8.0	-26.1	4.2	17.0
Industrial gross output ¹	4.8	-14.9	5.4	-25.0	-6.0	19.0	-20.0	5.0	na
Agricultural gross output	na	-9.0	8.0	-11.0	-7.0	-49.0	14.0	30.0	na
Employment	(Percentage change)								
Labour force (end-year)	2.6	2.7	2.9	2.5	10.9	4.0	na	na	na
Employment (end-year)	1.9	0.1	4.4	1.4	0.5	0.4	-0.2	na	na
	(In per cent of labour force)								
Unemployment ²	2.0	na	na	na	3.0	na	na	na	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	103	493	3,102	1,748	1,005	992	83.7	16.8	30.0
Consumer prices (end-year)	155	644	9,750	1,328	1,262	446	21.5	19.8	40.0
Gross average monthly wages in industry (annual average)	na	na	na	na	686	969	135	na	na
Government sector ³	(In per cent of GDP)								
General government balance	2.5	13.2	-0.5	-1.4	-1.6	-0.2	0.01	-2.7	-4.0
General government expenditure	38.2	42.2	19.2	10.4	12.5	16.9	29.2	na	na
Monetary sector	(Percentage change)								
Broad money M3 (end-year)	na	na	na	984	454	413	82	50	na
Domestic credit (end-year)	na	na	na	915	405	1,391	88	75	na
	(In per cent of GDP)								
Broad money M3	na	na	22.0	15.6	11.3	8.2	11.8	na	na
Interest and exchange rates	(In per cent per annum, end-year)								
Inter-bank interest rate (up to 30-day maturity) ³	na	na	na	na	55.0	121.4	38.6	na	na
Treasury bill rate (one-month maturity) ³	na	na	na	150	60	120	40.0	na	na
Deposit rate (one year) ⁴	na	na	50	206	80	130	47.2	na	na
Lending rate (one year) ⁴	na	na	108	300	70	200	48.7	na	na
	(Manat per US dollar)								
Official exchange rate (end-year)	na	na	2	75	200	4,070	4,165	5,200	na
Official exchange rate (annual average)	na	na	2	19	111	3,232	4,143	4,890	na
Commercial exchange rate (end-year) ⁵	na	na	30	75	2,400	5,055	5,090	12,100	na
Commercial exchange rate (annual average) ⁵	na	na	na	63	426	3,924	5,256	6,493	na
External sector	(In millions of US dollars)								
Current account	na	na	776	85	23	44	-595	-934	-160
Trade balance ⁶	590	1,140	1,100	485	440	159	-245	-523	90
Exports ⁶	1,238	2,149	2,693	2,176	2,084	1,691	759	614	1,099
Imports ⁶	648	1,009	1,593	1,691	1,644	1,532	1,004	1,137	1,009
Foreign direct investment, net	na	na	79	103	233	129	108	110	100
Gross reserves (end-year), excluding gold ⁷	na	na	818	927	1,165	1,172	1,287	1,137	na
External debt stock	na	na	168	418	550	667	1,360	1,749	na
	(In months of current account expenditures, excluding transfers)								
Gross reserves (end-year), excluding gold ⁷	na	na	6.2	5.1	6.3	7.9	10.5	11.0	na
	(In per cent of current account revenues, excluding transfers)								
Debt service	na	na	na	-1.8	-12.6	-16.6	-34.6	-82.8	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	3.8	3.8	3.9	4.0	4.5	4.7	4.7	4.8	na
GDP (in billions of manat)	na	na	na	141	1,072	7,752	11,109	13,241	19,000
GDP per capita (in US dollars)	na	na	1,191	552	562	424	450	421	na
Share of industry in GDP (in per cent)	20.0	59.0	55.1	73.2	52.2	50.0	44.3	na	na
Share of agriculture in GDP (in per cent)	46.0	19.0	11.5	9.0	30.3	17.5	19.8	na	na
Current account/GDP (in per cent)	na	na	16.5	3.8	0.9	2.2	-28.2	-45.8	-9.3
External debt minus reserves (in US\$ millions)	na	na	-650	-509	-615	-505	73	370	na
External debt/GDP (in per cent)	na	na	3.6	18.7	21.9	33.8	64.4	85.8	na
External debt/exports (in per cent)	na	na	6.2	19.2	26.4	39.4	179.2	248.9	na

¹ Official data, which do not include gas and electric power, cotton ginnery, and cooking oil industries. EBRD estimates suggest that output decline in 1997 would be closer to 30% if these items were included, while industrial output in 1998 would register a mild decline.

² Every Turkmen citizen is guaranteed employment, thus official unemployment does not exist. 1991 and 1995 figures are household survey estimates, but do not take account of substantial public sector overemployment.

³ General government includes the state, municipalities and some extrabudgetary funds. However, until 1997, most quasi-budgetary expenditures of sectoral ministries fell outside the budget and several off-budget funds were in operation. When state funds are taken into account, the 1998 deficit would be closer to 15%.

⁴ Deposit and lending rates are quoted for legal entities at joint-stock banks accounting for the bulk of financial transactions in the banking sector. Lending and deposit rates for 1993-96 are the highest of the total range. All interest rates are annual, uncompounded.

⁵ Refers to the rate at which citizens can purchase foreign exchange. Access to official rate is very limited.

⁶ From 1996 exports of gas are recorded free-on-board and transit costs are added to imports.

⁷ Foreign exchange reserves of the central bank plus the foreign exchange reserves fund. The ratio is to merchandise imports only in 1993.

Key reform challenges

- **Privatisation of remaining large industrial firms and public utilities needs to focus on attracting strategic investors to provide much-needed capital and new technology, and to improve corporate governance.**
- **Further deregulation and a reduction in the tax burden are required to promote the growth of the new private sector, especially of SMEs, within the formal economy.**
- **Access to bank financing remains an impediment to investment and output recovery, highlighting the urgency of strengthening the financial sector.**

Liberalisation

Trade and exchange restrictions introduced after the Russian crisis are being scaled back.

Most of the foreign exchange restrictions imposed in September 1998 were removed in the first half of 1999, although the 50% export revenue surrender requirement remains. In June the number of items on the critical import list (which are exempt from VAT until 2001) was lowered from over 200 to 48. However, a uniform 2% import surcharge was imposed for six months from the beginning of July, primarily to raise revenue. Various licences and permits are still required to engage in foreign trade.

Stabilisation

Budget deficit declines but fiscal consolidation remains fragile owing to budgetary arrears and generous tax exemptions.

Although direct budget subsidies to the economy have fallen, the government continues to give support to various groups via budget allocations. This support includes guarantees on foreign exchange loans by some enterprises and tax exemptions for special groups. For example, certain energy products remain exempt from VAT while agricultural producers received a two-year holiday on the payment of all taxes from the beginning of 1999. One consequence is that the tax burden is heavier on profitable enterprises. Tax arrears (including contributions to the pension fund) rose sharply during 1998, by over 8.5% of GDP, and netting operations have restricted the amount of revenue received as cash. As part of its fiscal consolidation efforts, over the last year the government has reduced the rate of payroll tax in two stages (from 49% to 39%) and introduced payment of VAT on an accruals basis. In June the government submitted a draft tax code to the Rada (parliament) which could lead to more comprehensive tax reform.

The exchange rate has fallen sharply since the Russian crisis.

By August 1999 the Ukrainian hryvnia had halved in value against the US dollar since the onset of the Russian crisis. With limited foreign exchange reserves, the National Bank of Ukraine (NBU) resorted to a range of temporary currency controls to slow the

decline. In February 1999 the NBU announced a new currency band (of UAK 3.4-4.6/US\$) and relaxed most of the foreign exchange controls by the end of June. The weakness of the exchange rate partly reflected concerns over funding the budget deficit. Public debt reschedulings with domestic banks have dried up the treasury bill market and current funding relies heavily on NBU purchases of state debt as well as IFI assistance. Shortages and the resulting higher prices of imports of petroleum products resulted in a sudden increase in the demand for hard currency in July, and by end-August the official rate was UAK 4.4/US\$.

Privatisation

The 1999 privatisation programme intends to promote cash sales.

Privatisation in Ukraine to date has predominantly taken the form of sales to management and employees or of voucher privatisation, leaving industry with little access to new capital. Small-scale privatisation is virtually complete. The Rada extended the mass (voucher) privatisation programme beyond the end of 1998, but this too is now almost completed with at least 9,500 enterprises more than 70% privatised. Over a quarter of the 200 larger enterprises originally identified for case-by-case privatisation through open tender have been privatised, although relatively few strategic investors have participated owing to a lack of transparency of procedures. The rationale behind the current privatisation programme is to promote cash sales by selling stakes in over 450 medium-sized and large enterprises (including some utilities), with revenues of UAK 800 million (US\$ 200 million) expected.

Privatisation has continued in the agricultural sector ...

Privatisation of the grain elevators originally owned by Khlib Ukrainy (KU) commenced in late 1997. By mid-1999, privatisation plans for most of the 442 elevators originally included in the IMF programme were under way and over 402 were more than 70% privatised. These developments should eventually strengthen competition in the grain market. However, the state retains a minority share in the elevators and owns KU (also responsible for the supply of inputs and grain procurement).

Liberalisation, stabilisation, privatisation

1991

Aug Independence from Soviet Union

1992

Mar Small and large-scale privatisation begins
Nov Interim currency (karbovanets) introduced
Dec VAT introduced

1993

Jan Income tax law adopted
Aug Multiple exchange rates reintroduced

1994

Oct Most prices liberalised
Oct Most export quotas and licences abolished
Oct Exchange rate unified
Nov Voucher privatisation begins

1995

Jan New corporate profit tax introduced
Mar T-bills market initiated
Dec Indicative export prices removed

1996

Jan Licensing requirement for grain exports abolished
Sep New currency (hryvnia) introduced

1997

Apr Full current account convertibility introduced
Jun Export surrender requirement revoked
Jul New corporate tax rate introduced
Oct VAT rate changed

1998

Mar Limits on auto imports
Sep Foreign exchange restrictions re-introduced, including surrender requirement
Sep Currency band widened
Sep Domestic debt rescheduling starts
Dec Agricultural sector given VAT exemption

1999

Feb Currency band widened further
Mar Ban on trading on the inter-bank currency market lifted by NBU
Jul Temporary import surcharge introduced

... but prospects for the sector as a whole are constrained by the lack of a land market.

The development of the agricultural sector is constrained by the sensitive issue of private land ownership. The lack of a land market has prevented land being used as collateral, thus severely limiting the availability of funding. In February, the Rada rejected

Enterprises, infrastructure, finance and social reforms

1991

Mar	Land code enacted
Oct	Central bank law adopted
Dec	Securities and stock exchange law adopted

1992

Feb	Competition agency established
May	Bankruptcy law enacted
Jun	Stock exchange begins trading

1995

Jun	Securities and exchange commission established
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1996

Mar	Grado bank placed under forced administration
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1997

Mar	Land code amended
Aug	First sovereign Eurobond

1998

Jan	IAS introduced for commercial banks
May	Limits on foreign bank ownership abolished

1999

Apr	Large increase in utility tariffs
Jun	New central bank law approved
Aug	Presidential decree on privatisation of electric power utilities

a presidential decree on the sale and purchase of non-agricultural land owing to concerns over land speculation. Reform in this area is now more likely to focus on land leasing. Although most farms remain collectivised, the private sector accounts for a significant share of the output of certain products.

Enterprise reform

The business sector continues to be affected by high taxes and excessive regulation.

The high tax burden is one of the main constraints on increasing output in the formal economy, and has contributed to further growth of the informal economy, to perhaps half of GDP according to some estimates. The tax burden includes complex compliance procedures, especially for VAT, as well as the number of taxes enterprises have to pay. Since January these have included a stamp duty and a 10% depreciation charge on fixed assets. The government has, however, introduced tax concessions to promote SMEs. Despite some progress in simplifying the regulation and licensing procedures, enterprises are still required to obtain

numerous permits and licences to conduct business and engage in foreign trade. The difficult investment climate has generally discouraged FDI, the flow of which remained low at US\$ 747 million in 1998 (US\$ 15 per capita).

The lack of financial discipline is reflected in the growth of non-monetary transactions.

In 1998 barter transactions accounted for over 40% of industrial sales. The amount of gross payables among enterprises increased by UAK 35 billion during 1998 – one-third of GDP – and continued to grow strongly this year. By May 1999 the volume of overdue payables was more than 80% of GDP. Non-monetary forms of settlement have kept loss-making enterprises afloat, which last year represented over half of the total in industry. The *kartoteka* system (whereby the government can freeze bank accounts of enterprises suspected of tax evasion) has also limited the incentives for enterprises to use the banks, although the President recently proposed its abolition. The weakness of bankruptcy enforcement has been one of the main reasons for the weak financial discipline. There has been some improvement in implementing existing legislation, with the number of bankruptcy cases increasing from 5,000 in 1996 to 9,000 in 1998. A new bankruptcy law was approved in August 1999 and will take effect from next year.

Infrastructure

Some progress has been made in raising utility charges ...

In April the government increased residential electricity and gas tariffs by 20% and 25% respectively following a ruling by the Constitutional Court that the Rada's attempt to block the increases was unconstitutional. Increases in other communal tariffs from May were reversed in many regions following a decision by the Rada that these should only apply once arrears on wages and pensions had been met. It is estimated that over 2 million families require state support to meet the higher charges.

... but privatisation of utilities has been slowed by reluctance to concede majority control to strategic investors.

Progress with the privatisation of Ukrtelecom has been slowed by opposition in the Rada. A June 1999 presidential decree states that a 25% stake will be sold for cash to a strategic investor via open tender, with the state retaining 50%. However, the Rada immediately voted against the proposal. Privatisation of the power distribution companies has been delayed. After selling seven of the 27 companies to financial investors last year, the government halted the programme to enable the procedures to be clarified to attract strategic investors. The main problems were the design of the tenders and the difficulties that some of the new

owners had in improving cash collection. In August a Presidential decree announced the sales of shares in the power companies (both distribution and generation) to strategic investors, including the sale of majority stakes in seven distribution companies.

Financial institutions

The banking sector has been weakened by the Russian crisis.

In May 1999 there were 171 operating banks in Ukraine, of which 29 had foreign capital. Banks' capital, estimated at US\$ 1.2 billion at the start of 1999, was affected by the devaluation of the hryvnia. Bank profitability has fallen as a result of the economic downturn and the drying up of profits from the treasury bill market. The sector's contribution to financial intermediation remains limited. Most of the increase in bank credit during 1998 was to the state sector, as credit to the non-government sector remained at about 8.5% of GDP. The latter was generally available only at high interest rates and for short terms.

The new central bank law may compromise NBU independence.

In June, the President approved the new law on the NBU, delineating its functions. There are concerns that the NBU's independence may be affected by the establishment of a council to oversee decisions of the NBU board.

Social reform

Financial pressures on the pension system have accentuated poverty among pensioners.

Low average pensions (estimated at UAK 60 or US\$ 15 per month) and significant pension arrears have accentuated social deprivation among pensioners. Over the last year the government introduced a range of new taxes intended to boost revenues for the Pension Fund, but these are unlikely to close the funding gap and allow for more adequate transfers. In the medium term there will also be mounting demographic pressures, which will make reform essential. Draft laws, on the introduction of non-state pension funds and improving the state pension scheme, are under consideration, but will probably have to be reviewed in the context of longer-term solutions.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – full	Primary privatisation method – vouchers	Independent telecoms regulator – no	Share of the population in poverty – 41%
Interest rate liberalisation – full	Secondary privatisation method – MEBOs	Separation of railway accounts – no	Private pension funds – no
Wage regulation – no	Tradability of land – limited de facto	Independent electricity regulator – yes	
Stabilisation	Enterprises	Financial sector	
Shares in general government tax revenues in GDP – 20.7%	Competition office – yes	Capital adequacy ratio – 8%	
Exchange rate regime – managed float		Deposit insurance system ¹ – no	
		Secured transactions law – restricted	
		Securities commission – yes	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	15.0	11.0	11.0	6.0	2.0	2.0	2.0	2.0
Share of exports to non-transition countries (per cent)	na	na	na	na	38.2	30.5	29.6	34.8	na
Share of trade in GDP (per cent)	na	na	56.2	42.6	40.4	41.9	39.6	34.9	35.4
Tariff revenues (per cent of imports) ²	na	na	na	2.9	1.7	1.7	1.2	1.9	2.4
EBRD Index of price liberalisation	na	na	na	na	2.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	1.0	3.0	3.0	3.0	2.7
Privatisation									
Share of small firms privatised	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	0.0	0.1	0.3	0.4	0.7	0.8	1.3
Private sector share in GDP	10.0	10.0	10.0	15.0	40.0	45.0	50.0	55.0	55.0
EBRD index of small-scale privatisation	na	na	na	na	2.0	2.0	3.0	3.3	3.3
EBRD index of large-scale privatisation	na	na	na	na	1.0	2.0	2.0	2.3	2.3
Enterprises									
Budgetary subsidies (per cent of GDP) ³	na	na	na	na	na	7.5	5.9	6.9	5.4
Efficiency of tax collection for social security (per cent)	na	na	65.7	58.9	69.3	57.5	56.2	58.9	na
Share of industry and construction in total employment (per cent)	40.3	40.2	38.0	36.7	34.9	31.2	29.5	27.5	na
Change in labour productivity in industry (per cent)	3.7	-4.0	-1.8	-1.9	-21.4	-4.0	3.1	6.1	6.6
Investment rate (per cent of GDP)	23.0	20.0	27.1	24.3	23.5	23.3	20.7	18.3	na
EBRD index of enterprise reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	13.6	14.2	14.7	15.2	15.7	16.1	18.1	18.5	na
Railway labour productivity (1989=100)	93.7	81.0	65.3	53.3	46.9	46.1	40.7	42.4	42.2
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	1.04 (60%)	3.5 (65%)	3.7 (70%)	3.34 (80%)	na
Electricity consumption/GDP (1989=100)	103.5	105.1	113.2	122.1	140.8	153.9	161.0	168.8	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	2.0
Financial institutions									
Number of banks (of which foreign-owned)	na	na	133 (na)	211 (na)	228 (1)	230 (1)	229 (6)	227 (12)	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	na	na	na
Bad loans (per cent of total loans)	na	na	na	na	na	na	na	na	na
Credit to private sector (per cent of GDP)	na	na	3.2	1.4	4.6	1.5	1.4	2.5	7.6
Stock market capitalisation (per cent of GDP) ⁴	na	na	na	na	na	na	na	8.6	4.7
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	7.0	7.8	10.5	8.5	10.1	10.0	8.8	9.6	na
Life expectancy at birth, total (years)	70.1	68.9	68.9	67.9	67.9	67.1	67.4	67.4	na
Basic school enrolment ratio (per cent)	92.3	91.5	91.1	90.4	90.6	90.8	91.2	90.7	na
Earnings inequality (Gini coefficient)	na	na	25.1	36.4	na	na	41.3	na	na

¹ Although there is no general deposit insurance, depositors of the Savings Bank are covered by a formal deposit insurance scheme.

² Refers to taxes on international trade and transactions.

³ Refers to consumer and producer subsidies. The figure for 1998 is an estimate based on the first six months of the year.

⁴ Data from Stock Market Survey. IFC data show much lower capitalisation of 2% of GDP in 1998.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								Estimate	Projection
Output	(Percentage change in real terms)								
GDP	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	-1.7	-2.5
Industrial gross output	-4.8	-6.4	-8.0	-27.3	-12.0	-5.1	-1.8	-1.5	na
Agricultural gross output	-13.0	-8.3	1.5	-16.5	-3.7	-9.5	-1.9	-8.5	na
Employment	(Percentage change)								
Labour force (end-year)	na	na	-1.7	-0.3	1.0	-0.7	-0.5	-0.2	na
Employment in industry (end-year)	na	na	-4.2	-7.5	-8.3	-8.0	-7.4	-7.6	na
	(In per cent of labour force)								
Unemployment	0.0	0.3	0.3	0.3	0.5	1.3	2.3	3.7	na
Prices and wages	(Percentage change)								
Consumer prices (annual average)	91	1,210	4,735	891	377	80	16	11	25
Consumer prices (end-year)	161	2,730	10,155	401	181	40	10	20	17
Producer prices (annual average)	125	2,384	4,619	1,144	489	52	8	13	na
Producer prices (end-year)	163	3,828	9,668	600	177	17	5	35	na
Gross average monthly wages in industry (annual average)	na	na	2,475	710	365	92	13	8	na
Government sector ¹	(In per cent of GDP)								
General government balance	na	-25.4	-16.2	-9.1	-4.9	-3.2	-5.6	-2.7	-1.5
General government expenditure	na	58.4	54.5	45.8	36.3	31.3	34.6	29.5	na
Monetary sector	(Percentage change)								
Broad money (end-year)	na	na	758	540	116	35	34	25	na
Domestic credit (end-year)	na	na	981	480	191	43	17	47	na
	(In per cent of GDP)								
Broad money	na	na	33.7	26.7	12.5	11.3	13.4	15.1	na
Interest and exchange rates	(In per cent per annum, end-year)								
Refinancing rate	na	80	240	252	110	40	35	60	na
Treasury bill rate (3-month maturity) ²	na	na	na	na	164	51	44	40	na
Deposit rate ³	na	82	149	209	70	24	19	24	na
Lending rate ³	na	77	184	250	123	61	43	41	na
	(Hryvnia per US dollar)								
Exchange rate (end-year, official rate)	na	0.01	0.13	1.04	1.79	1.89	1.90	3.43	na
Exchange rate (annual average, official rate)	na	0.002	0.05	0.32	1.47	1.83	1.86	2.45	na
External sector	(In billions of US dollars)								
Current account	na	-0.6	-0.8	-1.4	-1.2	-1.1	-1.5	-1.2	-0.4
Trade balance	na	-0.6	-2.5	-2.6	-2.7	-4.3	-4.2	-2.6	-1.9
Exports	na	11.3	12.8	13.9	14.2	15.5	15.4	13.7	13.0
Imports	na	11.9	15.3	16.5	16.9	19.8	19.6	16.3	14.9
Foreign direct investment, net	na	0.2	0.2	0.1	0.3	0.5	0.6	0.7	0.6
Gross reserves (end-year), excluding gold	na	0.5	0.2	0.6	1.1	2.0	2.4	0.8	na
External debt stock	na	0.5	3.7	7.7	8.1	9.2	11.8	11.7	na
	(In months of imports of goods and services)								
Gross reserves (end-year), excluding gold	na	0.5	0.1	2.3	3.7	5.2	5.6	2.7	na
	(In per cent of exports of goods and services)								
Debt service	na	na	1.3	11.4	9.3	6.0	9.4	19.4	na
Memorandum items	(Denominations as indicated)								
Population (in millions, end-year)	51.9	52.1	52.2	51.7	51.5	51.1	50.5	50.1	na
GDP (in millions of hryvnia)	3.0	50.3	1,483	12,038	54,516	81,519	93,365	103,869	128,000
GDP per capita (in US dollars)	169	488	631	728	720	872	994	846	na
Share of industry in GDP (in per cent)	45.8	44.6	27.6	30.0	34.4	27.5	26.4	24.6	na
Share of agriculture in GDP (in per cent)	24.4	20.3	21.6	16.0	14.5	12.2	11.8	11.4	na
Current account/GDP (in per cent)	-33.1	-2.4	-2.4	-3.7	-3.2	-2.5	-3.0	-2.8	-1.3
External debt minus reserves (in US\$ billions)	na	0.0	3.5	7.1	7.0	7.2	9.4	10.9	na
External debt/GDP (in per cent)	na	2.0	11.2	20.5	21.8	20.7	23.5	27.6	na
External debt/exports (in per cent)	na	4.4	28.9	55.4	57.0	59.4	76.6	85.4	na

¹ General government includes the state, municipalities and extrabudgetary funds, excluding pension funds from 1994.

² Treasury bills were introduced in March 1995.

³ Weighted average over all maturities.

Key reform challenges

- **Trade and foreign exchange restrictions shelter uncompetitive industries. Their removal will be a precondition for putting Uzbekistan on a sustainable long-term growth path.**
- **Advances in the planned strategic sales of large industrial enterprises will depend on offering controlling stakes as well as lowering unrealistic price expectations.**
- **To reap the full benefits of the planned involvement of private investors in the modernisation of infrastructure, the principles of commercialisation will have to be accepted and the regulatory framework improved.**

Liberalisation

Uzbekistan maintains highly restrictive foreign trade practices.

Restrictive trade practices introduced in 1997 remain in place, including registration and prepayment requirements for imports and high average import tariffs. The state trading monopoly for the export of cotton and gold, which generated over 40% of the country's foreign exchange earnings in 1998, also remains in place. Following the Russian crisis, Uzbekistan imposed high import duties on selected items from Kyrgyzstan and Kazakhstan (the latter partly in retaliation against Kazakhstani measures), and introduced barriers to shuttle trade, such as a US\$ 300 duty for vehicles entering Uzbek territory from these two countries (except those in transit). Against this background, WTO accession remains a distant prospect. A significant step towards the integration of Uzbekistan into the world economy was achieved, however, when the Partnership and Cooperation Agreement with the EU came into effect in July 1999.

Growing external imbalances aggravate the distortionary effects of the dual exchange rate system, although its removal is planned for 2000.

A presidential decree of 1 July 1998 sets the target date for signing Article VIII of the IMF's Articles of Agreement not later than 2000. However, the timing of exchange rate unification – a precondition for current account convertibility – has not yet been decided. Under pressure from deteriorating external accounts and waning confidence in the Uzbek som, the premium on the parallel foreign exchange market increased to 300% by mid-1999. In a move targeted to protect reserves, foreign exchange surrender requirements on exports were increased to 50% from 30% in January 1999. Surrendered foreign exchange is converted at the overvalued official exchange rate.

Stabilisation

Import controls and foreign borrowing provide only temporary reprieve from external pressures.

The Russian crisis, a bad cotton harvest in 1998 and falling world commodity prices all

contributed to a substantial deterioration in external balances over the past 12 months. The government's response has been to further restrict imports, to tighten access to foreign exchange, and to resort to increased foreign borrowing to finance public investments. The decline in net reserves by around US\$ 300 million during April-August this year suggests the limitations of this strategy, as capital flight has increased. Public external debt now stands at more than 50% of GDP, if calculated at realistic exchange rates. In June 1999, the government cut profit tax to 30% (from 35%) for exporting enterprises in an attempt to boost exports. The same government directive also allowed delayed payment of VAT on imported goods used in the production of exports for up to 90 days. The dual exchange rate system remains the primary constraint on export growth, however.

Privatisation

The state remains the dominant owner in most industrial companies.

Privatisation in Uzbekistan has so far been limited mainly to small enterprises, most of which had been transferred to employee collectives by end-1996. The mass privatisation programme launched in 1996 has not given controlling stakes in industrial companies to private owners. Individuals invested vouchers in Privatisation Investment Funds (PIFs), which were then used to bid for minority stakes (most not exceeding 30%) in around 150 mostly medium-sized companies. In 1998, the government shifted to trade sales for medium-sized enterprises, but progress has been held back by conflicts over the allocation of privatisation revenues. A May 1999 decree settled this issue by allocating 40% of domestic currency revenues to the state budget, 15% to the Small Business and Entrepreneurship Development Fund, 5% to the State Property Committee (SPC) and the remaining 40% to re-investment in privatised companies.

International investment tenders attract little interest.

In 1998, Uzbekistan announced international investment tenders for some of its largest industrial assets. However, only one large chemical plant had been sold by September 1999, while the end-1998 deadline for bids

Liberalisation, stabilisation, privatisation

1991

Sep Independence from Soviet Union

1994

Jan New currency (som) introduced
May Foreign investment law adopted

1995

May Foreign investment law amended
Oct IMF programme adopted

1996

Jun Privatisation programme adopted
Oct IMF programme suspended

1997

Nov Customs duties and export licensing abolished but tariffs increased
Dec Customs code enacted

1998

Jan Tax code enacted
Feb Import tariffs further increased
Dec Tender for six large enterprises announced

1999

Jan Export surrender increased to 50%
Feb Introduction of trade barriers against Kazakhstani and Kyrgyzstani imports
Jun Tender for large copper plant cancelled
Jul Partnership and Cooperation Agreement with EU effective

for shares in a further six large enterprises was extended several times due to limited foreign investor interest. The main problem remains the government's reluctance to offer majority stakes to strategic investors, although unrealistic price expectations, a difficult investment environment and the slump in commodity prices have also played a role. In July 1999, the SPC cancelled the tender for 46.5% of the shares in the Almalyk Mining and Metals Plant (priced at US\$ 478 million), one of Central Asia's biggest copper producers and the "flagship" of Uzbekistan's privatisation programme. In response to this failure, the SPC announced that it would look for the assistance of international financial advisers in future international sales, although the state will maintain majority stakes in most enterprises on offer.

Enterprise reform

Soft budget constraints and state domination limit industrial restructuring.

Implicit export taxes on cotton and gold through the system of dual exchange rates, export surrender requirements and state trading have been used to subsidise both the industrial sector and imports of priority

Enterprises, infrastructure, finance and social reforms

1990

Jun Decree on joint-stock companies adopted

1991

Feb Company law adopted

1992

Dec Pledge law adopted

1994

Apr Stock exchange established

May Bankruptcy law adopted

Jul Decree on securities transactions

1995

Aug Telecommunications law adopted

1996

Mar First T-bills issued

Apr Banking law adopted

Apr Land law amended

Aug Bankruptcy law amended

Dec Competition law adopted

1997

Mar Bank accounting standards adopted

1998

Aug Law on depositories enacted

Oct Banking reforms launched by presidential decree on commercial banks

1999

Apr Largest commercial bank partially offered for sale

commodities such as wheat and sugar. The central bank has also continued to provide significant transfers to the economy through directed credits at subsidised interest rates. Tax arrears for selected enterprises in the energy and agricultural sectors were rescheduled in 1998, with repayments stretched over several years. An example of the state's interventionist approach to industrial restructuring is a legal provision granting the state veto rights over major restructuring decisions even in companies where it holds small minority stakes.

SME promotion is a government priority but the poor investment climate stifles private sector development.

The government has recently stressed its commitment to build a vibrant SME sector. Financing initiatives supporting the development of private sector SMEs are being prepared by the EBRD and ADB. Additionally, in January 1999 German KfW granted a US\$ 15.3 million credit line to the National Bank of Uzbekistan to support SMEs. Yet the most serious impediments to the emergence of a

new private sector remain in place in the form of limited access to foreign exchange, discretionary government intervention and an unreliable judicial system.

Reforms in the agricultural sector are under way.

There are plans to transform Soviet-style collectives into cooperatives (*shirkat*). The main innovation is that members will be able to register personal equity stakes and households will formally contract out their labour services. However, these reforms may not suffice to improve agricultural productivity, as long as state trading for cotton remains in place and access to imported inputs restricted. The aim to achieve self-sufficiency in food production has prompted large subsidised credits for grain production, diverting resources away from higher value-added fruit, vegetables and dairy. In 1998, 70% of grain consumed was grown domestically. The 1999 harvest of 3.9 million tonnes of grain represented a 2.5% increase over 1998 but fell short of the official target of 4.6 million tonnes.

Infrastructure

The restructuring and modernisation of telecommunications begins.

A programme for the restructuring and subsequent privatisation of the telecommunications sector was drafted in July 1999. First steps include the establishment of a single national operator through the merger of Khalkaro Telecom (the international operator) and Makhally Telecom (the local calls operator). The government has launched a modernisation programme financed by concessional donor funds and targeting the development of long-distance communications and integration into an international information system. In the cellular market, competition has been strengthened by the substantial expansion of Daewoo Central Paging (DCP), the second-largest of six cellular companies. DCP signed a US\$ 20 million contract with Ericsson for doubling its network in and outside Tashkent, as well as extending it to Samarkand and the cities of the densely populated Fergana valley.

Greater private sector involvement is envisaged in the energy and transport sectors.

While resisting private sector involvement in the operation of public utilities, the government is increasingly moving towards the use of competitive tenders for private sector construction and modernisation projects in energy and transport. Uzbekistan's Power Ministry plans to announce a tender for the reconstruction of two thermal power stations by the end of 1999. BCI Industry Incorporated has been awarded a contract through an international tender for supplies of equipment for a new gas storage plant in the Fergana valley. The state oil and gas company Uzbekneftegas is offering foreign investors

projects to begin commercial production at three gas condensate fields. In the transport sector, a locomotive fleet modernisation programme is expected to begin in the first quarter of 2000 through an international competitive tender.

Financial institutions

Financial reforms are launched under World Bank guidance.

In June 1999 the World Bank approved US\$ 25 million for financial sector reforms in Uzbekistan. The project, to be carried out jointly with the EBRD, aims to strengthen corporate governance in commercial banks, increase the openness of the sector to foreign entry and strengthen the supervisory functions of the central bank. A commission on banking sector reforms has been established and a timetable set for the gradual elimination of bank cross-shareholdings, increases in minimum capital requirements, reductions in limits on shareholdings by state enterprises in state-owned banks, and the abolition of restrictions limiting the number of bank accounts for each legal entity to one. Following an October 1998 presidential decree to reduce state ownership to 50%, a 40% stake in the National Bank of Uzbekistan (by far the largest commercial bank) has been offered for sale. Another bank scheduled for privatisation this year or next is Asaka Bank.

Social reform

Uzbekistan maintains relatively high levels of social protection.

Unlike neighbouring countries, Uzbekistan has maintained a high level of social transfers from the budget. Social spending constitutes 37% of the 1999 budget and benefits are relatively generous at between 1.5 and 3 times the minimum wage. Allocations have increased, particularly to the education sector. Average public sector wages, allowances and pensions were increased by 60% since the beginning of 1999, after a 50% increase in June 1998. Uzbekistan has experimented with innovative ways of targeting social assistance and child allowance. Benefits have been allocated through the so-called Mahalla system that combines means testing and discretionary decisions by a local council of elders, based on a direct assessment of the applicant.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – limited	Primary privatisation method – MEBOs	Independent telecoms regulator – no	Share of the population in poverty – 29%
Interest rate liberalisation – limited de jure	Secondary privatisation method – direct sales	Separation of railway accounts – no	Private pension funds – no
Wage regulation – yes	Tradability of land – limited de jure	Independent electricity regulator – no	
Stabilisation	Enterprises	Financial sector	
Share of general government tax revenues in GDP – 28.1%	Competition office – no	Capital adequacy ratio – 8%	
Exchange rate regime 1 – managed float		Deposit insurance system – no	
		Secured transactions law – restricted	
		Securities commission – no	

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Liberalisation									
Share of administered prices in CPI (per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of exports to non-transition countries (per cent)	na	na	na	na	41.6	36.5	41.3	30.4	na
Share of trade in GDP (per cent)	na	na	na	na	49.8	33.5	28.5	26.0	20.1
Tariff revenues (per cent of imports) ²	na	na	1.3	2.4	2.5	2.9	1.8	2.2	na
EBRD Index of price liberalisation	na	na	na	na	3.0	3.0	3.0	2.7	2.0
EBRD Index of forex and trade liberalisation	na	na	na	na	2.0	2.0	2.0	1.7	1.7
Privatisation									
Share of small firms privatised ³	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, per cent of GDP)	na	na	na	na	0.7	1.6	2.4	2.9	na
Private sector share in GDP	10.0	10.0	10.0	15.0	20.0	30.0	40.0	45.0	45.0
EBRD index of small-scale privatisation	na	na	na	na	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	na	na	na	na	2.0	3.0	3.0	2.7	2.7
Enterprises									
Budgetary subsidies (per cent of GDP)	na	na	10.7	7.0	1.9	3.4	4.0	3.2	na
Efficiency of tax collection for social security (per cent)	na	na	na	5.4	na	33.5	35.9	na	na
Share of industry and construction in total employment (per cent)	24.1	22.7	21.6	21.5	18.9	19.3	19.2	19.1	19.2
Change in labour productivity in industry (per cent)	0.4	0.5	-1.7	2.3	10.5	-1.6	4.1	6.3	5.3
Investment rate (per cent of GDP)	30.6	12.0	na	na	na	na	36.8	34.6	na
EBRD index of enterprise reform	na	na	na	na	1.0	2.0	2.0	2.0	2.0
EBRD index of competition policy	na	na	na	na	na	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	6.9	7.0	6.7	6.6	6.9	7.6	6.7	6.4	na
Railway labour productivity (1989=100)	na	na	na	na	na	na	na	na	na
Electricity tariffs, Ucc/kWh (collection rate in per cent)	na	na	na	na	na	na	na	na	na
Electricity consumption/GDP (1989=100)	100.3	100.5	93.4	87.4	98.7	92.2	98.8	94.2	na
Average of EBRD infrastructure reform ratings	na	na	na	na	na	na	na	na	1.7
Financial institutions									
Number of banks (of which foreign-owned)	21 (na)	30 (na)	21 (na)	29 (1)	31 (1)	29 (1)	30 (3)	30 (3)	na
Asset share of state-owned banks (in per cent)	na	na	21.7	15.9	46.7	38.4	75.5	70.6	na
Bad loans (per cent of total loans)	na	na	na	na	na	na	na	na	na
Credit to private sector (per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (per cent of GDP)	na	na	na	na	0.0	0.4	0.5	0.2	na
EBRD index of banking sector reform	na	na	na	na	1.0	2.0	2.0	1.7	1.7
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.3	2.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
Social sector									
Expenditures on health and education (per cent of GDP)	na	na	na	na	na	na	na	na	na
Life expectancy at birth, total (years)	69.2	na	na	na	na	na	na	69.2	na
Basic school enrolment ratio (per cent)	91.1	87.9	87.5	87.9	88.6	na	89.0	89.7	na
Earnings inequality (Gini coefficient)	na	na	na	na	na	na	na	na	na

¹ The exchange rate is determined by a managed float, but there are multiple exchange rates and the two officially set rates are not determined by market forces.

² Refers to custom duties and export taxes.

³ Between 1994 and 1997, Uzbekistan privatised a total of 18,264 firms, mostly small and medium-sized. These include firms with only a minority private stake. Their share in the total number of firms is not known.

	1991	1992	1993	1994	1995	1996	1997	1998	1999
								<i>Estimate</i>	<i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>								
GDP	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.4	3.3	3.0
Industrial value added	-3.8	-23.9	1.5	-3.4	2	-7	2.2	na	na
Agricultural value added	-0.4	-9.7	-4.2	-6.6	-5.6	1.7	4.9	na	na
Employment	<i>(Percentage change)</i>								
Labour force (end-year) ¹	na	na	na	na	1.2	1.3	1.4	na	na
Employment (end-year)	4	0.2	-0.1	-1.3	3.7	1.3	1.4	na	na
	<i>(In per cent of labour force)</i>								
Unemployment ²	0.0	0.1	0.3	0.4	0.4	0.4	0.4	0.6	na
Prices and wages	<i>(Percentage change)</i>								
Consumer prices (annual average)	82	645	534	1,568	305	54	72	29	35
Consumer prices (end-year)	169	910	885	1,281	117	64	50	26	42
Producer prices (annual average)	147	3,275	2,545	1,428	499	107	52	42	na
Producer prices (end-year)	311	1,300	1,919	1,422	215	72	40	48	na
Gross average monthly wages (annual average)	51	612	1,148	963	252	102	68	49	na
Government sector ³	<i>(In per cent of GDP)</i>								
Consolidated central government balance	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	-2.3	-3.8	-3.8
Consolidated central government expenditure	52.7	43.4	46.4	35.3	38.7	41.6	32.3	35.5	na
Monetary sector	<i>(Percentage change)</i>								
Broad money (end-year)	na	468	784	680	144	113	36	28	na
Domestic credit (end-year)	na	na	na	na	55.2	268.5	70.0	na	na
	<i>(In per cent of GDP)</i>								
Broad money	na	69.4	53.5	32.8	18.1	19.6	16.4	16.0	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>								
Treasury bill rate (3-month maturity)	na	na	na	na	na	36	26	na	na
Deposit rate (1 year)	7	10	30	60	90	40	39	na	na
Lending rate (1 year)	na	na	na	100	105	60	59	na	na
	<i>(Som per US dollar)</i>								
Exchange rate (end-year) ⁴	2.0	415	1.3	25.0	36.0	55.0	80.2	110.0	na
Exchange rate (annual average) ⁴	0.6	222.0	1.0	11.4	30.2	41.1	67.1	103.5	na
External sector	<i>(In millions of US dollars)</i>								
Current account	na	-236	-429	119	-21	-980	-584	-152	-243
Trade balance	na	-235	-378	213	237	-706	-72	72	-7
Exports	na	1,424	2,877	2,940	3,475	3,534	3,695	2,888	2,537
Imports	na	1,659	3,255	2,727	3,238	4,240	3,767	2,816	2,544
Foreign direct investment, net	na	9	48	73	-24	90	167	226	226
Gross reserves (end-year), including gold ⁵	na	79	1,022	1,330	1,867	1,901	1,167	1,168	na
External debt stock ⁶	0	65	948	1,101	1,782	2,331	2,568	3,223	na
	<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), including gold ⁷	na	0.6	3.8	5.9	6.9	5.4	3.7	5.0	na
	<i>(In per cent of exports of goods and services)</i>								
Debt service	na	0.4	0.7	10.5	18.4	9.5	9.8	13.9	na
Memorandum items	<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	20.9	21.3	21.9	22.3	22.7	23.1	23.6	24.0	na
GDP (in millions of som)	62	447	5,095	64,878	302,787	559,100	976,830	13,58,800	1,791,440
GDP per capita (in US dollars)	na	na	233	255	442	590	609	591	na
Share of industry in GDP (in per cent)	26.3	26.6	25.0	19.0	20.0	20.0	19.0	na	na
Share of agriculture in GDP (in per cent)	37.3	35.4	31.0	38.0	32.0	26.0	29.0	na	na
Current account/GDP (in per cent) ⁸	na	-11.9	-8.4	2.1	-0.2	-8.6	-6.0	-1.7	-3.4
External debt minus reserves (in US\$ millions)	na	-14	-74	-229	-85	430	1,401	2,055	na
External debt/GDP (in per cent) ⁸	0.0	3.3	18.6	19.3	17.8	20.4	26.4	36.4	na
External debt/exports (in per cent)	0.0	4.6	33.0	37.4	51.3	66.0	69.5	111.6	na

¹ Data are from Uzbek Economic Trends.

² Officially registered unemployment. No labour force survey-based estimates available.

³ Includes extrabudgetary funds but excludes local government.

⁴ Roubles per US dollar until 1992; official rate of som per US dollar thereafter. The black market rate in 1998 was on average 200% higher.

⁵ Reserves in millions of som were converted to millions of US dollars using the average exchange rate reported above.

⁶ Includes only public and publicly guaranteed debt. Non-guaranteed private debt was approximately US\$ 400 million at end-1998.

⁷ As a share of merchandise imports only.

⁸ Since 1996, calculated using a weighted official and curb market exchange rate to obtain GDP in US dollars.

Methodological notes

Definitions and options for country snapshots

Liberalisation

Current account convertibility

Options: *full* (full compliance with Article VIII of IMF Agreement), *limited* (restrictions on payments or transfers for current account transactions).

Interest rate liberalisation

Options: *full* (banks are free to set deposit and lending rates), *limited de facto* (no legal restrictions on banks to set deposit and lending rates, but limitations arise from substantial market distortions, such as directed credits or poorly functioning or high illiquid money or credit markets), *limited de jure* (restrictions on the setting of interest rates by banks through law, decree or central bank regulation).

Wage regulation

Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward; options: *yes*, *no*.

Stabilisation

Share of general government tax revenue in GDP

General government includes central government, extra budgetary funds and local government.

Exchange rate regime

Options: *currency board*, *fixed*, *fixed with band*, *crawling peg*, *crawling peg with band*, *managed float*, *floating*.

Privatisation

Primary privatisation method

Options: *vouchers* (distribution of investment coupons at a symbolic price), *direct sales* (sales to outsiders), *MEBOs* (management/employee buy-outs), *liquidations*.

Secondary privatisation method

Options and definitions as above.

Tradability of land rights

Options: *full* (no substantial restrictions on the tradability of land rights beyond administrative requirements; no discrimination between domestic and foreign subjects), *full except foreigners* (as “full”, but with some differential treatment of foreigners), *limited de facto* (substantial de facto limitations on the tradability of land, for example due to the lack of enforceability

of land rights, a non-existent land market, or significant obstruction by government officials), *limited de jure* (legal restrictions on the tradability of land rights), *no* (land trade prohibited).

Enterprise reform

Competition office

Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent; options: *yes*, *no*.

Infrastructure

Independent telecommunications regulator

Independent body, but the scope of power may differ across countries; options: *yes*, *no*.

Separation of railway accounts

Accounts for freight and passenger operations are separated; options: *yes*, *no*.

Independent electricity regulator

Independent body, but the scope of power may differ across countries; options: *yes*, *no*.

Financial institutions

Capital adequacy ratio

Ratio of bank regulatory capital to risk-weighted assets; regulatory capital includes paid-in capital, retentions and some form of subordinated debt.

Deposit insurance

Deposits in all banks are covered by a formal deposit insurance scheme; options: *yes*, *no*.

Secured transactions law

Non-possessory security over movables permitted; options: *yes*, *restricted*.

Securities commission

Securities and exchange commission exists separately from any ministry, though it may not be fully independent; options: *yes*, *no*.

Social reform

Share of the population in poverty

Percentage of population living on less than US\$ 4 (in 1990 US\$ at PPP) a day per person. Most data are for 1997 from UNDP.

Private pension funds

Options: *yes*, *no*.

Liberalisation

Share of administered prices in CPI (%)

Administered prices are defined as those prices subject to regulation by the state.

Sources: EBRD survey to national authorities and IMF country reports.

Number of goods with administered prices in EBRD-15 basket

The EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, inter-city bus service.

Source: EBRD survey to national authorities.

Share of exports to non-transition economies (%)

Exports of merchandise only.

Source: IMF Directions of Trade Statistics. Data for CIS countries suffer from under-reporting of intra-CIS trade for the early 1990s and are reported for 1994 onwards only.

Share of trade in GDP (%)

Average of exports and imports as a share of GDP.

Source: EBRD staff calculations based on macroeconomic indicators (see country pages).

Tariff revenues (% of imports)

Tariff revenues include all revenues from international trade. Imports are imports of merchandise only.

Source: EBRD staff calculations based on IMF country reports and national authorities.

Privatisation

Share of small firms privatised

Ratio between the cumulative number of small firms privatised by year-end and the total number of small firms initially identified for privatisation.

Sources: EBRD survey to national authorities and EBRD staff assessments.

Privatisation revenues (cumulative, % of GDP)

Government revenues from cash sales of enterprises, not including investment commitments.

Sources: National authorities and IMF country reports.

Definitions and data sources for structural indicators

Privatisation (continued)

Private sector share in GDP

The “private sector shares” of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies, as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Sources: EBRD staff estimates. For data prior to 1994, the source is IMF staff estimates.

Enterprise reform

Budgetary subsidies (% of GDP)

Budgetary transfers to enterprises and households, excluding social transfers and, in most countries, soft loans from the banking system.

Sources: National authorities and IMF country reports.

Efficiency of tax collection for social security (%)

Ratio of effective collection of social security taxes over total labour income in the economy, divided by the statutory social security tax rate. A collection of 6% of total payroll for a statutory rate of 10% would give an efficiency of tax collection of 0.6. The EU average is 0.65.

Sources: *OECD Revenue Statistics*, *IMF Government Finance Statistics*, *UN National Account Statistics*, *World Bank Atlas*, *CIS Statistical Yearbook*, national statistical publications and IMF country reports.

Share of industry and construction in total employment (%)

Industry includes electricity, water, power, mining and manufacturing.

Sources: *ILO Labour Statistics Yearbook*, *UN National Account Statistics*, national statistical publications and IMF country reports.

Change in labour productivity in industry (%)

Labour productivity is calculated as the ratio of industrial production and industrial employment; changes refer to annual averages.

Sources: National statistical publications and IMF country reports.

Infrastructure

Main telephone lines per 100 inhabitants

Fixed lines only, excluding mobile telephones.

Sources: *World Telecommunications Development Report*, International Telecommunications Union.

Railway labour productivity (1989=100)

Productivity measured as the ratio of the number of traffic units (passenger-kms plus freight tonne-kms) and the total number of railway employees.

Sources: National authorities, World Bank.

Electricity tariff, US cents per kWh (collection ratio in %)

The average retail tariff; the collection ratio is defined as the ratio of total electricity payments received (in cash and non-cash) and total electricity charges.

Sources: *Power in Eastern Europe*, Financial Times annual publication; national authorities; World Bank.

Electricity consumption over GDP (1989=100)

Electricity consumption is defined as production, minus net exports, minus transmission losses.

Source: International Energy Agency.

Financial institutions

Number of banks (of which foreign-owned)

Number of commercial and savings banks, excluding savings cooperatives; foreign-owned banks are defined as banks with foreign ownership exceeding 50%, end-of-year.

Source: EBRD survey to central banks.

Asset share of state-owned banks

Share of total assets of majority state-owned banks in total bank sector assets; the state is defined to include the federal, regional and municipal levels, as well as the state property fund and the state pension fund; state-owned banks are defined as banks with state ownership exceeding 50%, end-of-year.

Source: EBRD survey to central banks.

Bad loans (% of total loans)

Non-performing loans, excluding loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey to central banks.

Credit to private sector (% of GDP)

Stock of bank credit to private sector including households and enterprises, end-of-year, as a percentage of GDP.

Source: IMF International Financial Statistics.

Stock market capitalisation (% of GDP)

Market value of all shares listed on the stock market as a percentage of GDP, end-of-year.

Source: EBRD survey to national stock markets. In some cases, the data differ notably from capitalisation as reported by the IFC *Handbook of Emerging Markets*. The difference in most cases is due to the exclusion in the IFC data of companies listed on the third tier.

Fiscal and social reform

Expenditures on health and education (% of GDP)

Expenditures of general government, excluding those by state-owned enterprises.

Sources: EBRD survey to ministries of finance, IMF country reports, *World Development Indicators* (World Bank).

Life expectancy at birth, total (years)

Life expectancy is defined as the average age reached by an individual after the first day of life, excluding deaths at birth.

Source: *World Development Indicators* (World Bank).

Basic school enrolment ratio (%)

Gross rates, % of relevant population between 7 and 15 years old. Basic school includes 8 years of schooling from the age of 7/8 to 14/15.

Sources: UNICEF, International Child Development Centre, TransMONEE Database.

Earnings inequality (Gini coefficient)

The Gini coefficient measures the distribution of employees' earnings. A higher coefficient implies a higher degree of earnings inequality. The Gini coefficient is derived from the cumulative distribution of earnings across the workforce ranked in order of ascendance. It is defined as one half of the mean difference between any two observations in the earnings distribution divided by average earnings. Its possible values range between 0 and 1. The Gini coefficients presented in the table are calculated using monthly earnings data as reported by employers. Small employers are often excluded, and some data refer to the public sector only.

Sources: UNICEF, International Child Development Centre, TransMONEE Database.

EBRD indices

Indices range from 1 to 4; 0.3 decimal points are added or subtracted for + and – ratings that were introduced in 1997. There is therefore a statistical break in end of these indices between 1996 and 1997. For definitions of ratings, see Table 2.1, Annex 2.2 (for legal transition indicators) and Annex 2.3 (for infrastructure indicators). The infrastructure rating is an unweighted average of four sector-specific reform ratings for power, railways, telecommunications and water.

Source: EBRD staff assessments.

Methodological notes

Definitions and sources for selected macroeconomic indicators

Data for 1991-98 represent official estimates of out-turns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon, the Institute of International Finance and Tacis Economic Trends. Data for 1999-2000 reflect EBRD evaluations, partly based on information from these sources. Because of frequent revisions to official data sources, there may be changes to all series published in the *Transition Report* and *Transition Report Update* from year to year.

Country-specific notes can be found under each country table.

Output

Official estimates of GDP, industrial and agricultural production. Growth rates can lack precision in the context of transition due to large shifts in relative prices, the failure to account for quality improvements, and the substantial size and change in the informal sector. In some countries, national authorities have started to incorporate the informal sector into their estimates of GDP.

Employment

For most countries, data reflect official employment records from the labour registries. In many countries, small enterprises are not recorded by official data. A number of countries have moved towards ILO-consistent labour force surveys in recording changes in labour force, employment and unemployment. Where available these data are presented.

Prices and wages

Data from the statistical offices or IMF. In some countries, notably Belarus, Turkmenistan and Uzbekistan, official CPI data may underestimate underlying inflation because of price controls and inadequate measurement of price increases on informal markets. Wage data are from national authorities and often exclude small enterprises as well as the informal sector.

Government sector

Data for the general government, including local government and extrabudgetary funds, where available. Data for most countries are from IMF country reports. Budget balance data can differ from official estimates due to different budgetary accounting, in particular with respect to privatisation revenues and foreign lending.

Monetary sector

Broad money comprises base money (central bank reserve money and currency in circulation) and quasi-money (sight and demand deposits of the banking system). In some countries, where foreign exchange deposits are a large proportion of demand deposits, broad money also includes deposits in foreign currency. Data from IMF country reports, International Financial Statistics, and monetary authorities.

Interest and exchange rate

Deposit and lending rates from most countries are weighted averages across maturities. For some countries, weighted averages are not available and rates are quoted for the most frequently used instruments. Data from monetary authorities and IMF country reports. Belarus, Turkmenistan and Uzbekistan operate dual exchange rate systems or have substantial parallel markets with high premiums on the official exchange rate. For these countries, the official exchange rate is quoted and the premium on the parallel market rate is given in a footnote.

External sector

Data are from the balance of payments as published by the monetary authorities and in IMF country reports. Trade data in many countries can differ between balance of payments and customs statistics, because of differences in recording and of shuttle trade, which is typically not recorded by customs statistics. See country notes for details. External debt are estimates based on IMF staff evaluations, BIS reports and national authorities. Concepts for recording external debt differ from country to country, and debt to GDP or exports ratios are not strictly comparable.

Transition report 1999

The *Transition Report* is a unique source of information on developments in central and eastern Europe, the Baltic states and the Commonwealth of Independent States. Drawing on the EBRD's experience as an investor in 26 countries in the region, the *Report* offers comprehensive analysis of each country's progress in the transition towards a market economy.

Country-by-country assessments and statistical tables provide invaluable information on progress in the key areas of market liberalisation and competition, macroeconomic stabilisation, enterprise restructuring and privatisation, reform of finance and infrastructure and legal reform. Offering extensive coverage of structural reforms, institutional and behavioural change and economic performance, this annual publication makes essential reading for investors, policy-makers and researchers.

This special issue of the *Transition Report* takes stock of the first ten years of transition. In particular, it examines the forces that move transition forward and the constraints that have held back progress. Much of the analysis draws on a major new survey of over 3,000 enterprises in 20 transition economies, which was especially commissioned for this *Report*.

Part I of the *Report* focuses on conditions at the start of transition, progress in reform, economic performance and the links between these factors. Part II looks at how the state's role in the economy has been transformed by transition and at the political factors influencing the reform process. Part III examines how enterprises have responded to reforms and identifies the economic forces that encourage innovation and expansion of the private sector.

